STAFF PAPER

IASB Meeting

Project	**Financial Instruments: Impairment**		
Paper topic	Stage 1 Measurement objective		
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Introduction

Purpose of this paper

1. The Exposure Draft ED/2013/3 *Financial Instruments: Expected Credit Losses* ('the ED') proposed that 12-month expected credit losses (ECL) be recognised for financial instruments for which there has not been a significant increase in credit risk since initial recognition. 12-month ECL are the expected shortfalls in contractual cash flows over the life of a financial instrument that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring.

2. The purpose of this agenda paper is to consider whether the IASB would want to retain the 12-month ECL measurement objective for financial instruments in Stage 1 of the proposed general model. The paper does not consider any alternative expected credit loss impairment models, such as recognising lifetime ECL on all financial instruments. It also does not consider the measurement of expected credit losses which will be discussed at a future meeting.

Summary

3.   The vast majority of respondents supported the proposals in the ED as an appropriate balance between faithful representation of credit losses on financial instruments and the costs of producing that information. Most specified that they agree with the IASB that initial credit loss expectations are priced into assets when originated or purchased and supported an approach that considers increases in credit risk when deciding the extent to which expected credit losses should be recognised. Furthermore, most accepted the 12-month ECL as an operational simplification of reflecting the initial credit loss expectations and welcomed the ability to use different methods to calculate it. However, some did not agree with recognising any expected credit losses for financial instruments where credit risk has not increased significantly since initial recognition. Others suggested alternative measurement objectives that would address some of the concerns raised about the conceptual justification and/or operability of the proposed measurement objective.

4.   The staff note that the IASB has already considered and rejected some of the alternatives suggested. This agenda paper therefore considers the suggested alternatives as follows:

     (a)   Alternatives previously considered:

         (i)   Foreseeable future or reliably estimable and predictable period (paragraph 24-26);

         (ii)   Loss emergence periods (paragraph 27-30);

         (iii)   Outlook period longer than 12 months (paragraph 31-33).

     (b)   Other alternatives

         (i)   Option 1: No ECL allowance for Stage 1 (paragraph 34-40);

         (ii)   Option 2: Retain 12-month ECL measurement objective (paragraph 41-48);

Staff recommendation

5. The staff consider the 12-month ECL (Option 2) to be superior to all the other alternatives considered as the Stage 1 measurement objective, for the reasons set out in the ED and for the reasons discussed in paragraphs 43 and 44: The staff therefore recommend that the IASB retain the measurement objective for financial instruments in Stage 1 as proposed in the ED and reaffirm why this measurement objective is considered appropriate a proxy for:

    (a) the measurement and allocation of initial expected credit losses; and

    (b) subsequent changes in credit risk that are not considered significant.

6. This paper is set out as follows:

    (a) What the ED proposed and why (paragraphs 7-9)

    (b) Detailed feedback received (paragraphs 10-22);

    (c) Analysis of alternatives suggested (paragraphs 23-48); and

    (d) Staff recommendation and questions to the IASB (paragraphs 49-51).

What the ED proposed and why

7. This section provides the relevant proposals, the related Basis for Conclusions and the question asked in the ED:

    > [Par 4] Subject to paragraphs 12–15, at the reporting date an entity shall measure the expected credit losses for a financial instrument at an amount equal to the *12-month expected credit losses* unless the requirements of paragraph 5 are met.

    > [Par 5] At the reporting date, the entity shall measure the expected credit losses for a financial instrument at an amount equal to the *lifetime expected credit losses* if the credit risk on that financial instrument has increased significantly since initial recognition.

[App A] 12-month expected credit losses: The expected credit losses that result from those default events on the financial instrument that are possible within the 12 months after the reporting date.

8.   Extract from the Basis for Conclusions:

[BC29] The IASB concluded that a recognition mechanism is required that preserves, to as great an extent as possible, the objective of the 2009 ED and reduces the effect of double-counting. Thus, the IASB decided to pursue a model that recognises two different amounts for different phases of deterioration in credit quality. Such a dual-measurement model would require that an entity must recognise:

(a) a portion of the lifetime expected credit losses from initial recognition as a proxy for recognising the initial expected credit losses over the life of the financial asset; and

(b) the lifetime expected credit losses when credit quality has deteriorated since initial recognition (ie when the recognition of only a portion of the lifetime expected credit losses is no longer appropriate because the entity has suffered a significant economic loss).

