Brazilian Accounting Standards Board

IASB EMERGING ECONOMIES GROUP **December 5th 2012**

Issue for discussion: Impairment of Financial Assets

Paper Topic: Do EEG members support a move towards an expected loss model?

This paper has been prepared for the benefit of those participating in the IASB Emerging Economies Group. Its purpose is to discuss the issues arising from the latest thinking on the expected loss model for impairment of financial assets presented to the Board at the November 2012 IASB meeting. More specifically the paper aims to address those issues affecting emerging economies.

Introduction

1. The objective of this paper is to provide participants with an overview of the latest thinking of the IASB ́s staff on the impairment project. Appendix A to this document contains the series of papers on impairment presented at the November 2012 IASB meeting. These have been prepared following the outreach the Board has performed with its stakeholders to get a better understanding of the operational aspects of the “three bucket” model outlined in the limited release of the Impairment staff draft in September 2012.

2. In this session we aim to generate the discussion of the topic between participants with the view of providing constructive feedback to the IASB as the Board approaches a critical stage of the deliberation process of the future exposure (ED) draft on impairment.

3. The paper is solely focused on the issues we identified both with the staff draft and the papers to be presented at the November Board meeting (see reference at last page of this Agenda Paper) . This paper is structured as follows:

a. An overview of the main issues with the decisions made to date;
b. An overview of the issues that we consider more prevalent in emerging markets; and
c. An overview of the issues with the latest thinking of the IASB staff.
d. Some considerations about the FASB model.

Issues with the decisions made to date

4. In the following two sub-sections we aim to provide an outline of the main issues we consider relevant for discussion as result of the decisions made to date. These were identified on our analysis of the staff draft recently provided by the Board.

General issues

5. The impairment project deals with one of the most complex issues in financial reporting and will require significant investment and operational effort to be implemented appropriately. Therefore, it is recommended that the Board should give careful consideration to the lead time needed to implement these proposals. In addition it must be considered that impairment is a fundamental part of IFRS 9 therefore it is recommended that before making the standard enforceable the Board should give careful consideration to whether this standard should be implemented without the existence of a robust and fully tested impairment model.
6. The staff draft provided the structure of the new model that will be subject to a new exposure draft in due course. The document still requires further work to better reflect the objectives of the model, its underlying principles and related application guidance which in our view should be expanded to ensure that the Board ́s original intentions are well understood and diversity in practice is reduced.

Specific issues

7. The three-stage model seems to have created an intermediate category for loans where there has been deterioration in the credit quality that is more than insignificant and it is at least reasonably possible that the contractual cash flows of the financial asset will not be collected. To operationalize these two concepts further application guidance needs to be provided in order to achieve comparability and consistency in the application of these criteria.

8. The existence of an intermediate category will require entities to track deterioration and more specifically the events that led to the classification within each stage of the model. This seems different from current practice which is generally consistent with the definitions in BASLE II. Hence, new policies and procedures need to be developed in order to make the model operational.
9. The requirement to calculate "life" probabilities of default (PD) will require significant effort as this is something entities may have not modeled in the past. In addition to the modeling effort, entities will have to perform a significant exercise to be able to gather the raw data, test the relevance and structure of the data sets and test the relevance of the results. Finally application of life PD to some retail portfolios is questionable due to the long average life of the transactions.
10. The symmetry of the model requires significant tracking mechanisms as loans can move in both directions within the three stages of credit deterioration. This will increase the pressure on several processes such as: risk categorization, model review, calibration and update, outliers' analysis and classification of the significance of the event etc. These are complex and costly processes that need to be subject to careful review before the model is implemented.
11. The outcomes produced by the symmetry of the model might be inconsistent with regulatory guidance or risk management practice. This means that entities may choose or be required to keep loans within a category that is inconsistent with the outcome the model. Consideration of a further link to the BASLE II concepts or providing application guidance in the form of indicators to assess when loans should move between stages would make the model more aligned with current practice, easier to implement and increase comparability.

