

## STAFF PAPER

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## REG IASB Meeting

Project	Financial Instruments: Impairment		
Paper topic	Report on the Fieldwork		
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## Introduction

1. During the July 2013 joint IASB and FASB meeting the staff presented Agenda Paper 5B *Impairment: Outreach Summary Feedback—Fieldwork*. The paper summarised some of the main observations that were made during the IASB's fieldwork. It also included, as an Appendix, the instructions and the hypothetical scenario that was provided to participants. The Appendix is not reproduced in this paper.

## Structure of the paper

2. The flow of the paper is:
  - (a) reasons for and benefits of undertaking the fieldwork (see paragraphs 3-5)
  - (b) overview of field work participants and portfolios (see paragraphs 6 - 12)
  - (c) Fieldwork: Operability of proposals, feedback and observations
    - (i) Operability and feedback on having a model with different measurement objectives based on changes in credit risk (see paragraph 13)

- (ii) Operability and feedback on the identification of the significant increase in credit risk (including use of operational simplifications) (see paragraphs 14 -24)
  - (iii) Operability and feedback on measuring the loss allowance for assets that did not have a significant increase in credit risk (see paragraphs 25 -30)
  - (iv) Operability and feedback on the measurement of expected credit losses (ECL) (including use of discount rate, behavioural life on credit cards, lifetime ECL on day 1) (see paragraphs 31 - 37)
  - (v) Operability and feedback on the treatment of financial instruments for which there is objective evidence of impairment (see paragraphs 38 - 41)
  - (vi) Operability and feedback on the use of the simplified approach for trade and lease receivables (see paragraphs 42 - 48)
  - (vii) Time and resources required to implement new standard (see paragraphs 49 - 50)
- (d) Responsiveness and directional impact of proposals – compared to IAS 39 on transition and over time (see paragraph 51)
- (e) Next steps (see paragraph 52); and

## Reasons for and benefits of undertaking the fieldwork

3. The IASB believes that a wide consultation with interested and affected parties enhances the quality of IFRS. This consultation can include fieldwork (see paragraph 3.41 of the *Due Process Handbook* (as published in February 2013)). The IASB therefore decided that the staff should undertake fieldwork as part of the consultation on the proposed Exposure Draft: *Financial Instruments: Expected Credit Losses* during the comment period.
4. The primary objective of the fieldwork was to determine how the proposed impairment model responds to changing economic circumstances over time. It also provided us with an understanding of the operational challenges for the implementation of the proposals, specifically the operability of:
  - (a) a model with different measurement objectives based on changes in credit risk;
  - (b) assessing significant increases in credit risk;
  - (c) measurement of ECL; and
  - (d) the simplified approach applied to trade and lease receivables.

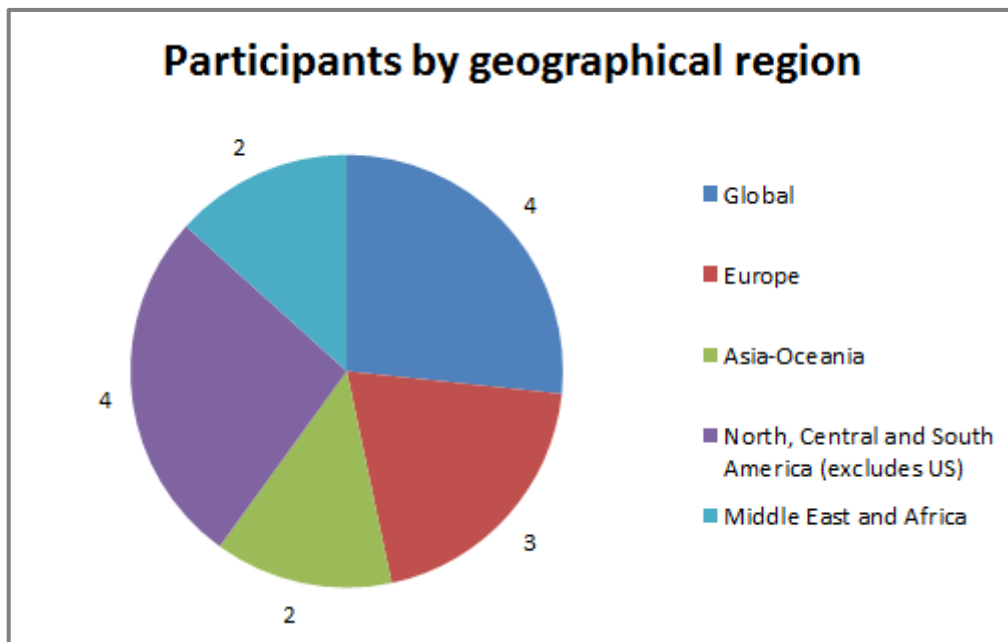
In addition, the fieldwork provided us with directional information on the allowance balances compared to current IFRS.

