STAFF PAPER

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REG IASB Meeting

Project	**Financial Instruments: Impairment**
Paper topic	Purchased or originated credit-impaired financial assets

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Purpose of the paper

1. The Exposure Draft *Financial Instruments: Expected Credit Losses* (the 'ED') proposed that the general impairment model should not apply to financial assets that have objective evidence of impairment (referred to as purchased or originated credit-impaired) on initial recognition.[1]

2. Instead the ED proposed to carry forward the existing requirements for purchased or originated credit-impaired financial assets (POCI assets) in IAS 39 *Financial Instruments: Recognition and Measurement*.

3. In this paper we discuss the feedback received on these proposals and areas for potential clarification. This paper does not discuss the disclosure requirements for POCI assets, which will be discussed at a future meeting.

Structure of the paper

4. The paper is set out as follows:

   (a) what the ED proposed and why (paragraphs 5–7);

   (b) detailed feedback received (paragraphs 8–10); and

[1] In the general model an entity recognises lifetime expected credit losses on instruments for which the credit risk has significantly increased; and for other instruments the entity recognises 12-month expected credit losses. In addition, the entity recognises interest revenue on the instruments using the effective interest rate, unadjusted for initial expected credit losses.

(c) staff analysis and recommendation (paragraphs 11–25).

What the ED proposed and why

5. The ED proposed that for POCI assets the entity should:

   (a) not recognise a loss allowance for its initial estimates of lifetime expected credit losses (ECL);

   (b) recognise at each reporting date, as a loss allowance, *cumulative changes in lifetime ECL* since initial recognition. Cumulative changes in lifetime ECL are recognised as an impairment gain or loss; and

   (c) measure and present interest revenue by applying the *credit-adjusted* effective interest rate (EIR) to the amortised cost (net carrying amount) of the POCI asset, ie adjust for the allowance.

6. The proposals effectively carried forward the requirements in paragraph AG5 of IAS 39. Furthermore, the proposals are also consistent with the model presented in the 2009 Exposure Draft *Amortised Cost and Impairment* (the '2009 ED').[2]

7. In developing the proposals for POCI assets, the IASB argued:

> BC137 … to carry forward the scope and requirements in paragraph AG5 of IAS 39, whereby an entity is required to include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate for financial assets that have objective evidence of impairment on initial recognition. In addition, entities shall present interest revenue from financial assets

[2] In contrast to our proposals, the FASB's Proposed Accounting Standards Update *Financial Instruments – Credit Losses (Subtopic 825-15)* (ASU) amendments proposed that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition should not be amortised into and recognised as interest income over the life of the asset. To achieve this result, upon acquisition the initial estimate of expected credit losses would be recognised as an adjustment that increases the cost basis of the asset. Apart from this requirement, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favourable or unfavourable) would be recognised immediately as bad-debt expense rather than as yield. [Question 6 of the ASU]

subject to this measurement requirement in the statement of profit or loss and other comprehensive income, calculated by applying the credit-adjusted effective interest rate to the amortised cost of the financial asset (adjusting for any loss allowance).

BC138 … the IASB acknowledged the superior information that would be provided as a result of applying the proposed requirements in the 2009 ED, particularly if the credit quality of the financial asset is so low that the financial asset has objective evidence of impairment on initial recognition. In the IASB's view, this model more faithfully represents the underlying economics for these financial assets than the general model, and the benefits of this better representation outweigh the costs for these financial assets. Some users of financial statements would prefer a single expected credit loss model for all financial assets to ensure comparability. However, in the IASB's view, applying the general model to purchased or originated credit-impaired financial assets would not[3] achieve the desired comparability, because the model will not faithfully represent the underlying economics for this set of financial assets.

…

BC140 Consistently with the 2009 ED, this model considers the initial credit loss expectations to be part of the effective interest rate and thus interest revenue will represent the effective yield on the asset. An entity will recognise changes in the initial expected credit losses as gains or losses. … However, in developing the proposals in this

[3] The word 'not' was omitted in the ED. This was a typo error.

