

# STAFF PAPER

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Project	Financial Instruments: Impairment		
Paper topic	Direction of movement between buckets		
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## Purpose of the paper

1. See the Cover Paper, IASB Agenda Paper 4/FASB Memorandum 135, for a brief background on the topic.
2. The purpose of this paper is to discuss whether, and if so under what circumstances, financial assets should move up to Bucket 1. The movement into and out of Bucket 1 is important because it changes the measurement of expected credit losses from a lifetime expectation outside Bucket 1 to a 12-month expectation within Bucket 1.
3. This paper excludes from the discussion trade receivables that would be categorised into Bucket 2 or Bucket 3 on initial recognition (see IASB Agenda Papers 4B and 4C and FASB Memorandum 137).
4. This paper seeks the boards' decisions on the following two issues:
  - (a) **Issue 1:** Whether purchased credit-impaired assets<sup>1</sup> should ever move up into Bucket 1; and

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<sup>1</sup> The term 'purchased credit-impaired assets' is used as shorthand throughout this paper for 'assets purchased with an explicit expectation of credit losses'. For the IASB, the scope of these assets will be similar to what is used in existing IFRSs (ie assets purchased at a deep discount that reflects incurred credit

- (b) **Issue 2:** whether originated and purchased non-credit-impaired assets should ever move up into Bucket 1 after previously deteriorating to the point of being transferred into Bucket 2 or 3.

## Background and scope

5. The staff have been developing the model with the thought that assets that started in Bucket 1 but subsequently deteriorated into Bucket 2 or 3 would move back into Bucket 1 if credit quality improved<sup>2</sup>.
6. During the December 2011 meeting, the boards expressed a desire to discuss whether and how assets could move back into Bucket 1.
7. Consequently, this paper addresses this issue. In other words, this paper discusses whether an improvement in credit quality for which favourable changes in expectations regarding the likelihood of the collectibility of cash flows after initial recognition should ever result in a change to the measurement objective (ie from lifetime expected credit losses to a 12-month expected credit loss).
8. The boards have already discussed how to account for favourable changes in expectations in cash flows in the financial statements within the context of purchased credit-impaired assets at the January 2012 joint board meeting<sup>3</sup>. The boards tentatively decided that favourable changes in cash flows expected to be collected would be recognised immediately in profit or loss as an adjustment to the impairment loss line item. As described in paragraphs 57 and 58 of the

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losses). The FASB requested the FASB staff to also explore an approach whereby the scope of purchased financial assets would include assets that, since origination, have experienced a more than insignificant deterioration in credit quality and for which the likelihood of default is such that it is at least reasonably possible that all or some of the contractual cash flows may not be collected.

<sup>2</sup> See July 2011 IASB Agenda Paper 7A/FASB Memorandum 100: paragraph 16 (in the context of the Credit Quality Approach) referred to the ability of assets to migrate upwards and downwards between buckets. The Credit Quality Approach was the approach that would categorise assets into the buckets according to their credit quality (ie highest quality assets in Bucket 1 and lowest quality assets in Bucket 3). Also see September 2011 IASB Agenda Paper 4B/FASB Memorandum 110, which discussed the movement in the context of the Bucket 1 Approach—ie initially categorising all assets into Bucket 1. Paragraph 18b of that paper states an ‘improvement would in principle cause the asset to transfer back into Bucket 1 and return to a 12...month expected [credit] loss amount for the allowance balance.’

<sup>3</sup> See Issue 3 of IASB Agenda Paper 8/FASB Memorandum 126 of the January 2012 joint board meeting.

January 2012 board paper, the treatment decided upon by the boards is based on the idea of symmetry. That is, favourable changes in cash flow expectations represent an economic gain and should be recognised consistently with unfavourable changes in cash flow expectations, which represent an economic loss (ie immediately through profit or loss).