5. We believe that the benefits of the fieldwork undertaken, *which included simulations using real economic data*, were:
  - (a) it allowed the field participants to actively engage with us to better understand the proposals and to provide us with enriched and valuable feedback based on their experience, as they had to consider in detail how they will implement our proposals (and alternative models); and
  - (b) by working with field participants the staff have obtained a more thorough understanding of the mechanics of measuring expected credit losses (both 12 month and lifetime), techniques to adjust forward-looking information, potential approaches to assess credit deterioration and the effects and relevance of discounting.

## Overview of fieldwork participants and portfolios

### Participants

6. The IASB invited a small number of preparers who represented the major geographical regions across the world and who were at different levels of sophistication of internal credit risk management systems to participate in the fieldwork.
7. In total 15 participants were involved in the fieldwork. These participants included both financial and non-financial entities and both ‘global systemic important banks’<sup>1</sup> and regional/ country based businesses.



8. Only a small group of entities were used for the fieldwork because we asked for detailed numbers to be provided. The fieldwork also required significant investment of resources from the participants. The man-hours utilised during the fieldwork included:
  - (a) For field participants: 200-250 manhours (smaller businesses), 400-450 manhours (larger businesses) and even 500-550manhours for a few; and
  - (b) for IASB staff to develop the fieldwork, meetings with fieldwork participants and portfolio analysis approximately 400manhours.

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<sup>1</sup> These are banks considered by the Financial Stability Board (FSB) to be global systemic important banks as per the November 2012.

## Portfolios

9. The portfolios selected by participants comprised the following, which in aggregate have a total carrying amount in excess of US\$500 billion:
- (a) retail mortgages including:
    - (i) normal amortising loans (ie payment of both interest and principal from the first payment);
    - (ii) interest only loans; and
    - (iii) equity-line loans.
  - (b) corporate (wholesale) loans;
  - (c) revolving credit products, for example credit cards;
  - (d) lease receivables, for example vehicle finance; and
  - (e) other unsecured lending, for example personal loans/ payday loans.
10. Generally, the portfolios excluded derivatives and guarantees to make the calculations easier and to help participants to meet the short deadlines for the fieldwork.
11. The portfolios selected had an average behavioural life of:

< 1 year	1 - 2 years	2 - 5 years	> 5 years (up to 30 years)
<ul style="list-style-type: none"> <li>• Revolving credit products</li> <li>• Lease receivables</li> </ul>	<ul style="list-style-type: none"> <li>• Lease receivables</li> </ul>	<ul style="list-style-type: none"> <li>• Lease receivables</li> <li>• Corporate loans</li> <li>• Retail loans</li> <li>• Unsecured lending products</li> </ul>	<ul style="list-style-type: none"> <li>• Corporate loans</li> <li>• Retail loans/ mortgages</li> <li>• Unsecured lending products</li> </ul>

12. The portfolios tested were often data rich. This allowed participants to gain a better understanding of what information they would need to implement the proposals. It also challenged participants to think about how they would implement the proposals for portfolios that do not have this rich data.