[BC30] The IASB considered the timing of the recognition of the full lifetime expected credit losses together with the size of the portion of the lifetime expected credit losses that are recognised from initial recognition. The IASB considered the interaction between these decisions to be a determinant of what would provide a more faithful representation of the economic loss, and what would best approximate the outcome of the model in the 2009 ED. Thus, if an entity recognises a smaller portion of the lifetime expected credit losses initially, it should recognise the full lifetime expected credit losses earlier than if it were

required to recognise a larger portion of the lifetime expected credit losses initially.

[BC40] While the proposal to require an entity to recognise 12-month expected credit losses for financial instruments that have not significantly deteriorated in credit quality will be less costly and complex than estimating the full expected cash flows for all financial instruments, the calculation will increase the cost and complexity compared to current requirements (see paragraphs BC61–BC66). This cost will be lower for entities that are already required to measure a similar amount to comply with prudential regulations. However, even those entities would have to adjust the measurement to meet the requirements of the proposals in this Exposure Draft. The requirements will increase the costs of implementation for entities that are not required to measure 12-month expected credit losses to comply with prudential regulations, because it will be a unique calculation that would not normally be required for other purposes. Notwithstanding these costs, measuring 12-month expected credit losses will be less costly and complex than a measurement that would require the entity to estimate all expected cash flows, such as the 2009 ED and the model in the SD. In addition, in some cases, entities can use information such as credit loss rates for measuring 12-month expected credit losses, thus building on information that they have already used for credit risk management purposes.

[BC61] The IASB considered what measure of expected credit losses would be both appropriate and cost-effective for financial instruments at initial recognition and before significant deterioration in credit quality has occurred. The IASB accepted the concerns of interested parties about the operational complexity of the methods proposed in the 2009 ED and the SD. The IASB also accepted that significant judgement would be required for any estimation

technique that an entity might use. Consequently, the IASB decided that an entity should measure the loss allowance at 12-month expected credit losses. In the IASB's view, the overall result of such a measurement, combined with the earlier recognition of the full lifetime expected credit losses, would achieve an appropriate balance between the benefits of a faithful representation of expected credit losses and the operational costs and complexity. The IASB acknowledges that this is an operational simplification, and that there is no conceptual justification for the 12-month time horizon.

[BC62] The IASB considered whether an entity should recognise a larger portion of expected credit losses before there is significant credit deterioration. However the IASB rejected requiring a larger portion of expected credit losses to be recognised because:

(a) a larger portion would increase the overstatement of expected credit losses at initial recognition and thus, when considered with the much earlier timing of the recognition of the lifetime expected credit losses, would be a less faithful representation of the underlying economics; and

(b) 12-month expected credit losses are similar to a measurement that some regulated financial institutions already apply, and would therefore be less costly to implement for those entities.

[BC63] To address concerns raised about the ambiguity of the 'foreseeable future' definition in the SD, the IASB decided to define the portion of the lifetime expected credit losses that are to be recognised initially in a better way than the SD did. 12-month expected credit losses is the lifetime cash shortfalls that will result if a default occurs in the 12 months after the reporting date, weighted by the probability of that default occurring. Thus, 12-month expected credit losses are a portion of the lifetime expected credit losses. An entity would measure both

amounts consistently at an expected present value (see paragraphs BC81–BC97). 12-month expected credit losses are not the lifetime expected credit losses that an entity will incur on financial instruments that it predicts will default in the next 12 months. The IASB observed that if an entity applies the proposals properly, it would recognise lifetime expected credit losses on financial instruments on which it predicts a default to occur in the next 12 months, because they would have deteriorated in credit quality since initial recognition (unless they are purchased or originated credit-impaired financial assets). 12-month expected credit losses are not the cash shortfalls that are predicted over the next 12 months.

[BC64] The similarity between the 12-month expected credit losses calculation and some prudential regulatory requirements for the 12-month probability of default also reduces the cost of implementation for some sophisticated financial institutions. However, an entity will have to adjust these regulatory measurements of the probability of default to comply with the proposed requirements in this Exposure Draft. For other entities, the measurement of the 12-month expected credit losses is a calculation that would not normally be required for other purposes. However, in some cases, the cost can be minimised by building on information that an entity already uses for risk management purposes, such as credit loss rates.