9. The staff believe that the same rationale applies to originated and purchased non-credit-impaired assets. As a result, for all financial assets within the scope of the impairment model, favourable and unfavourable changes in cash flow expectations should be treated in the same way (ie immediately recognised in profit or loss in the impairment loss line item).

#### ***Restructured debt***

10. During the December 2011 Board meeting, there were some specific concerns raised related to restructured debt and migration between buckets. The staff intend to address in a subsequent meeting the application of the general impairment model to restructured debt.

#### **Issue 1: Purchased credit-impaired assets**

11. The staff have considered whether purchased credit-impaired assets should ever change measurement objectives (ie move up into Bucket 1) if improvements in expectations occur (whether by, or to, a specific credit quality). However, because of the following reasons, the staff do not believe it appropriate for such assets to ever move to Bucket 1, regardless of the level of improvement. In other words, throughout their lives purchased credit-impaired assets would remain in either Bucket 2 or 3 with the changes in lifetime credit loss expectations reflected in the allowance balance.
12. In January 2012, the boards decided that purchased credit-impaired assets would:
  - (a) be categorised in Bucket 2 or 3 at the time of purchase;

- (b) the purchase price would accrete to the expected cash flows (ie the effective interest rate (EIR) would be calculated considering initial lifetime credit loss expectations, which is referred to herein as a credit-adjusted EIR); and
- (c) the impairment allowance would be equal to the change in lifetime expected credit losses since acquisition.

In effect, purchased credit-impaired assets are treated differently from other assets within the 'three-bucket' impairment model. The other assets use contractual cash flows to determine the EIR and initially categorise assets in Bucket 1.

13. A credit-adjusted EIR will be lower than a non-credit-adjusted EIR. Consequently, the interest revenue recognised will be less over the lifetime compared to interest revenue recognised with a non-credit-adjusted EIR. In effect, the initial expected lifetime credit losses are recognised over the life through the interest revenue line item by using the credit-adjusted EIR. Because the reporting entity has to include the initial estimate of the lifetime expected credit losses in determining the credit-adjusted EIR, it is consistent to always recognise changes in the lifetime expected credit losses for these assets (similarly to what was proposed in both the IASB's and FASB's original exposure drafts). As a result, purchased credit-impaired assets use a different impairment model to that of the general model.
14. The credit-adjusted EIR is 'locked in', so the effect of the initial credit loss estimate is held constant. If movements to Bucket 1 (ie a change in measurement objective) were permitted, it would be very complex to only reflect the effect of a 12-month expected credit loss estimate as the allowance (or *changes* in the 12-month expected credit loss estimate) when the lifetime expected credit losses are already reflected in the credit-adjusted EIR. Trying to reverse the effects of the lifetime estimate included in the credit-adjusted EIR would be unduly onerous and would create unnecessary complexity.

15. If transfers up to Bucket 1 were permitted, then the question would arise of whether changing back to the original measurement objective (ie transferring back into Bucket 2 or 3) should happen upon *any* deterioration, or only if the assets have deteriorated back to a level at least as bad as the original purchased level. Both of these options create additional complexities in the model. For example:
- (a) If moving down to Bucket 2 or 3 upon *any* deterioration, it is possible that a purchased credit-impaired asset that improves and then deteriorates is still a better quality asset than when first purchased. Yet, it would be moved to Bucket 2 or 3 (which in the rest of the model represents that deterioration has happened in those particular assets).
  - (b) Moving back down to Bucket 2 or 3 only when the asset has deteriorated to the original purchased credit quality level might create another inconsistency within the general ‘three-bucket’ impairment model, because it may have to deteriorate further than would be required under the general model for originated assets. This is because the original credit quality of the credit-impaired purchased asset might have been below the level of credit risk captured in the general transfer notion (ie when it is at least reasonably possible that all or some of the contractual cash flows may not be collected).