## Fieldwork: Operability of proposals, feedback and observations

### *Operability and feedback on having a deterioration model*

13. Participants confirmed that a model that distinguishes between financial instruments based on changes in credit risk reflects their internal credit risk management systems; particularly the distinction between performing and underperforming/non-performing financial instruments. Participants agreed that where there is a significant increase in credit risk, the credit risk management system should capture this change and reflect it in the measurement of the allowance.

### *Operability and feedback on identifying significant increases in credit risk*

#### **Main observations**

Participants supported the operability of the proposals for a model that where the measurement of the allowance changes as there is an increase in credit risk. Participants stated that this is similar to their credit risk management.

Participants used a number of methods to assess significant increases in credit risk. Some used more sophisticated information (for example an increase in PD) whereas others may use delinquency information.

A few participants observed that although changes in the 12month PD often served as a good proxy to changes in the lifetime PD, it will not be appropriate for financial instruments that have back ended payment profiles.

Participants supported the operational simplifications introduced. They observed that 30 days past due was a good indicator of a significant increase in credit risk. Although supporting the exemption for low credit risk financial instruments some participants suggested making this a rebuttable presumption.

Participants did identify some challenges to identifying a significant increase in credit risk; including (i) identifying significant increase on a transactional level; (ii) credit risk information is currently performed at a counterparty level; (iii) including forward looking information; and (iv) limited information about credit risk at origination.

*Determining significant increases in credit risk*

14. Participants applied different methods to identify significant increases in credit risk.
- (a) participants that apply PD-based models (ie models adjusted for probability of default) today often built on that knowledge and assessed significant increases in credit risk from the relative changes in the probability of a default occurring.
  - (b) Some participants used approaches that also aim to identify increases in credit risk early, being:
    - (i) internal watch lists (particularly in wholesale/ corporate lending) to identify significant increases in credit risk. Internal watch lists are used to identify borrowers that a lender considers to be at risk of default based on internal assessment; and
    - (ii) an absolute approach where a significant increase in credit risk occurs when the credit quality drops below the lowest level at which the lender would originate a new asset.
  - (c) Others with less sophisticated systems (often in retail lending) relied more on directly observable information, being:
    - (i) delinquency information (the 30 days past due presumption), together with loans that are restructured or where a forbearance<sup>2</sup> arrangement has been entered into.
15. Participants that use Basel/Internal Ratings Based (IRB) approaches today, benefited as they were able to leverage their existing models. However, they still made adjustments to the PD factors to reflect point-in-time (PIT) information (ie actual expectations for the relevant outlook period). Some participants suggested that the IASB should permit them to use the ‘through the cycle’ PD information (which is explicitly required by Basel) that is captured currently in their systems to further leverage their existing information.

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<sup>2</sup> Forbearance is an arrangement between lender and borrower to modify the terms and conditions to allow the borrower to meet its debt servicing obligations (such as postponing repayment).

16. To identify significant increases in credit risk, participants considered forward looking information, including macroeconomic factors. In doing so, participants observed such forward looking data must be:
- statistically relevant (a large enough sample to perform statistical analysis); and
  - statistically correlated (must show a dependent relationship with credit risk).

Some macroeconomic factors participants considered were:

Retail	Corporate	Other
<ul style="list-style-type: none"> <li>• GDP (Gross domestic product)</li> <li>• House price index</li> <li>• Unemployment</li> <li>• Interest rates</li> <li>• Inflation</li> </ul>	<ul style="list-style-type: none"> <li>• GDP</li> <li>• Commercial real estate</li> <li>• Equity market index</li> <li>• Commodity prices</li> </ul>	<ul style="list-style-type: none"> <li>• Manufacturing output</li> <li>• Construction put in place</li> <li>• Tonnage index (logistics)</li> </ul>

