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IFRS Developments

A new approach to credit impairment is in the works

What you need to know

- The IASB and the FASB are developing a new credit impairment approach that takes into account feedback they have received.
- Loans would be split into three buckets based on the credit risk of the loans and information available.
- To estimate credit losses, all available information, including all reasonable and supportable forward-looking information, would be considered.
- The new approach may be exposed to constituents as early as September 2011.

Overview

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) (collectively, the Boards) are jointly developing a new credit impairment approach in a continuing attempt to achieve convergence.

Under the new model, loans would be split into three buckets based on their credit quality. Credit impairment would be calculated separately for loans in each of the buckets using historical, current and reasonable and supportable forward-looking information.

The model would represent a big change from current practice under both IFRS and US GAAP. It would also differ from the models that the Boards had previously discussed and proposed.

Background

Following the financial crisis, the IASB and the FASB each proposed impairment models that were significantly different from their existing models and from each other. Constituents have consistently urged the Boards to achieve a converged solution.

The Boards jointly proposed a model in a Supplementary Document (SD) issued in January 2011. That model required assets to be split into a "good book" and a "bad book," based on a company's internal credit risk management policies. For the good book, credit losses would have been recognised on a time-proportional basis, with a minimum allowance (or floor) equal to losses expected in the foreseeable future. For assets in the bad book, the full amount of the expected loss would have been recognised immediately.

The Boards received mixed feedback on the SD model and decided not to develop that approach further. Instead, the Boards have recently started developing an approach based on variations of the previous proposals, taking into account the feedback received on the Boards' exposure drafts and the SD.

The three-bucket approach

Under the new approach, loans would be split into three buckets based on their credit risk characteristics and any changes in credit risk since origination. Impairment accounting for each of the three buckets would be different.

Loans would move from one bucket to another based upon available information about credit quality. As information becomes more specific and granular, the impairment calculations would change from portfolio level to individual asset level, and companies would progress from recognising a portion of expected losses to recognising full lifetime expected credit losses.

Loans would be split into the three buckets as follows:

- Bucket 1 — This bucket would consist of loans evaluated collectively for impairment that have not been affected by observable events that indicate possible future defaults, i.e., all loans not falling into buckets 2 or 3. Loans in this bucket may suffer changes in credit loss expectations due to macroeconomic events that are not specific to either a group of loans or a single loan. Because there is no direct relationship to possible future defaults, lifetime expected losses would not be recognised. The Boards tentatively decided that an allowance for 12 months of expected credit losses plus the full lifetime effect of any *changes* in expected losses would be required for loans in this bucket. However, allowance calculations for this bucket would be done at the portfolio level, because there is no asset-specific default information available.
- Bucket 2 — This bucket would consist of loans that have been affected by observable events that indicate possible future defaults, but specific assets that could default have not been identified. Because there is a direct relationship to possible future defaults, the Boards tentatively decided that lifetime expected losses should be recognised for loans in this bucket. However, allowance calculations for this bucket would be done at the portfolio level, because there is no asset-specific default information available.
- Bucket 3 — This bucket would consist of loans where observable information indicates that credit losses are expected to occur, or have already occurred, on individual assets. Because there is asset-specific information available, the Boards have tentatively decided that lifetime expected losses should be recognised for loans in this bucket at the individual asset level. It is to be expected that the lifetime expected losses calculated for such loans on an individual basis will be higher than would be attributed to the same loans on a portfolio basis in bucket 2.

The approach is illustrated below:
Illustration 1: Three-bucket approach

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Bucket 1	Bucket 2	Bucket 3
Assets not affected by observable events	**Assets affected by observable events**	**Individual assets expected to default**
Allowance	Allowance	Allowance
Twelve months of expected credit losses based on initial expectations plus full lifetime effect of any change in expected credit losses	Full lifetime expected credit losses calculated at a portfolio level	Full lifetime expected credit losses calculated at an individual asset level

Deterioration of credit quality

The following example is based on IASB discussion papers and illustrates the application of the three-category approach:

Consider Bank Z whose entire portfolio consists of loans in Country X. This includes mortgage loans to individuals in Town ABC and Town XYZ. The national GDP in Country X decreases such that the general level of credit defaults for Bank Z's entire portfolio increases. This change of circumstances would be considered in the amount of expected losses estimated for the first category but would not result in a transfer of loans to the second category where the entire lifetime expected losses would be recognised. However, if housing prices in Town ABC decrease to such a level that defaults are expected to increase, all mortgage loans to borrowers in Town ABC would be transferred from category 1 to category 2 and the entire lifetime expected losses would be recognised immediately. This is because the declining house prices have a direct relationship to potential future defaults, but it is not clear yet which specific loans to borrowers in Town ABC are likely to default.

The result of transferring loans from category 1 to category 2 is potentially dramatic, with the recognition of all lifetime expected losses, compared to twelve month's losses for category 1.

How we see it

The new approach appears to be operationally complex and contains some elements of the approach included in the SD that constituents raised concerns about:

- **Tracking:** The lifetime expected losses will need to be tracked vintage by vintage in order to capture and respond to subsequent changes. (Note that this was one of the main criticisms of the impairment model proposed by the IASB in its ED of November 2009).
- **Dual calculations:** Will be required for the good book (or category 1) – firstly, the 12 months expected losses and then the lifetime expected losses by vintage. (Note that this was perceived as a drawback of the approach proposed by the Boards in the Supplementary Document of January 2011). This may be operationally difficult for open portfolios, because it would require entities to distinguish between credit deterioration resulting from loans added in the period and expectations about loans already in the portfolio.
- **'When' to transfer:** The approach requires that there is an observable event which causes loans to be transferred between the proposed categories. Currently, IAS 39 requires certain trigger events to be considered in determining the collective provisioning for a portfolio of loans, although it is worth noting that there is diversity in the practical application of these requirements.

Therefore, the operational success of the new approach to be proposed by the Boards could potentially depend on: (i) refining the criteria/factors that trigger a transfer from category 1 to category 2 and; (ii) banks being able to maintain vintage information. In addition, given that lifetime expected losses are not recognised in bucket 1 at origination, we have some difficulty understanding the logic of the proposal to recognise *changes* in such losses in that bucket.

What's next

The Boards plan to further develop the three-bucket approach and it is expected that the new proposals will be published as an Exposure Draft in September 2011.

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