### **Staff recommendation**

16. For purchased credit-impaired assets, the staff do not recommend moving those assets up into Bucket 1 if credit quality improves. Purchased credit-impaired assets use a different impairment model to the general impairment model. Furthermore, the impairment allowance represents the changes in lifetime expected credit losses and all changes (favourable and unfavourable) are immediately recognised in profit or loss.
17. Moving those assets up to Bucket 1 if credit quality improves would create measurement inconsistencies, additional complexities, and the need for the boards to define additional requirements (ie when to transfer back into Bucket 2 or 3).

As a result, the staff recommend that purchased credit-impaired assets should remain for their life in Bucket 2 or 3 with changes in lifetime expected credit losses recognised.

#### Question to the boards

Do the boards agree with the staff analysis and recommendation that a financial asset purchased with an explicit expectation of credit losses (ie a purchased credit-impaired asset) should not move into Bucket 1 during its lifetime (ie the lifetime expected credit loss measurement objective should be maintained throughout its lifetime)? If not, why not and what would the boards like to do instead?

## Issue 2: Originated and purchased non-credit-impaired assets

18. Originated and purchased non-credit impaired assets (ie those that accrete from the purchase price to the contractual cash flows) are initially categorised in Bucket 1. Assets only move out of Bucket 1 after there has been more than an insignificant deterioration in credit quality since initial recognition and the likelihood of default is such that it is at least reasonably possible that all or some of the contractual cash flows may not be collected.
19. The boards have been developing a model that requires the use of all reasonable and supportable information, including forward-looking data, to determine expected credit losses as well as the credit quality of the assets (ie an *expected* credit loss model). An asset is moved out of Bucket 1 when there ‘has been more than insignificant deterioration...’. A list of indicators was discussed at the December 2011 joint meeting that indicate when deterioration has occurred because something has happened that is expected to negatively affect the future ability of the borrower to meet its obligations. So, to be consistent, the discussion below is also based on expectations (ie considering all reasonable and supportable information, including forward-looking data, to determine the measurement and the credit quality of the assets). The question to be considered is whether and

when assets should move back to Bucket 1 after previously deteriorating into Bucket 2 or 3. The staff have identified the following possibilities:

- (a) **Alternative 1:** YES, assets should move back to Bucket 1 after previously deteriorating into Bucket 2 or 3, and the movement upwards would work as follows:
  - (i) **Alternative 1a:** Use the same downward transfer notion
  - (ii) **Alternative 1b:** Use different criteria for movement upward.
- (b) **Alternative 2:** NO, assets should not move back to Bucket 1 after previously deteriorating into Bucket 2 or 3.

**Alternative 1: YES**

- 20. An entity must use all reasonable and supportable evidence when evaluating an asset's credit quality, whether its credit quality has changed and when measuring expected credit losses. Assets are moved out of Bucket 1 when a more than insignificant deterioration in credit quality and the lifetime likelihood of default, not the 12-month likelihood of default, is such that it is at least reasonably possible that some or all of the contractual cash flows may not be collected. Likewise, when considering whether and how the transfer back into Bucket 1 would work, consideration is given to improvements in credit quality reflected in the lifetime likelihood of default, not just the 12-month likelihood of default.
- 21. Requiring that the need for transfer be evaluated based on a lifetime likelihood of default helps to ensure that the improvements in that likelihood are not just short-term improvements when the overall picture looks as poor, or worse, than today. In other words, a transfer back to Bucket 1 could not occur just because an entity believes that there may be improvements over a 12-month horizon. For the purpose of determining when to move in and out of Bucket 1, the improvements (and deterioration) need to be based on supportable evidence that takes into consideration the picture over the lifetime of the financial assets.

22. Moving up to Bucket 1 does not create major incremental operational issues<sup>4</sup>. During the development of the general ‘three-bucket’ impairment model, constituents raised concerns with the operationality of an approach that starts all assets in Bucket 1<sup>5</sup>. The feedback on the operational issues from constituents was that once systems for tracking need to be built, then the issues are the same for tracking either downward or upward movement. Given that tracking will have to occur for the downward movement, the staff are not aware of any major incremental operational issues with tracking back up.