Exposure Draft, the IASB observed that this requirement in IAS 39 has not presented issues in practice and proposes to retain it, and to use a scope that is based on IAS 39 to minimise the operational challenges for preparers.

Detailed feedback

8. Except as discussed in paragraph 9, respondents were almost unanimous in their support for the proposals for POCI assets. Respondents noted that:

   (a) it is the conceptually correct answer, similar to the 2009 ED, and appropriately reflects the economics of the transaction. Respondents argued that for POCI assets the proposals are operable because they are consistent with the existing accounting treatment in accordance with IAS 39; and

   (b) the proposals better reflect management's objective when acquiring or originating such assets, which is to earn a return after considering ECL.

9. A number of respondents did not agree with the proposals. These respondents preferred a 'gross-up' approach, stating that:[4]

   (a) it would be operationally simpler to have a gross presentation of all initial ECL (ie for both POCI assets and other financial assets within the scope of the impairment model). They argue that the proposals in the ED result in the POCI assets being segregated and tracked as closed portfolios, which is burdensome and not aligned with the way assets are managed.

   (b) comparability would be improved for users of financial statements if there was an allowance balance for POCI assets like there is for other assets.

10. Lastly, some respondents asked for more guidance on identifying originated credit-impaired financial instruments.

[4] This is an approach proposed by the IASB whereby an allowance is recognised for initial ECL and used to gross-up the carrying amount of the POCI asset.

Staff analysis and recommendation

11. Respondents were almost unanimous in their support for the proposals to apply the credit-adjusted EIR on POCI assets and to recognise subsequent changes in lifetime ECL immediately in profit or loss. No new information was raised that we consider would affect our previous analysis. Furthermore, respondents did not raise any concerns on the threshold to apply the POCI asset proposals being 'objective evidence of impairment' on initial recognition. We believe that this is aligned with their argument that the treatment is the same as IAS 39 today. Therefore, we do not intend to discuss these aspects of the proposals again. Instead, we are only discussing the recognition of initial lifetime ECL and potential clarifications for POCI assets.

Recognition of lifetime ECL

12. As mentioned in paragraph 9, some respondents preferred a gross-up approach to recognise initial lifetime ECL. The following diagram illustrates the difference between the gross-up approach and the current proposals:

Diagram: illustrating gross-up approach vs current proposals

Gross-up approach
- Asset of 925
- Allowance (175)

Loan at par	1000
Non-credit discount	75
Allowance for credit impairment	175
Pay cash	750

Current proposal
- Asset of 750 (EIR adjusted for losses of 175)

13. The arguments put forth by respondents were previously considered by the IASB and addressed in the Basis for Conclusion as discussed in paragraph 7 of this Staff Paper.

14. We note that even if the allowance balance was calculated for POCI assets, the carrying amounts would not be comparable—POCI assets will be grossed up for the allowance balance, whereas other assets would be *net* of the allowance. Also, even for POCI assets lifetime ECL are disclosed.

15. To address the need for users to be able to perform an analysis of key performance ratios, considering the initial ECL, the IASB already proposed disclosure of the total amount of undiscounted ECL at initial recognition (see paragraph 35(d) of the ED).

16. We are of the opinion that the reasons set out in the ED and its Basis for Conclusions still hold and that no new arguments were presented. We therefore recommend confirming the proposals in the ED for POCI assets.

Clarifications

Originated credit-impaired financial assets

17. As mentioned in paragraph 10, some respondents requested more guidance on when an instrument would be regarded as originated credit-impaired.