[BC66] The IASB acknowledges that the 12-month expected credit losses proposal in this Exposure Draft would result in an overstatement of expected credit losses for financial instruments, and a resulting understatement of the value of any related financial asset, both at and immediately after initial recognition of those financial instruments. In particular, the initial carrying amount of financial assets would be below their fair value. However, isolating initial credit loss expectations for recognition over

the life of financial instruments is operationally complex and this measurement of expected credit losses serves as a practical approximation. The recognition of a portion of expected credit losses for financial instruments that have not deteriorated significantly in credit quality also limits the requirement to perform the more costly and complex calculation of the lifetime expected credit losses. In addition, in the IASB's view, measuring 12-month expected credit losses for some financial instruments would be less costly than always calculating the lifetime expected credit losses as proposed in the SD.

9.   Questions from the ED:

> **Question 2 [extracted from ED]**
>
> (a) Do you agree that recognising a loss allowance (or provision) at an amount equal to 12-month expected credit losses and at an amount equal to lifetime expected credit losses after significant deterioration in credit quality achieves an appropriate balance between the faithful representation of the underlying economics and the costs of implementation? If not, why not? What alternative would you prefer and why?

> **Question 4 [extracted from ED]**
>
> Is measuring the loss allowance (or a provision) at an amount equal to 12-month expected credit losses operational? If not, why not and how do you believe the portion recognised from initial recognition should be determined?

Detailed feedback received

Stage 1 measurement objective

10. Most respondents, including users of financial statements accepted the 12-month ECL as a pragmatic solution to achieve an appropriate balance between faithfully representing the underlying economics and the cost of implementation. Most users considered 12 months a reliable period to estimate expected credit losses for financial instruments that have not significantly deteriorated. Additionally some user representative groups stated that a 12-month ECL allowance provides them with useful information, as they consider that on a portfolio level some expected credit losses may arise during the reporting period that were not adequately priced in.

11. However, some respondents did not agree with recognising any expected credit loss allowance for financial instruments that have not experienced significant credit deterioration since initial recognition. These respondents considered initial expectations of credit losses to be included in the pricing of a financial instrument and they were conceptually opposed to the recognition of a loss allowance on initial recognition ('Day 1 losses'). A few others were only opposed to recognising 12-month ECL on financial assets such as high quality debt securities that would be measured at fair value through other comprehensive income (FVOCI) in accordance with the Classification and Measurement ED.

12. Jurisdictional differences and/or preferences have also emerged, whereby preparers in some jurisdictions were concerned that the 12-month ECL would result in a reduction of overall allowance balances. This is because entities in these jurisdictions have applied current accounting requirements (including in some cases IAS 39) more broadly.

13. One respondent noted that replacing the term 'probability of default' with the probability of 'significant deterioration' would in their view ensure that the 12-month ECL is not linked solely to payment default but instead captures indicators or loss expectation that precipitate eventual non-payment.

14. The staff note that in some cases concerns about the adequacy of the 12 month allowance may have been related to a misconception about when such financial instruments would move to a lifetime ECL measure or a concern about how the proposals might be applied in practice. The ED proposed that changes in credit risk should be assessed over the life of the instrument and not just over the next 12 months so the outlook period for the assessment of deterioration extended beyond 12 months.

Foreseeable future or reliably estimable and predictable period

15. Some respondents explicitly commented that they do not support concepts such as 'foreseeable future' or 'reliably estimable and predictable' as a measurement objective. These respondents consider the foreseeable future to be open to manipulation because it cannot be clearly defined and is not founded in credit risk management. They also consider a foreseeable future or reliably estimable and predictable period to weaken the link to the 2009 ED of expected credit losses reflecting the economics of lending.

16. Others were concerned that a period that is reliably estimable and predictable during favourable economic circumstances may not remain the same under less favourable circumstances (ie it may contract in periods of increased uncertainty). Respondents also expressed concern that such an approach would penalise more sophisticated entities that are capable of longer range forecast and may discourage entities from properly developing expected credit loss models.

Outlook or loss emergence period longer than 12 months

17. A small number of respondents, in particular some regulators and users of financial statements, were concerned that the 12-month ECL would not adequately reflect the expected credit losses inherent in some financial instruments such as interest-only mortgages or bullet repayment loans (instruments that require that significant payments only be made at maturity). Some of these respondents considered an outlook or loss emergence period of more than 12 months to be a potential way in which to achieve convergence.

18.   Others specifically commented that they were strongly opposed to extending the loss allowance for financial instruments that have not significantly deteriorated to encompass an outlook period beyond 12 months. They were willing to accept the 12-month ECL as a pragmatic solution (see paragraph 10) to recognise the initial expected credit losses and measure changes in expected credit losses resulting when those changes are not significant.