*Alternative 1a: YES, using similar criteria/indicators*

23. Under this alternative, the assessment of whether assets should move back into Bucket 1 would be based on the same transfer concept used for the movement out of Bucket 1. In other words, when the downward transfer notion is no longer satisfied, the asset would move back to Bucket 1.
24. The concept for the improvement in credit quality that would cause the requirement to recognise lifetime losses to no longer be appropriate would be as follows:
- (a) An entity is required to change the credit impairment measurement objective from (a) lifetime expected credit losses to (b) 12 months of expected credit losses when the asset (or asset group<sup>6</sup>) has improved so that:

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<sup>4</sup> See paragraphs 36-38 of the September 2011 IASB Agenda Paper 4A/FASB Memorandum 109 and paragraphs 18, 24-29 of the September 2011 IASB Agenda Paper 4B/FASB Memorandum 110, which discusses the tracking issue and that any tracking creates operational difficulties, which are not minimised by reducing the time that assets need to be tracked.

<sup>5</sup> The concern was that each asset would have to be tracked in order to know when to move to Bucket 2 and recognise lifetime expected credit losses. The boards considered that feedback, but eventually decided that the most appropriate way forward was to require originated and purchased non-credit-impaired assets be initially categorised in Bucket 1.

<sup>6</sup> As tentatively agreed to by the boards in the December 2011 joint board meeting (see IASB Agenda Paper 6C/FASB Memorandum 120), assets may be grouped for purposes of evaluating whether an impairment loss exists based on shared credit characteristics and a sufficiently detailed level (ie not at a more aggregated level if there are shared risk characteristics for a subgroup that would indicate whether recognition of lifetime losses would be appropriate).



- (i) it has not experienced (on a cumulative basis since initial recognition) a more than insignificant deterioration in credit quality; or
  - (ii) the likelihood of default is no longer such that it is at least reasonably possible that the contractual cash flows may not be recoverable.
25. Some might be concerned that financial assets would move back to Bucket 1 based on a ‘premature’ improvement in credit risk. That is, when credit risk improves temporarily (eg using a 12-month horizon), but subsequently declines, showing that the improvement had no substance over the longer horizon. However, as noted in paragraphs 20 and 21, it is proposed that movements would have to be assessed over an outlook period that covers the lifetime of the assets using all reasonable and supportable information, including forward-looking information, to arrive at an expectation. This should ensure that the assessment of a move to Bucket 1 is not based a short-term outlook without considering all reasonable and supportable evidence for the financial assets.

### *Advantages*

26. As mentioned in paragraph 8, unfavourable and favourable changes in cash flow expectations are treated consistently by immediately recognising the effect of the changes in profit or loss (ie a symmetrical treatment). Using the same transfer notion for evaluating when to move assets back in to Bucket 1 (ie changing back to recognising 12 months’ expected credit losses) also provides symmetry within the model, because it relates to whether and under which circumstances the measurement attribute changes. The staff believe the more areas in an impairment model that are symmetrical, the fewer complexities will exist.
27. Some staff also believe that this alternative faithfully represents the economics of the transactions. When assets satisfy the proposed criteria (ie no longer satisfy the downward transfer notion), then the expectations of credit losses are again moving towards the initial expectation that was included in pricing. In other words, the overall deterioration (improvement) that has occurred since

origination/acquisition no longer warrants recognition of lifetime credit losses (ie comparing where an asset is today versus when originated/purchased).

28. In addition, some staff believe this alternative is more consistent with the boards' thinking in developing a model that is responsive to new information. For example, in the three-bucket approach, the timing of recognition of credit losses is dependent on the extent of deterioration. Consistently with the treatment of assets deteriorating (ie responding to new information by moving buckets and reflecting lifetime expected credit losses), this alternative would be responsive to new information by moving buckets up (ie by reflecting 12 months' expected credit losses). These staff believe that information content that is provided in showing the transfer between the buckets that is equally valid on credit improvement as for deterioration.