12. The impact of the valuation of collateral on the calculation of the loss given default (LGD) is a critical issue particularly for large retail portfolios. Additional clarity around this topic would be welcomed.
13. The Board should clarify how different is the exposure at default (EAD) in the impairment model from the one in Basle II as this can may have an impact on the allowance balance that is difficult to explain.
14. Disclosures for the proposed model are onerous and will require significant effort to be produced. We therefore welcome the recent disclosure task force designed to streamline the disclosure requirements and we encourage the Board to increase its outreach with preparers and users to better understand which set of disclosures provides the best information at a reasonable cost.

Issues specific to emerging markets

15. In this section we aim to outline some of the issues that are more prevalent in emerging markets. Although not entirely specific to these markets they are likely to have a greater impact on entities exposed to those.
16. The proposed model has heavy reliance on internal credit risk management practice. Entities applying the impairment model are at different stages of development and have different levels of sophistication therefore consistent application may be difficult to achieve. For example not all financial institutions in emerging markets have models compliant with BASLE II (i.e. PD/LGD models) and rather choose to track credit deterioration using days past due. Whether the allowance balance created using days past due/loss rates is enough to comply with requirements of the model is questionable and should be subject to further assessment by the Board. This is a common theme for non-financial institutions where this is the prevalent way of tracking credit deterioration for trade receivables.
17. The level of restructuring is traditionally higher in emerging markets than it is in a mature market. The link between the concepts underlying restructuring and the symmetry of the model should be carefully considered by the Board.

Issues with the current thinking of the IASB staff

18. In this section we aim to provide an overview of the **main** issues we encountered with the latest thinking of the IASB ́s staff on the expected loss model. We consider that the issues below supplement the ones identified in the sections above. We commend the IASB staff for trying to provide more clarity on the model however; there are some points that in our view require further consideration. These are outlined in the paragraphs below:
19. While trying to explain the thought process of the IASB ́s staff, the papers have inadvertently become unduly complex. This will generate additional challenges as entities will have difficulties understanding the Board ́s original intentions.
20. The papers aim to clarify when lifetime expected losses are required and how the transfer criteria would work. However, we think that the proposed guidance still need further analysis of its operational consequences such as:
    a. The papers use ratings agency language which is difficult to incorporate in any accounting standard.
    b. Implementation of the methodology described in the papers will need to be carefully considered for retail porfolios as the staff papers seem to be focused on individual assets rather than portfolios of assets. Practical expedients would be welcomed to make the model more operational.
    c. The existence of a credit quality criterion based on “investment grade” may have unintended consequences in emerging economies which traditionally originate sub-investment grade. This is because the existence of this criteria and the fact that if loans are originated below the investment grade threshold requires a tighter monitoring of credit deterioration will potentially cause recognition of lifetime expected losses for more assets than intended and will inadvertently penalize jurisdictions where entities are less sophisticated with significant more need for tracking.
21. The staff papers lack the analysis of the practical expedients. For example, the use of delinquency is presented as one alternative to track credit risk. However,

this practical expedient has not been reconciled with the main principles of the three bucket model hence; it is unclear what kind of information needs to be collected to demonstrate that this practical expedient is compliant with the expected loss model.

The FASB Model

22. The FASB recently proposed an alternative model to deal with specific concerns raised by US constituents.
23. This model is currently "work in progress" and several questions have been raised in relation to its operationality and also on the appropriateness of the outcomes produced by the model. The FASB recently clarified that their model is intended to be applied to portfolios of assets.
24. While full convergence is desirable we understand the differences in views that the two Boards currently have. However and despite this, we think that the IASB should try to converge with the FASB on the fundamental aspects of the impairment model as alignment will help IFRS entities from emerging economies required to file its financial statements with the US SEC.

Question to participants

25. Do participants have any views or comments on the topics discussed in the staff papers and/or in the staff draft?
26. Do participants have any concern that the requirement judgments underlying the implementation of an expected loss model could give room to undesired earnings management?
27. If the answer to 26. is YES, what would be participants suggestion to mitigate the risk on undesired earnings management?

Staff papers presented at the IASB´s November 2012 Board Meeting

As of November 19, 2012, the following Papers prepared by the IASB Staff were available to be discussed by the Board at its meeting this week. For further understanding of the underlying arguments supporting this discussion, such papers may be consulted. They are:

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