

# STAFF PAPER

**21 May – 25 May 2012**

## REG IASB Meeting

<b>Project</b>	<b>Financial Instruments: Impairment</b>		
<b>Paper topic</b>	Modified Financial Assets		
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## Introduction

1. This paper presents how modifications on financial assets should be treated in the ‘three-bucket’ impairment model.

## Scope

2. The scope of this paper addresses financial assets at amortised cost that are renegotiated or otherwise modified, but that do not result in a derecognition of the financial asset.
3. Modifications for the purpose of this paper are not limited to circumstances in which the lender, for economic or legal reasons, grants a concession to the borrower because of financial difficulties of the borrower) that the lender would not otherwise consider. This is because it is often difficult to assess the reason for modifications as noted in the Basis for Conclusions to the Amendments to IFRS 7 Financial Instruments: Disclosures issued in May 2010:

[T]he [IASB] was informed that commercial terms of loans are often renegotiated regularly for reasons that are not related to impairment. In practice it is difficult,

especially for a large portfolio of loans, to ascertain which loans were renegotiated to avoid becoming past due or impaired.

4. This paper is limited to modifications that do not result in derecognition. A modification that results in the derecognition of the original financial asset would result in the recognition of a new financial asset. That new asset would be treated consistently with all other new assets (ie initial recognition at fair value and categorised in Bucket 1 with a 12-month expected loss recognised as the allowance balance).

## Background

5. At their February 2012 meeting, the Board considered whether, and under which circumstances, financial assets that had previously been moved out of Bucket 1 should move back to Bucket 1 (that is, whether the model would be symmetrical)<sup>1</sup>. At that meeting, the Board tentatively decided that:
  - (a) Originated and purchased non-credit-impaired assets would transfer back to Bucket 1 if the transfer notion from Bucket 1 is no longer met.
  - (b) Purchased credit-impaired assets can never move into Bucket 1. As a result, *changes* in lifetime expected credit losses are recognised throughout its life.
6. Modified (ie restructured) debt was excluded from the scope of that discussion. However, considering how modified instruments are treated is important, because movements in and out of Bucket 1 change the measurement of expected credit losses between lifetime expected credit losses and 12 months' expected credit losses.
7. As a result, this paper addresses the following issues:
  - (a) Issue A — Whether modified financial assets should be considered for transfer in the same way as other assets. See paragraphs 11-17.

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<sup>1</sup> The decisions referred to in this paper were made by both the FASB and the IASB. However, this paper is IASB-only so the analysis refers only to IASB decisions.

- (b) Issue B — How should the transfer notion be evaluated for originated and purchased non-credit-impaired financial assets that have been modified (ie, which credit quality/cash flows should be considered?). See paragraphs 18-30.
- (c) Issue C — Whether the requirements should be explicit about the presentation of a modification (ie whether the carrying value of the instrument should be reduced or the impairment allowance increased). See paragraphs 31-36.

### Staff recommendations

- 8. **Issue A** – Modified assets should be considered for transfer in the same way as other assets
  - (a) Originated and purchased non-credit-impaired financial assets that have been modified should move up to Bucket 1 if the transfer notion is no longer met.
  - (b) Purchased credit-impaired assets that are modified should remain outside Bucket 1 throughout their lives.
- 9. **Issue B** – When evaluating if the transfer notion is no longer met an entity should:
  - (a) evaluate the current credit quality against the original credit quality in determining whether there has been more than an insignificant deterioration in credit quality, and
  - (b) consider the cash flows of the modified instrument when evaluating whether the likelihood of default is such that it is at least reasonably possible that some or all of the contractual cash flows may not be recoverable.
- 10. **Issue C** – The impairment loss for modifications should be required to be recognised against the gross carrying value of the asset.

## Issues for Discussion

### *Issue A – Symmetry of model*

11. The Board's tentative decision was that the general impairment model should be symmetrical in the treatment of deteriorations and improvements in credit quality.
12. Financial assets that are modified but not derecognised are not new financial assets from an accounting perspective. Consequently, the impairment model should apply as it does for other financial assets reflecting their changes in credit quality over their lives (ie they should be treated consistently with other, non-modified financial assets, so that originated and purchased non-credit impaired financial assets that have been modified should move up to Bucket 1 if the transfer notion is no longer met). Similarly, consistent with assets that are not modified, purchased credit impaired assets that are modified remain should outside Bucket 1 throughout their lives.
13. Some argue that it is not unusual for troubled debt to be modified more than once. They fear that judgement about transferring originated or purchased non-credit-impaired financial assets that have been modified up to Bucket 1 may be based on over-aggressive or optimistic projections. They may even prefer those modified assets to remain outside Bucket 1 or that there should be different (stricter) criteria for transferring assets back into Bucket 1.
14. However, the assessment of credit quality should be based on all reasonable and supportable information (including historical and forward-looking information). History can provide relevant information in assessing credit quality and should therefore be considered when assessing the transfer to Bucket 1 (ie consideration should be given to the circumstances that led to the restructuring). In addition, the evaluation of the credit quality to determine a transfer to Bucket 1 should examine the entire life of the instrument, in the usual way not just over a short-term horizon.
15. A model that allows modified assets to move back into Bucket 1 when they no longer meet the downward transfer notion is consistent with the Board's previous decision in February 2012 to have a model which permits the upward and downward movement between buckets

due to changes in credit quality. Such a model represents the economics of the transaction and the staff are of the view that that should not be sacrificed for anti-abuse purposes.