### *Challenges*

29. Any differentiation between the buckets based on principles inevitably involves significant management judgement. Some might be concerned that moving financial assets back into Bucket 1, with 12 months of expected credit loss recognised as the allowance, creates opportunities for earnings management. This is because it is based on management's view of all reasonable and supportable information, including forward-looking information. As a result, some staff feel that a model that uses the same criteria for the move up to Bucket 1 creates greater potential for earnings management.

#### *Alternative 1b: Using different criteria for movement up to Bucket 1*

30. Under this alternative, assets would still move to Bucket 1 following improvements in credit quality. However, there would be some sort of 'prudence' layer built in so that assets would move back to Bucket 1 at a higher credit quality than that which would have required a move out of Bucket 1. Or, in the case of the method in paragraph 30(c), they would have to exhibit sustained improvement to move up. There could be various alternative criteria for moving assets up to Bucket 1, for example:

- (a) Requiring the likelihood that some or all of the contractual cash flows that may not be collected would have to be a higher credit quality than ‘at least reasonably possible’. For example, the likelihood of not collecting some or all of the contractual cash flows requiring a move to Bucket 1 could be ‘remote’ or ‘less than reasonably possible’.
  - (b) Requiring assets to improve to the same credit quality at which they were originated/purchased.
  - (c) Requiring the improvement in expectations to be sustained over several reporting periods. After the improvements in expectations have been sustained for the specified number of reporting periods, then the assets would move to Bucket 1.
31. If the boards decide that different criteria for moving into, as opposed to out of, Bucket 1 is appropriate, then further analysis will need to be performed as to which criteria should be used.

### *Advantages*

32. Requiring a higher credit quality for the movement back into Bucket 1, as compared to the criteria for the move out of Bucket 1, creates an additional prudence layer. Some believe that this additional layer is appropriate and lessens, although does not remove entirely, the reliance upon management’s judgment and their ability to manage earnings. Furthermore, some staff believe that comparability will be improved, because the number of instances in which management judgment is required will be reduced. For example, if sustained improvement as described in paragraph 30(c) is required for, say, 3 reporting periods, then the move back to Bucket 1 (and to 12 months’ expected credit loss) is arguably less judgemental. However, other staff believe that the determination of whether there is an improvement is still dependent on management estimates. They believe that judgement is also required to assess when a movement out of Bucket 1 is appropriate, and so they question why the judgement that is needed for the movement into Bucket 1 justifies such asymmetry.

33. Requiring an additional layer of prudence before moving into Bucket 1 may minimise the frequency in movements in and out of Bucket 1. Some staff believe that users may find frequent changes in the measurement objective to be difficult to interpret and understand. Consequently, those staff believe that minimising the frequency of the changes may make the model easier for users to understand.

### *Challenges*

34. Not using the same criteria creates additional complexity in the application of the impairment model. The staff note that it was a challenge to develop the indicators/criteria for the move out of Bucket 1. In consequence, determining different indicators/criteria for moving into Bucket 1 would be just as challenging and would create complexities in the model.
35. Adding a prudence layer will not stop movements in both directions, and some staff believe that it will not make the model easier to interpret and understand, because it requires an understanding of the different assessment required for when assets should move up to Bucket 1 (thereby returning to a 12-month expected credit loss amount).
36. If similar criteria are not used to move assets in and out of Bucket 1, then entities may be reluctant to move assets into Bucket 2 or 3 in the first place, because lifetime expected credit losses would be more likely to be recognised for the remaining life of those assets. This may create a similar perceived problem as under today's model, because it will create a disincentive to move assets out of Bucket 1, which would result in later recognition of credit losses.
37. Some believe that a model that includes a prudence layer for transferring back into Bucket 1 sacrifices neutrality and faithful representation. In other words, original pricing considered initial credit risk, so a model based on deterioration should also take into consideration when assets improve back towards their original credit risk (included in pricing). That was part of the reason for starting assets in Bucket 1.
38. The differentiation between the buckets inevitably involves significant management judgement. Those that support a neutral and symmetrical approach

related to the movement do not believe that the approach should be sacrificed for anti-abuse considerations.

