

STAFF PAPER

21 May – 25 May 2012

REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Discount rate		
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Introduction

Purpose of the paper

1. This paper addresses the discount rate that should be used when discounting expected losses in the general ‘three-bucket’ impairment model. The analysis includes feedback received from the joint supplementary document published in January 2011, *Financial Instruments: Impairment* (the SD).

Background

2. In the ‘three-bucket’ model, the IASB has tentatively decided to use a ‘decoupled’ effective interest rate (EIR)¹. That is, interest revenue and impairment are separately recognised and accounted for in the financial statements.
3. For interest revenue recognition, the Board has agreed that the effect of expected credit losses of a loan would not be integrated into the calculation of the EIR for originated and purchased non-credit impaired assets². Interest revenue is

¹ This decision has been made by both the FASB and the IASB. However, this paper is IASB only so the analysis refers only to IASB decisions.

² The IASB tentatively decided that for purchased credit impaired assets (ie those with an explicit expectation of losses) a credit-adjusted EIR shall be determined (ie an integrated EIR that includes consideration for expected credit losses).

recognised by applying the original, non-credit adjusted, EIR to the amortised cost balance, which does not include a reduction for the impairment allowance. The impairment allowance would be accounted for separately.

4. With respect to measuring expected losses, the Board tentatively decided that the expected losses³:
 - (a) would include the shortfall of all cash flows (principal and interest); and
 - (b) would be a discounted amount.
5. The Board also tentatively decided that the discount related to the expected losses would be unwound in the impairment loss line item.

The issue

6. Amortised cost is calculated using the effective interest method. Amortised cost determines the carrying amount and revenue recognition pattern for a financial asset as part of an integrated calculation. The effective interest rate used in recognising revenue is also used in measuring an impairment loss. In that sense, the carrying amount of a financial asset, the associated revenue recognition and impairment calculations are interrelated.
7. Maintaining the same EIR reflects that amortised cost is a cost-based measurement.
8. Although the discount rate has to be kept constant over the life of the assets⁴, the staff understand that in practice today, many entities do not calculate the original EIR. This is because in an open portfolio, entities have operational difficulty in maintaining historical EIR information⁵.
9. Instead, entities make approximations. They often use the contractual interest rate as well as allocate premiums/discounts, fees etc on a straight-line basis over the life of the asset to recognise interest revenue. For impairment, some entities

³ See IASB Agenda Papers 4B, 4D and 4E of the April 2011 joint board meeting.

⁴ Except for floating rate instruments.

⁵ See IASB Agenda Paper 13B from the September 2010 joint board meeting.

estimate what the original EIR would have been, knowing that any difference is likely to be immaterial. This approach results in a similar effect to using the original EIR.

10. Under the 'three-bucket' model, lifetime expected credit losses are recognised earlier than in the incurred loss model. The earlier recognition of lifetime expected losses causes expected losses to be discounted over longer periods than is required today. Hence, the discount rate used has a more significant effect in measuring the impairment loss and the practical approach described above may no longer result in a similar effect to using the original EIR.
11. This paper asks the Board what discount rate should be used for discounting the expected credit losses, considering whether it is appropriate to permit flexibility in the selection of a discount rate given the operational challenges described above.

Staff recommendation:

12. To provide operational relief, the staff recommends permitting an entity to choose a discount rate between, and including, the risk-free rate and the effective interest rate (as calculated in IAS 39).

Feedback from comment letters and outreach

13. The IASB original exposure draft, *Financial Instruments: Amortised Cost and Impairment* (the ED) published in November 2009 proposed requiring the use of an integrated EIR approach based on all expected cash flows, including expected credit losses. However, determining the EIR as well as maintaining historical data related to the EIR was considered operationally difficult⁶. As a result, the Board published the SD which 'decoupled' the EIR.
14. To make discounting operationally feasible, the SD proposed that entities have flexibility in the discount rate when calculating discounted expected loss amounts. The proposals permitted entities to use any discount rate between, and including.

⁶ See paragraphs A14-A25 of IASB Agenda Paper 9B of July 2010 meeting.

the risk-free rate and the effective interest rate as calculated in IAS 39 (see Appendix for the Board's previous discussion of the topic)⁷.

15. The SD included the following question:

Question 11

(a) ...

(b) **Do you agree with permitting flexibility in the selection of a discount rate when using a discounted expected loss amount? Why or why not?**

16. More than half of the IFRS constituents that responded supported flexibility in choosing which discount rate should be applied. These respondents agreed that this flexibility was helpful to ease the operational challenges of determining and maintaining the discount rate. They also felt that it was appropriate to allow preparers to choose the most appropriate rate for the level of sophistication of their systems and their operational capability.
17. Most other respondents (primarily U.S. GAAP constituents) did not support flexibility because they generally did not support discounting. Even of those non-IFRS constituents who supported discounting, the majority did not support flexibility in choosing which discount rate should be applied and preferred that the Board specify a single rate.
18. Those who did not support permitting flexibility in determining the appropriate rate, wanted to maintain comparability between entities. Other respondents believe comparability can be achieved by including disclosure of the discount rate used and any significant assumptions made.
19. Some constituents highlighted the risk that auditors may enforce a bright line, imposing a particular rate, if a single discount rate is not specified.

⁷ It is noted that the FASB did not deliberate this issue, but it was included in the joint SD for comment because it was considered an integral part of the overall proposals, including the time-proportional approach.

20. Many of those who did not support permitting flexibility believe that the EIR (as determined under current accounting requirements) should be used. This is because they view the EIR as conceptually the right answer, as it reflects the economic reality more closely than the risk-free rate and is consistent with the notion of the time value of money.