Operability

19.   Although most respondents considered the 12-month ECL to be without conceptual justification, many accepted it as a pragmatic solution to achieve the objectives of the proposed model.

20.   Most respondents, including some who did not support the 12-month ECL as the measurement objective for Stage 1, considered it to be operational. This was because entities would be able to leverage existing credit risk management systems and data, including regulatory models, as the basis from which to apply the proposed approach.

21.   Among the respondents that considered the 12-month ECL to be operable were insurance entities and corporate entities, as well as financial institutions that were using less sophisticated credit risk management systems. These respondents did however request additional guidance and examples on how to implement the proposals.

22.   Some respondents have commented that for Basel-regulated entities, the operational complexity could be further reduced if the 12-month ECL were fully aligned to the expected credit loss measure applied for prudential regulatory purposes[1].

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[1] This agenda paper does not consider the measurement of expected credit losses. This will be considered at a future meeting.

Alternatives previously considered and rejected

23.   During the development of the expected credit loss model proposed in the ED, the IASB considered alternative measurement objectives for those financial instruments where credit risk has not increased significantly since initial recognition. The following alternatives suggested by respondents in their comment letters have been previously considered and rejected by the IASB for the reasons set out below and no further analysis of these alternatives are performed.

Foreseeable future or period that is reliably estimable and predictable

24.   The Supplementary Document *Financial Instruments: Impairment* ('the SD') published in January 2011 proposed that financial assets should be divided into two groups: those for which the recognition of lifetime expected credit losses over time would be appropriate ('the good book') and those for which the immediate recognition of lifetime expected credit losses would be appropriate ('the bad book'). The loss allowance for the good book would have been calculated as the greater of:

(a)   a time-proportionate loss allowance and

(b)   expected credit losses for the foreseeable future, ie a 'floor' for expected credit losses.

25.   The feedback received about the floor for the good book was geographically split, with respondents outside the US generally opposing it and respondents from the US generally supporting it. Furthermore, respondents expressed concerns about the calculation of expected credit losses for the foreseeable future, with many expressing confusion about the underlying conceptual basis for such a limitation to the time period[2]. Many also noted that, notwithstanding the conceptual concerns, the boards had not sufficiently defined the term 'foreseeable future' to ensure consistent application.

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[2] In contrast, the 12-month ECL measure considers the <u>lifetime</u> ECLs that would arise if a default arose in the next 12 months, weighted by the probability of such default occurring.

26. In response to the concerns raised about the foreseeable future, the IASB rejected the approach. To address these concerns about the ambiguity of the foreseeable future definition in the SD, the IASB decided to define the measurement objective for financial instruments in Stage 1 as 12-month ECL.

Loss emergence period

27. During the development of the proposed model, the IASB considered defining the Stage 1 measurement objective as the total amount of shortfalls in cash flows expected to materialise on financial assets for which there has been no meaningful deterioration in credit quality, based on expected loss emergence patterns[3]. Under this alternative, entities would consider all reasonable and supportable information available to it, including historical information in order to determine the average period of time over which meaningful deterioration is expected to occur.

28. In considering the loss emergence period, the IASB considered the following three approaches:

    (a)   not defining boundaries for the emergence period;

    (b)   a floor of 12 months but with no upper boundary; and

    (c)   defining a range for an emergence period (eg between 12 and 24 months).

29. The IASB considered that different asset classes have different loss patterns and different loss emergence periods, therefore estimating expected credit losses over the relevant period of time it takes for an event to happen and for the effects to be known, may be conceptually correct. However, the IASB noted that 'emergence' notions fit more naturally in an incurred loss model where it is difficult to identify when a loss has been incurred on an individual items.

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[3] Agenda paper 6A, Topic 2, December 2011

30. The IASB also noted that emergence periods may change over the life of financial instruments and depend on the economic cycle. As a result, the IASB considered that this approach would be more operationally difficult than one that has a defined period because an entity would have to continually assess that it was using the appropriate emergence period using all information available to it.

Outlook period of more than 12 months

31. The IASB also considered whether to require expected credit losses to be estimated over an outlook period of more than 12 months, in particular 24 months was considered. The IASB rejected this approach for the following reasons as set out in paragraph BC62 of the ED:

    (a) A longer outlook period would increase the overstatement of expected credit losses at initial recognition and thus, when considered with the much earlier timing of the recognition of the lifetime expected credit losses (when significant increases in credit risk occur), would be a less faithful representation of the underlying economics; and

    (b) 12-month ECL are similar to the measurement that some regulated financial institutions already apply, and would therefore be less costly to implement for those entities than a measure that requires a period of more than 12 months.