39. If a higher credit quality or additional criteria were to be required, entities with assets that have a long lifetime could be penalised. For example, the longer the life of an asset, the greater the chance that those assets could deteriorate at some point, which would move them into Bucket 2 or 3. Even if the assets improved towards their original credit quality, because of the higher credit quality required for a move into Bucket 1, they would have to leave those assets outside Bucket 1 and recognise the lifetime expected credit losses rather than 12 months' expected credit losses.
40. Furthermore, if the criteria for an upward movement did not consider original credit risk at origination/acquisition (alternatives in 30(a) and 30(c)), then some assets that started at a poorer quality in Bucket 1, may have to improve even beyond their original credit quality, or maintain the improvement to their original credit quality for a number of periods, before moving back to Bucket 1. The boards would need to consider what the appropriate credit quality or sustained time period would be.
41. If the assets had to improve to the original credit quality at origination/acquisition (alternative in 30(b)), then assets that had a high credit quality at origination/purchase would have to improve by a large amount to move back into Bucket 1. In other words, even if the asset improved to credit quality levels where the uncertainty in the ability to recover all or some of the contractual cash flows is *de minimis*, it would not move to Bucket 1 until its original credit risk has been reached. For example, assume an entity uses a rating scale of 1-15 with 1 being the highest credit quality. An asset originated at a 2 deteriorates to 7, moving it out of Bucket 1. Even if the asset subsequently improves back to say, a 3 rating with a very low probability of default, it would remain in Bucket 3.

**Alternative 2: NO**

42. Under this alternative, assets can only move out of Bucket 1 and can never move back into it. In other words, once moved out of Bucket 1, the assets stay out of Bucket 1 and changes in the lifetime expected credit losses are recognised as an impairment loss each period.

**Advantages**

43. Similarly as for the advantage described in paragraph 32, not allowing a movement back to Bucket 1, creates an additional prudence layer, which some believe is appropriate and lessens, although does not entirely remove, management's ability to manage earnings.
44. Similarly as for the advantage described in paragraph 33, some staff believe that reducing the frequency at which the measurement objective changes (ie not allowing a move back to Bucket 1) may make the model easier for users to understand.

**Challenges**

45. Similarly as for the challenge described in paragraph 36, if assets are not permitted to move back into Bucket 1, then entities may be reluctant to move assets into Bucket 2 or 3 in the first place, because lifetime expected credit losses would be more likely to be recognised for the remaining life. This may create a similar perceived problem as under today's model, because it will create a disincentive to move assets out of Bucket 1, which would result in later recognition of credit losses.
46. Similarly as for the challenge described in paragraph 37, this alternative would create an asymmetrical model for the movement between buckets.
47. Similarly as for the challenges described in paragraph 38, the differentiation between the buckets inevitably involves significant management judgement. Those that support a neutral and symmetrical approach related to the movement do not believe the approach should be sacrificed for anti-abuse considerations.

48. Similarly as for to the challenge described in paragraph 39, this alternative could penalise entities with longer-term assets. Even if the assets improved back towards the original pricing, the lifetime losses would continue to be recognised as opposed to the 12-month expected credit losses.

### **Staff recommendation**

49. The staff recommend Alternative 1a for originated and purchased non-credit-impaired assets (ie assets move to Bucket 1 when the downward transfer notion is no longer satisfied). The staff believe that just as favourable and unfavourable changes in expectations are treated symmetrically, the movement in and out of Bucket 1 should be symmetrical.

#### **Question to the boards**

Do the boards agree with the staff recommendation to move originated and purchased non-credit-impaired assets to Bucket 1 when the downward transfer notion is no longer satisfied? If no, why not and what would the boards prefer instead?