17. A number of participants used the operational simplification of changes in the 12-month PD as a proxy for the change in the lifetime PD to assess significant increases in credit risk as proposed in the ED. Participants thought that in most instances this would be a good proxy, however they noted that in instances where products develop losses in the latter part of the product life (for example bullet loans), it would not be applicable.
18. A few participants also considered how different levels of change in the lifetime PD represent a significant increase in credit risk and the impact thereof. In one sample the participant compared a significant increase in credit risk using a 40 per cent change in PD (2 per cent–2.8 per cent) versus a 200 per cent change in PD (2 per cent–6 per cent).
- They observed that for the financial instruments they were considering a relative 40 per cent change in PD might result in the loss allowance becoming overly sensitive and causing items to move too easily when



significant increase in credit risk may not in fact have occurred. That is, the loss allowance would react to ‘model noise’. An entity therefore would need to carefully consider what in PD would be to be considered to reflect a significant increase in credit risk.<sup>3</sup>

*Feedback on operational simplifications introduced*

19. Fieldwork participants supported the two operational simplifications proposed in the Exposure Draft. These were:
  - (a) a rebuttable presumption that there is a significant increase in credit risk when a borrower is 30 days past due; and
  - (b) that an entity would continue to recognise a 12month allowance on financial instruments that have low credit risk.
20. A number of participants relied on the 30 days past due presumption to identify significant increases in credit risk in the retail loan portfolios. However, some participants noted that this was a lagging indicator to identify significant increases in credit risk. Some participants observed the following relative increases in the probability of default, substantiating that 30 days past due leads to a significant increase in credit risk:
  - (a) a 124 per cent increase in PD from being current (ie not past due) to past due (but less than 30 days past due); and
  - (b) a 400 per cent increase in PD from being past due to 30 days past due (a 700 per cent increase from being current).
21. Participants particularly made use of the low credit risk exemption for their wholesale/corporate portfolio. Participants mapped their internal credit grades to those of external rating agencies. On the retail side (eg mortgages) the use of the low credit risk exemption was limited. This was because participants often:
  - (a) did not originate to individuals who are low credit risk; or
  - (b) were unable to map internal ratings to external ratings.

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<sup>3</sup> The relevant change will also be situation specific.

22. Most participants treated a deterioration in credit quality from above to below 'low credit risk' as a trigger for the recognition of lifetime ECL. Others combined this increase with an assessment of the relative change in credit risk.
23. Some participants stated that they would prefer the low credit risk exemption to be rebuttable. They would recognise lifetime ECL when a significant increase in credit risk occurs regardless of the credit quality. They believe this would also be more aligned to the principle of a significant increase in credit risk and their credit risk management.

*Difficulties in identifying significant increases in credit risk*

24. While participants were generally able to operationalise the assessment, identifying significant increases in credit risk was not without its obstacles. Participants raised the following difficulties in the assessment:

- (a) *Being able to identify significant increases in credit risk on a transactional level*, particularly for retail products. For those portfolios participants were often able to only identify a significant increase in credit risk on a transaction level once there has been delinquency/ forbearance.
  - (i) Participants observed because of the limited timeframe for fieldwork they were not able to better perform work to identify a significant increase in credit risk for a portfolio. This would require further work to better segment portfolios. They believe such an approach would be beneficial in better identifying significant increase in credit risk.
  - (ii) Some participants noted that there could be instances where a significant increase in credit risk has occurred but has not yet been identified on a transaction level. Participants argued that a type of 'management overlay' may be appropriate in these circumstances.
- (b) *Being able to identify a significant increase in credit risk on a transactional level where the assessment is currently done for credit risk purposes on a counterparty level*. To deal with this:
  - (i) some participants followed an absolute approach, ie if the credit risk/credit quality of a counterparty reached a

specified level, all loans to the counterparty were transferred to lifetime ECL;