Staff analysis and recommendation

21. While conceptually, credit losses should be discounted in the ‘three-bucket’ model using the original non-credit adjusted EIR, the operational challenges of maintaining information in an open portfolio (ie the EIR) remain.
22. To make discounting operationally feasible, entities have told us that they need the flexibility to use a current rate.
23. However, the disadvantage of permitting a current rate is that amortised cost is a cost-based measurement. Conceptually, using a current rate is inconsistent with cost-based measurement. Permitting a current rate would be based on operational rather than conceptual considerations.
24. Using a rate other than the original EIR to discount expected cash flows to determine the impairment allowance will result in a measurement inconsistency. This is because the gross carrying value is calculated using the original EIR (paragraphs 6-9) but the impairment allowance is not.
25. In addition, flexibility in the discount rate will result in entities using different discount rates within the permitted range. Nevertheless, some believe that it is most important for investors to understand the rate that has been used to discount the expected losses. This could be achieved through disclosures.
26. The alternative is to permit either the current risk-free rate or the IAS 39 EIR (ie no flexibility in determining a rate in between the current risk-free rate and the EIR as calculated under IAS 39). However, the current risk-free rate is the furthest away from the EIR. While it takes into account the time value of money, it does not take into account the other components of the EIR (eg compensation

for accepting risk, profit margin etc, as described in the Appendix paragraph A3). Thus, it could be argued that it is the least relevant or appropriate basis for discounting.

27. Given that levels of systems sophistication differ considerably across entities and jurisdictions, and on the basis of the feedback received, the staff recommend confirming the proposal in the SD that entities be permitted to use a discount rate between, and including, the risk-free rate and the EIR to provide operational relief. This would allow less sophisticated entities to apply a simplified approach, but permit entities with more sophisticated systems to determine a discount rate that is closer to the EIR.

Question to the Board

Does the Board agree with the staff recommendation to permit an entity to use a rate between, and including, the risk-free rate and the effective interest rate (as used for the effective interest method in IAS 39)?

If not, what would the Board prefer and why?

Appendix

- A1. The following represents an excerpt (with minor modifications to reflect only the discussion related to discount rates) from the 1 December 2010 IASB-only board meeting, Agenda Paper 1B.
- A2. The annuity approach and the straight-line approach for discounted EL involve discounting. Using the risk-free rate plus a spread adjustment as the discount rate would be directionally consistent with the effective interest rate (EIR) used under the ED to discount EL. However, adjusting for a spread could be operationally challenging (for similar reasons as determining and maintaining EIR information). The Board could consider rates between (and including) the following two rates:
- a. the risk-free rate—can be more easily determined and would capture the time value of money; or
 - b. the ED's EIR.
- A3. The staff note that the ED's EIR lies between the risk-free rate (see (a) above) and the IAS 39 EIR. The IAS 39 EIR reflects the following:
- a. time value of money ('risk-free rate');
 - b. compensation for initial expected credit losses;
 - c. compensation for accepting risk (eg unexpected credit loss, liquidity risk etc);
 - d. a profit margin; and
 - e. adjustments for premiums or discounts, fees and points paid, and/or transaction costs.

The ED's EIR reflects all the above components except for (b) above.

- A4. In summary, the staff consider in the context of open portfolios that the discount rate should be updated should correspond to the remaining average life of the portfolio (eg if the weighted average life-to-date is 2 years and the weighted

average total life of the portfolio is 5 years, the current 3-year risk-free rate (plus any spread, if applicable) should be used).

- A5. Conceptually, the discount rate for cash flows of an asset cannot be below risk free. The discount rate used in the ED is conceptually appropriate for calculations in connection with amortised cost measurement. The staff note that taking into consideration the operational challenges of determining and maintaining discount rates the following aspects should be considered:
- a. the risk-free rate is the minimum rate and has a clear conceptual meaning (it captures only the time value of money) but risk-free rates are not always readily available (and have become a more hypothetical construct during recent market conditions);
 - b. many financial institutions for internal valuation purposes use a benchmark-type rate (eg a swap rate), which reflects the interest level in the most liquid part of the market—using such a rate would provide significant operational relief;
 - c. the ED’s EIR is from an operational perspective the most difficult to determine and maintain;
 - d. the IAS 39 EIR would be more readily available than the ED’s EIR;
 - e. the contractual rate might be more readily available than the IAS 39 EIR.
- A6. The staff consider that any rate that lies between the risk-free rate and the ED’s EIR could be considered reasonable—see paragraphs A2 and A3. The staff note that the ED sets out why the IAS 39 EIR is too high. Hence, this rate could only be considered as the ‘upper limit’ for practical reasons. The difference between the EIRs in IAS 39 and the ED is determined by the compensation for initial expected credit losses (see paragraph A3). Hence, the magnitude of this compensation will determine to what extent the IAS 39 EIR might be considered an approximation of the ED’s EIR.

- A7. An important consideration is that if the Board wants to allow entities to use a discount rate from within a range of reasonable rates, specifying the ED's EIR as the upper limit would have the effect of requiring the complexity of determining this rate for the purpose of ascertaining whether a more readily obtainable rate could be used. Hence, the operational complexity of determining the ED's EIR would not be avoided, which would defeat the purpose of providing operational relief. For this practical reason the Board might consider the IAS 39 EIR even though it is (conceptually) too high.
- A8. For the contractual rate a general assessment whether it might be an appropriate discount rate is impossible. For example, for an instrument acquired at a significant discount or an instrument with uneven coupons the contractual rate can differ significantly from an EIR. Hence, the staff do not consider that a reference to the contractual rate is appropriate when describing discount rates that an entity might use.
- A9. The staff think that the Board could consider allowing entities to use a discount rate that would lie between (and include) the risk-free rate and (in order to provide operational relief) the IAS 39 EIR.