32. As noted in paragraph 18, some respondents specifically commented that they would not support a period of more than 12 months as the measurement objective for Stage 1. They consider a 12 month period to be consistent with the period used for credit risk management and regulatory purposes. Some also noted that for some products a period of more than 12 months, eg 24 months may be close to or more than the expected lifetime of the product, which would result in lifetime ECL being recognised without a significant increase in credit risk since initial recognition.

33.   The staff are of the view that the only circumstance in which the IASB should reconsider extending the outlook period would be if that provided an opportunity for convergence (ie if the FASB were to consider making a distinction in the measurement of ECL based on changes in credit risk and were to use an outlook period of more than 12 months for those items where credit risk has not increased significantly).

Other alternatives (not previously considered by the IASB)

Option 1: No ECL allowance for Stage 1

34.   Most of the respondents that did not support the measurement objective for Stage 1 did so because they disagree conceptually with recognising expected credit losses on initial recognition of a financial instrument that is initially measured at fair value (as is always the case under IFRS) as this does not faithfully represent the economics of the transaction.

35.   Some also noted that the proposed model is not responsive enough to changes in credit risk and that the effect of significant increases in credit risk are not captured on a timely basis[4]. They noted that if the responsiveness of the proposed model is improved so that significant increases in credit risk are captured even if it is not evident at the individual exposure level, no allowance balance would be required for financial instruments for which credit risk has not increased significantly.

Staff analysis:

36.   Paragraph BC66 of the ED acknowledges that the 12-month ECL would result in an overstatement of expected credit losses and a resulting understatement of the initial carrying amount of financial assets which would be below their fair value. Recognising no allowance balance for financial instruments for which credit risk has not increased significantly, would in fact be consistent with the requirement in IFRS 9 *Financial Instruments* that financial instruments should be recognised at fair value on initial recognition.

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[4] See Agenda Paper 5A for this meeting

37.   The staff does acknowledge that there is a relationship/balance to be struck between the recognition of ECLs for financial instruments in Stage 1 and for other financial instruments. Therefore if the IASB decides to make changes to the proposals in the ED that result in earlier recognition of significant increases in credit risk[5] there is arguably less need to capture ECLs for items that have not significantly increased in credit risk that are essentially still appropriately priced for their credit risk. However, only recognising lifetime ECL when there has been a significant increase in credit risk, without recognising any expected credit losses before that to reflect the changes in initial expectations since initial recognition, would still fail to appropriately reflect the economic losses experienced as a result of those changes (even if not significant). As explained in paragraph BC19 expected credit losses are implicit in the initial pricing for the instrument but <u>subsequent changes in those expectations represent economic losses (or gains) in the period in which they occur</u>. Not reflecting increases in credit risk before the change is considered significant, will fail to recognise those economic losses.

38.   Regulators and users of financial statements were particularly concerned that changes in loss expectations since initial recognition may not be adequately recognised and measured until significant credit deterioration occurs. Recognising expected credit losses only when there has been a significant increase in credit risk will further delay the recognition of expected credit losses compared with the ED. It would also risk being subject to the same criticisms as the incurred loss model that the recognition of expected credit losses would be delayed until the occurrence of an event, even if the event represents a significant increase in credit risk rather than an incurred loss.

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[5] See Agenda paper 5A for this meeting.

Staff conclusion

39. The staff agree with the reasons provided in paragraphs BC19 and BC66. More importantly, the staff consider not recognising the economic losses that arise from changes in initial expectations before they are considered significant, as inconsistent with the objectives of the proposed model. They also note that in the absence of the recognition of some ECLs for financial instruments in Stage 1 the full contractual interest would be recognised with no offset for initial credit loss expectations. While the recognition of the 12-month ECL is a very crude approximation for the yield adjustment achieved by the IASB's 2009 ED, the staff think that it would be inappropriate to have no adjustment at all.

40. The staff believe that if no loss allowance is required for financial instruments in Stage 1, the point at which lifetime ECL is recognised should be earlier than when credit risk has increase significantly. However, most respondents agreed that it is appropriate to recognise lifetime ECL when there has been a significant increase in credit risk. The staff therefore does not recommend changing the timing of recognition of lifetime ECL in conjunction with having no allowance for Stage 1 financial instruments.