- (ii) some participants combined a counterparty credit risk/credit quality assessment with a relative increase in credit risk compared to the origination of each individual loan to identify financial instruments with a significant increase in credit risk.
- (c) *Incorporating forward looking information into the assessment, particularly for retail loans.* Often credit risk systems today do not incorporate macro-factors for various products and portfolios. Participants indicated that more work is needed to understand the relevant factors and the impact these factors would have on credit risk to identify significant increases in credit risk.
- (d) *Limited information available on the credit quality at origination.*
  - (i) On transition participants noted that they would not have the information to determine whether there had been a significant increase in credit risk. Participants indicated that without this information based on the ED, they would often measure lifetime ECL on financial instruments on transition;
  - (ii) Tracking information on a transaction level versus counterparty level. Often systems track the credit quality on a customer level. As the credit quality information is updated, both the customer information and the transaction level information is updated too. The result is that the information used to assess a significant increase in credit risk is not done on a facility/transaction level.

***Operability and feedback on measuring the allowance for assets that did not have a significant increase in credit risk (12month allowance)***

**Main observations**

Participants considered the 12month allowance to be operational as information on the 12m PD is readily available and already often used (albeit sometimes requiring adjustments) for internal credit risk or regulatory purposes.

Where information was not readily available internally, participants indicated that information is obtainable in the market to enable this to be determined.

Participants did not support increasing the period beyond 12months as this would require additional modifications to current internal credit risk management systems.

Participants applied different alternatives when considering default.

25. Participants were asked to calculate the 12month allowance for the financial instruments that did not have a significant increase in credit risk since initial recognition. Those participants that elected to measure the allowance on lease receivables at lifetime ECL did not provide feedback on this aspect.
26. To determine the 12month allowance, participants needed to determine the probability that the borrower would default in the next 12 months (12m PD). Almost all participants had the information available as it is currently used for internal credit risk management and/or regulatory purposes. The participants that did not have the information available indicated that they were able to obtain the relevant information or make reliable estimates of the 12m PD using data that was available internally or in the market (for example, from credit rating agencies). Participants would not readily have the information when:
- (a) for internal credit risk management and regulatory purposes they do not report using a 12m period; or
  - (b) for internal credit risk management and regulatory purposes they do not adjust the 12m PD for forward looking information.
27. Participants made the following observations:

- (a) even when a 12m PD was readily available, this often needed to be adjusted. The Exposure Draft proposed that the PD be adjusted for point-in-time (PIT) information. Consequently, participants had to adjust their available PD information. No specific concerns have been raised; however some participants did suggest that the 12m PD be permitted to be the unadjusted through-the-cycle (TTC) number.
- (b) Where 12m PD information was not available participants used other representative information to derive the PIT 12m PD. For example:
  - (i) the PD of an instrument with a one year term/ maturity; or
  - (ii) the TTC 12m PD adjusted with information that was obtainable in the market (for example Moody's Expected Default Frequency) to adjust the 12m PD for more forward looking period specific information.
- (c) One participant observed that when measuring the allowance the entity considers information for the next 12months (to determine the PD) and the lifetime of the asset (to determine the ECL). This creates complexity due to the different time horizons that the entity has to consider.

28. Participants generally did not support the adjustment of the ECL for stage 1 for a probability of default beyond 12months as this would require the majority of them to develop and calculate new information. This would add to the operational burden as they would not be able to utilise regulatory and internal credit risk management for such a measurement.

*Considering the definition of default*

- 29. During the fieldwork participants had to consider what 'default' means. Defining what default is directly impacts the measurement of the financial instruments in Stage 1 (see further Agenda Paper 5D).
- 30. Participants applied different criteria for default. A number of participants indicated that they do not automatically use the default definition consistent with regulatory requirements for credit risk management purposes. Some of the alternatives for default used by participants were:

Retail	Corporate
<ul style="list-style-type: none"> <li>• 90 days past due</li> <li>• 180 days past due</li> <li>• Point where charge off starts/ work out period</li> </ul>	<ul style="list-style-type: none"> <li>• 90 days past due</li> <li>• Basel definition of ‘unlikely to meet obligation’</li> <li>• Forbearance</li> </ul>

### ***Operability and feedback on the measurement of ECL***

#### **Main observations**

Participants applied different methods to measure lifetime ECL, however, the LGDxEAD method was the most frequently used.