16. It would also be difficult to have different criteria for the movement to Bucket 1 only for particular modified assets (eg only those arising from the borrower's financial stress) because it is often difficult to assess the reasons for renegotiations (see paragraph 3).
17. There therefore appears to be no reason why originated or purchased non-credit-impaired assets that are modified, but that do not result in derecognition, should be treated differently (eg remain outside Bucket 1 throughout their lives). In fact, if a modified asset cannot move up to Bucket 1 (or if the movement is dependent on different, more prudent criteria) it might create opportunities for abuse. For example, a lender could try to circumvent this restriction by issuing a new loan instead of modifying the old loan.

**Question 1**

Does the Board agree that modified financial assets should be considered for transfer in the same way as other assets, that is:

- (a) originated and purchased non-credit-impaired financial assets that have been modified should move back to Bucket 1 if the downward transfer notion is no longer met; and
- (b) purchased credit-impaired financial assets that have been modified should remain outside Bucket 1 throughout their lives?

If not, what would the Board prefer, and why?

***Issue B – Evaluating the transfer notion***

18. The issue for discussion is how to determine whether the downward transfer notion is no longer met after a financial asset has been modified. In other words, it is whether the transfer notion should be evaluated in accordance with the original terms/credit quality or the modified terms/credit quality.

19. The evaluation for credit deterioration, and for movement into and out of Bucket 1, considers whether (a) there has been a more than insignificant deterioration in credit quality and (b) the likelihood of default is such that it is at least reasonably possible that some or all of the contractual cash flows may not be recoverable.
20. For the purpose of determining the extent of deterioration in credit quality (ie part (a) of the transfer notion), the question is therefore whether an entity compares current credit quality to (1) the credit quality at the date of modification, or (2) to the original credit quality.
21. When evaluating the likelihood that some or all cash flows may not be fully recoverable (ie part (b) of the transfer notion), an entity should always look to the collectibility of the current contractual cash flows (ie the cash flows of the modified instrument). The original terms/cash flows are no longer relevant because the entity has replaced them with new terms and conditions. In short, it is inappropriate to consider the collectibility of cash flows that are no longer due.
22. As a result, the following section *only* considers part (a) of the transfer notion (ie whether (1) the credit quality since origination, or (2) the credit quality since modification, is relevant in evaluating the extent of deterioration).

*Evaluating deterioration in credit quality [part (a) of the transfer notion]*

23. The staff considered whether the lender should evaluate the ‘deterioration in credit quality’ since the *date of modification* for purposes of determining whether the downward transfer notion is no longer met.
24. Upon modification, the asset would, by definition, *not have* experienced ‘a more than insignificant deterioration in credit quality’ from the viewpoint of the evaluation of the deterioration since the date of modification. As a result, every modified asset would move immediately back to Bucket 1.
25. Some believe that a modification, in and of itself, creates a ‘fresh start’ in that it may create a sense of giving the opportunity to recall the rate to the terms for the market and the condition

of the obligor. So they believe that the carrying amount should be adjusted and, therefore, the asset move immediately back to Bucket 1 upon modification.

26. However, the staff does not support this approach and did not consider it further for the following reasons:
- (a) The original financial asset has not been derecognised and as a result, from an accounting perspective, the modified financial asset is not a new instrument. Because the modified financial asset is not a new instrument the original credit quality should not be reset to the modified credit quality for evaluating deterioration in credit quality. History matters to reflect the deterioration in a consistent manner with the overall model. Resetting the credit quality to the modified credit quality, that is, moving the financial asset immediately into Bucket 1 upon modification, is inconsistent with the Board's tentative decision with respect to the treatment of changes in credit quality for an asset over its life. Whereas for all other financial assets a transfer back to Bucket 1 could only occur when there is no more than an insignificant deterioration in the credit quality of the financial asset over its life, due to a modification alone, this approach would allow transfers back to Bucket 1 subject only to satisfying the second part of the test. Thus, by modifying the terms, the hurdle for transfers would be changed.
  - (b) Moving the financial asset immediately to Bucket 1 upon restructuring can be seen as being inconsistent with the population of financial assets that the Board tried to capture in Bucket 1. One of the arguments for starting all originated and purchased non-credit-impaired assets into Bucket 1 is that they have been priced according to market. In the staff's view, a modified asset is likely not repriced at market.
27. If, instead, the extent of deterioration in credit quality is evaluated *since initial recognition of the original instrument*, the modified asset either remains outside Bucket 1 or moves back to Bucket 1 depending on its overall change in credit quality.
28. Assessing the transfer notion based on the original instrument's credit quality reflects the economics of the transaction. It takes into account that the financial asset has not been

derecognised and should only move to Bucket 1 when the credit quality improves towards the initial expectation of credit losses that was included in the pricing of the original instrument. This is consistent with the deterioration notion that underpins the model.