Option 2: Retain 12-month ECL subject to clarification

41. As stated in paragraph 10, most respondents, including users of financial statements accept the 12-month ECL as a pragmatic solution to achieve an appropriate balance between faithfully representing the underlying economics and the cost of implementation.

42. However, respondents raised the following concerns and proposed that these matters be clarified to improve the understanding and application of the Stage 1 measurement objective:

    (a)   lack of conceptual understanding about what the 12-month ECL represents;

    (b)   limiting the outlook period to 12 months only considers the probability that a default will occur within the 12-months after the reporting date and ignores the subsequent periods; and

(c)   the information that should be considered and how the 12-month ECL
should be measured.

The discussion below considers (a) and (b) above. The information that should
be considered and the measurement of expected credit losses ((c) above) will
be considered at a future meeting.

Staff analysis

(a)   Understanding what the 12-month ECL represents

43.   With the 2009 ED, one of the IASB's objectives was to address concerns that the
existing incurred loss model in IAS 39 results in overstating interest revenue in
periods before a credit loss event occurs. Because of operational challenges and
the desire of users of financial statements to see the contractual interest revenue
separately from the accounting for expected credit losses, the IASB decided to
decouple the measurement and allocation of initial expected credit losses from the
determination of the effective interest rate. The 12-month ECL therefore serves as
a crude proxy for the measurement and allocation of initial expected credit losses.

44.   In addressing the operational challenge of having to estimate the full expected
cash flows for all financial instruments as required by the 2009 ED, the proposed
model only requires lifetime ECL to be recognised when credit risk has increased
significantly. However, as explained in paragraph 37, changes in credit loss
expectations subsequent to initial recognition give rise to economic losses. Only
recognising lifetime ECL when there has been a significant increase in credit risk,
without recognising any expected credit losses before that to reflect the changes in
initial expectations since initial recognition, would fail to appropriately reflect the
economic losses experienced as a result of those changes. The 12-month ECL
therefore also serves as a proxy to measure those subsequent changes in
expectations in a way that is operational and less costly than the proposals in the
2009 ED.

(b)   Limited to 12 month outlook period

45.   One of the main areas for concern expressed about the 12-month ECL is that it
only considers the probably of a default occurring within the 12 months after the
reporting date and ignores those that are expected to occur in later periods.

46.   The staff note that although 12-month ECL is measured based on the probability of a default occurring in the next 12 months, the period over which changes in credit risk should be assessed is the remaining life of the instrument and is <u>not</u> limited to 12 months. Thus it was not the case that the ED ignored default risk beyond a 12 month period. As explained in paragraph 44, the 12-month ECL was a pragmatic solution to recognise changes in credit risk that are not significant. **Agenda paper 5A** considers concerns that the significant increases in credit risk are not identified on a timely basis.

Staff conclusion

47.   The staff consider the 12-month ECL to be superior to all the other alternatives considered as the Stage 1 measurement objective, for the reasons set out in the ED and in the above paragraphs.

48.   The staff therefore recommend that the IASB retain the measurement objective for financial instruments in Stage 1 as proposed in the ED and reaffirm why this measurement objective is considered appropriate[6].

Staff recommendation

49.   The staff **recommendation** is to retain the 12-month ECL as the measurement objective for financial instruments in Stage 1 (**Option 2**) for the reasons set out in the ED and as explained in paragraphs 43-46.

50.   The staff **rejected** not recognising a loss allowance for Stage 1 financial instruments (**Option 1**) because the staff consider that not recognising the economic losses that arise from changes in initial expectations before they are considered significant is inconsistent with the objectives of the proposed model which aims to reflect changes in credit risk on a timely basis.

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[6] Some suggested a modification to focus on the probability of significant deterioration. However this would be inconsistent with credit risk management systems and thus would require recalibration of risk parameters which would involve significant costs. Furthermore, if the expected credit losses measured for accounting purposes are not consistent with the information used for credit risk management purposes, relevant and useful information will not be provided to the users of financial statements. While the staff acknowledge it would result in more timely recognising lifetime ECL, they do not think that this approach is viable due to the cost of producing this information and the disconnect with credit risk management.

51.   The staff further believe that if no loss allowance is required for financial instruments in Stage 1, the point at which lifetime ECL is recognised should be earlier than when credit risk has increased significantly. However, this would be inconsistent with the feedback received from respondents regarding what is operational.

Question to the IASB

Does the IASB agree with the recommendation to retain the 12-month ECL as the measurement objective for financial instruments in Stage 1 of the proposed model? If not, why not and which measurement objective does the IASB prefer?