The main challenges were the effects of discounting, incorporating forward-looking information and considering the maturity of financial instruments.

Generally, participants supported having the ability to use a range of discount rates as it allowed them to leverage existing information.

Participants did not support the calculation of lifetime ECL on all financial instruments as they argue that this is too complex operationally.

Participants suggested calculating the allowance for credit cards using behavioural information, rather than contractual rights.

31. One of the benefits of the fieldwork was that it allowed the staff to gain a better understanding of the various methods used by participants to calculate the ECL and the various challenges of those models. During the fieldwork the staff also facilitated a call with interested participants to discuss the various methods and their suitability in meeting the measurement objectives in the Exposure Draft.
32. The various methods used by participants to calculate ECL were:
  - (a) migration matrices: a method that estimates the losses that would arise from a financial instrument if the instrument defaults given a specific credit risk grading/ credit quality.
  - (b) loan loss rates: the ECL are calculated using the losses that occurred during a specified period in the past (for example 12 months). Includes

elements of write-offs, changes in incurred losses and the incurred but not reported (IBNR) allowances.

- (c) LGDxEAD methods: a method that requires the lender to determine what it estimates the exposure at date of default (EAD) to be. The loss given default (LGD) relevant for that EAD is then determined based on; (i) the percentage of loss expected on default; (ii) time value of money; and (iii) collateral held<sup>4</sup>.

33. In determining the ECL using the various methods, the following issues were raised:

- (a) Timing of ECL: the proposals require an entity to discount to the current value at the reporting date. Current systems do not discount at all or discount only to the date of expected default. Participants indicated that systems would need to be modified to:
  - (i) better capture the expected timing of credit losses; and
  - (ii) to discount future amounts to the reporting date.
- (b) adjustment for forward-looking data, including macroeconomic data. Some models are easier to update to reflect future estimates and macroeconomic data than others.
- (c) maturity: the proposals require that lifetime ECL should be modelled for financial instruments with a significant increase in credit risk. Entities could use long term averages to assist in estimating ECL beyond an outlook period in which more specific estimates can be made, however it still requires significant estimates and judgement.

34. Participants supported the range of discount rates the proposals in the Exposure Draft permitted. They stated that some models, for example the EADxLGD model, already implicitly include a discount factor. The discount factor is often a weighted average discount rate, rather than an individual effective interest rate for each loan. Although participants acknowledge that the best conceptual approach is

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<sup>4</sup> So for example for an EAD on 100 an entity may determine that on a default it would expect to lose 60 per cent of that exposure given the counterparty, timing of loss and collateral provided.

the effective interest rate range, allowing the range of discount rates enables them to better leverage information in their internal credit risk management systems;

35. Support for the range of discount rates was however not unanimous. The participants that did not support the range stated that in high interest yielding markets the range of discount rates would result in materially different ECL estimates. Participants in those jurisdictions prefer to require all entities to use the effective interest rate to increase comparability.
36. We also requested that fieldwork participants calculate lifetime ECL on all financial instruments. Apart from those that elected this option for lease receivables, participants did not support this approach. They noted:
- (a) that from an operational perspective this is challenging. This is because it required the use of supportable forecast data over a large number of exposures for their full lives. Currently, entities do not have supportable data for performing ('good') loans over the life of the asset. This feedback was received even though participants were aware that beyond the period that more specific estimates could be made ECL could be measured using mean reversion concepts (subject to any necessary adjustments).
  - (b) recognising lifetime ECL where significant increase in credit risk has not occurred is not reflective of the business of a lender.
37. During the fieldwork we also requested that some participants include credit cards as one of the portfolios to test. Participants that tested credit cards requested more clarity on how to perform calculations for those products. They stated that in general the contractual cancellation period of these products is one day, but in practice credit is offered for a longer period based on the entity's business practice (eg conducting an annual limit or facility review). Facilities are generally not immediately withdrawn. Using the contractual period may therefore lead to an understatement of ECL and would not represent the expected exposure for the financial instruments. Participants recommended that the ECL on loan commitments should be estimated over the behavioural life as this would more faithfully represent their credit risk exposure.