29. In addition, it is in line with the Board's tentative decision, in that the consideration of changes in credit quality in the model should be symmetrical. A modified asset, like all others would be transferred into or out of Bucket 1 based on changes in credit quality from initial recognition.
30. As a result of the analysis above, the staff recommend that when evaluating whether a modified asset should be transferred back to Bucket 1 an entity should:
- (a) evaluate the current credit quality against the original credit quality in determining whether there has been more than an insignificant deterioration in credit quality; and
  - (b) consider the cash flows of the modified instrument when evaluating whether the likelihood of default is such that it is at least reasonably possible that some or all of the contractual cash flows may not be recoverable.

### Question 2

Does the Board agree with the staff that when evaluating whether a modified asset should be transferred back to Bucket 1 an entity should:

(a) evaluate the current credit quality against the original credit quality in determining whether there has been more than an insignificant deterioration in credit quality; and

(b) consider the cash flows of the modified instrument when evaluating whether the likelihood of default is such that it is at least reasonably possible that some or all of the contractual cash flows may not be recoverable?

If not, why not, and what would the Board propose instead?



### **Issue C – Presentation**

31. Issue C discusses the presentation of a modification (ie whether the carrying value of the instrument should be reduced or the impairment allowance increased).
32. From the creditors' perspective, upon modification current IFRSs recognise an impairment loss as the difference between (a) the present value (using the original effective interest rate) of cash flows on the modified instrument and (b) the carrying value of the instrument before its modification. However, IAS 39 is silent on whether the impairment loss shall be recognised against the impairment allowance or against the carrying value of the asset.
33. Under IAS 39, it is not necessary to be specific about whether the carrying value or the allowance balance shall be adjusted. This is because interest revenue is calculated as the effective interest rate multiplied by the net carrying value (ie the amount that includes a reduction for the impairment allowance). As a result, the interest revenue takes into account that some losses have been crystallised, by modifying the contractual cash flows.
34. However, the Board has tentatively decided upon a decoupled approach to interest revenue and impairment recognition. Interest revenue would be calculated by multiplying the effective interest rate by the amortised cost, which does not include a reduction for the impairment allowance (ie the gross carrying value). As a result, not adjusting the carrying value upon modification will have the effect that interest revenue, as well as the allowance balance, is inflated relative to the current contractual cash flows<sup>2</sup>, not taking into account that losses have been crystallised.
35. As a result, the staff recommend that the new requirements state that impairment loss for modifications should be recognised against the gross carrying value of the asset, with the new carrying value representing the present value of the future cash flows discounted at the original effective interest rate (see the Appendix for a brief example). The staff note that if the board decides to permit and an entity measures impairment losses pre-modification using a current discount rate (see IASB Agenda Paper 5A), the carrying value adjustment could

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<sup>2</sup> This assumes a downward adjustment in cash flows.

result in a profit or loss effect that does not relate to the impairment/crystallisation of the losses upon modification.

36. The staff also notes that the adjusting the carrying value may result in situations with upward adjustments (ie recognition of a gain). However, this is consistent with IFRS today which treats changes in cash flows symmetrically.

**Question 3**

Does the Board agree that the new requirements should state that the impairment loss for modifications should be recognised against the gross carrying value of the financial asset? If not, what would the Board prefer, and why?

## Appendix

- A1. This example uses a 4-year bullet loan. Its principal amount is CU1,000 with an interest rate of 5% paid annually. The EIR is 5% based on the full contractual cash flows.
- A2. In year 3, the loan is modified. This example assumes the following modifications to the loan:
- (a) Principal is reduced to CU700.
  - (b) Term of the loan is extended by 3 years (to a total of 6 years).
- A3. For simplicity the following should be noted:
- (c) The credit quality of the instrument deteriorates only in year 2 and 3. It then remains unchanged to the end of period 6.
  - (d) Although losses were expected, after the restructuring no losses ever occurred. As a result, the impairment gain in the last year represents the release of the allowance balance which is no longer necessary.

<b>T</b>	<b>Beginning Gross CV</b>	<b>Impairment (loss) / gain</b>	<b>Restructuring (loss)</b>	<b>Interest revenue</b>	<b>CV Adjustment</b>	<b>Ending Gross CV</b>	<b>Allowance balance</b>
	<b>A</b>	<b>B</b>	<b>C</b>	<b>D = 5% X F</b>	<b>E</b>	<b>F = A + E</b>	<b>G</b>
1	0	(1)		50	1000	1000	1
2	1000	(96)		50	0	1000	98
3	1000	(156)	(202)	35	(300)	700	156
4	700	63		35	0	700	93
5	700	51		35	0	700	42
6	700	42		35	(700)	0	0