18. Appendix A of the ED defined an originated credit-impaired financial asset as:

> … [an] originated financial assets(s) that have **objective evidence of impairment on initial recognition.**
>
> [emphasis added]

19. Furthermore, Appendix A defined what information indicates 'objective evidence of impairment'. It stated:

> One or more events that have occurred that have an impact on the expected future cash flows of the financial instruments. It includes observable data that has come to the attention of the holder of the financial instrument about the following events:
>
> (a) significant financial difficulty of the issuer or the borrower;
>
> (b) a breach of contract, such as a default or delinquency in interest or principal payments;
>
> (c) the lender(s) of the borrower, for economic or contractual reasons relating to the borrower's financial difficulty, having granted to the borrower a concession(s) that the lender(s) would not otherwise consider;

> (d) it becoming probable that the borrower will enter bankruptcy or other financial reorganisation;
>
> (e) the disappearance of an active market for that financial asset because of financial difficulties; or
>
> (f) the purchase of a financial asset at a deep discount that reflects the incurred credit losses.
>
> It may not be possible to identify a single discrete event—instead, the combined effect of several events may have caused objective evidence of impairment

20. In short, an instrument would be originated credit-impaired when, on origination, it would be classified as Stage 3 of the proposed model (see also Staff Paper 5C of this month's papers).

21. In the Basis for Conclusion, the IASB stated that it does not think this would occur often:

> BC139 … while the scope usually relates to purchased financial assets, in **unusual circumstances** financial assets could be originated that would be within this scope. However, this does not mean that all financial assets originated at a low credit quality are within the scope—there has to be objective evidence of impairment on initial recognition. The IASB considered a **situation in which there was a substantial modification of a distressed asset that resulted in derecognition. In such a case, it would be possible for the modification to constitute objective evidence that the new asset is impaired.**
>
> [emphasis added]

22. We note that the concept of an originated credit-impaired asset is not new to IFRS. The IASB considered that instruments do not have objective evidence of impairment *merely* because they have it has high credit risk (low credit quality) at initial recognition. This is because when an entity originates a high credit risk

instrument, it would be priced to reflect (ie the interest rate charged would reflect) the initial ECL.

23. Originated financial assets that have objective evidence of impairment at initial recognition were also previously considered by the IFRS Interpretation Committee. The following is an extract from the *IFRIC Update* for July 2012.[5]

> **IAS 39 *Financial Instruments: Recognition and Measurement*—Scope of paragraph AG5**
>
> … **Applying paragraph AG5 of IAS 39 means that the effective interest rate would be determined at initial recognition using estimated cash flows that take into account incurred credit losses.**
>
> The Committee noted that **paragraph AG5 of IAS 39 applies to acquired assets, which includes both purchased and originated assets.** The Committee also noted that even though an **origination of a debt instrument with an incurred loss is rather unusual**, there are situations in which such transactions occur. For example, in the context of significant financial difficulty of an obligor, transactions can arise that involve originations of debt instruments that are outside the normal underwriting process but instead forced upon already existing lenders by a restructuring process. This could include situations in which modifications of debt instruments result in derecognition of the original financial asset and the recognition of a new financial asset under IFRSs. In these circumstances, new financial assets could be recognised that have incurred losses on initial recognition. The Committee noted that whether an incurred loss exists on initial recognition of an asset is a factual matter and that the assessment requires judgement.

[5] 2012 July IFRIC Agenda Paper 6A *IAS 39: Recognition and Measurement: Determining the effective interest rate of restructured Greek Government Bonds*.

> The Committee considered that in the light of its analysis of the existing requirements of IAS 39 an interpretation was not necessary and consequently [decided] not to add the issue to its agenda.[emphasis added]

24. As noted in paragraph6, the requirement of paragraph AG5 of IAS 39 was carried forward to the proposals in the ED. Therefore, the same analysis would apply.

25. We recommend addressing the respondents' concerns for more guidance in drafting.

Question to the IASB
Does the IASB agree to: - confirm the proposals in the ED for POCI assets; and - address, in drafting, the request for more guidance on originated credit-impaired financial?