**Operability and feedback on the treatment of items for which there is objective evidence of impairment (stage 3)****Main observations**

Participants considered the proposals to measure interest revenue on the net basis operable for those assets with objective evidence of impairment.

A few participants requested that interest not be accrued for the financial assets with objective evidence of impairment.

38. An entity would change the measurement of interest revenue to the net basis (ie calculated on the gross carrying amount less allowance) when it considers there to be objective evidence of impairment on the financial asset.
39. For the purposes of the fieldwork, participants treated the point of default (refer paragraph 29- 30) as the point of objective evidence of impairment. However, in practice, there will be objective evidence of impairment prior to default.
40. Participants considered that it was operational to measure interest revenue on a net basis. This was because the calculation is consistent with the current treatment of financial instruments under IAS 39 *Financial Instruments: Recognition and Measurement* for financial instruments that are individually determined to have objective evidence of impairment.
41. Regardless of the operability of measuring the interest on a net basis, a few participants raised their preference to present interest on a non-accrual basis. This would be similar to how those respondents report information for regulatory purposes. The participants did acknowledge that this will be an operational simplification and not conceptually consistent with the notion of accrual accounting and time value of money.

**Operability and feedback on the simplified approach for trade and lease receivables****Main observations**

Participants supported the inclusion of the accounting policy election for lease receivables.

Participants requested clarity on the level at which an entity should make this accounting policy election.

42. The fieldwork included portfolios of lease receivables. The level of sophistication of the current internal credit risk varied for these portfolios.
43. The portfolios on which the fieldwork was performed for lease receivables were high credit quality portfolios and short term in nature (average life of less than two years).
44. Because of the short term nature of these portfolios and their unsophisticated internal credit risk management systems, the participants elected to measure the allowance at lifetime ECL. For these portfolios the participants indicated that a lifetime ECL would easily fit into their current credit risk management system and allowance measurement models.
45. However, one participant observed that having a lifetime ECL on initial recognition would result in higher capital requirements for the lender. This would be burdensome for start-up businesses, growing businesses or new markets.
46. Participants requested clarification as to the level at which the entity needs to make the accounting policy election, ie ie should an accounting policy election be:
  - (a) on a consolidated group level; or
  - (b) on an entity-by-entity basis.
47. Participants stated that such clarification would be needed because, in some groups of entities some:
  - (a) with sophisticated systems, for example a finance entity, have more PD-based models, which enables them to track significant increases in credit risk; and

- (b) others do not have sophisticated models and are not able to track credit deterioration.

48. Regardless of the support for the accounting policy election for lease receivables, one participant did state that monitoring is still required for increases in credit risk. This is because the entity still needs to change the measurement of the interest revenue to a net basis (ie gross carrying amount less allowance) once there is objective evidence of impairment.

### **Time and resources required to implement a new Standard**

49. Participants were asked what they think the cost of implementation would be.

50. Most participants did not specify details of resources that would be required.

Those that did respond noted:

- (a) a three-year lead time would be required to ensure that their current systems could be upgraded, tested and implemented to report under the new requirements;
- (b) significant efforts would need to go into the design of the credit risk management systems and the reporting; and
- (c) significant costs would be incurred to modify systems (and configure warehouse databases) to retrieve and maintain information of credit quality/credit risk on origination.

### **Responsiveness and directional impact of proposals – compared to IAS 39 on transition and over the period tested**

51. We refer the IASB back to Agenda Paper 5B *Impairment: Outreach Summary Feedback—Fieldwork* paragraphs 14-26 which provided a detail overview of the responsiveness and directional impact of the proposals.

### **Next steps**

52. The staff do not intend to perform further work in the future on the fieldwork.

However, they will utilise the feedback received:

- (a) in considering the effect analysis of the final Standard; and
- (b) during redeliberations as input in the feedback received and the staff .