

IFRS Developments

IFRS 9: Financial Instruments

New credit impairment approach takes shape

What you need to know

- ▶ The new three-bucket credit impairment approach that the Boards expect to propose later this year captures different phases of deterioration in credit quality of financial assets.
- ▶ All originated and purchased financial assets¹ would be initially classified in Bucket 1.
- ▶ Assets would be transferred between the buckets based on changes in credit loss expectations.
- ▶ The impairment allowance for Buckets 2 and 3 would be based on full expected lifetime losses.
- ▶ The Boards have yet to decide whether the allowance for Bucket 1 would be based on 12 months or 24 months of expected credit losses.

Overview

The International Accounting Standards Board (IASB) and the US Financial Accounting Standards Board (FASB) (collectively, the Boards) have continued to discuss their new three-bucket credit impairment approach and have made several tentative decisions to refine the approach.

The Boards continue to develop a three-bucket credit impairment approach.

Previously, the Boards decided that assets would be split into the three buckets based on their underlying credit risk. Assets would be transferred between buckets based on the deterioration in the credit quality of the assets. Credit impairment would be calculated separately for assets in each of the three buckets using all reasonable and supportable information available. Such information would include historical data, current economic conditions and supportable forecasts of future events and economic conditions. The allowance for Bucket 1 would represent a portion of remaining lifetime expected credit losses, while the allowance for Buckets 2 and 3 would represent full remaining lifetime expected credit losses.

The staffs of both Boards have been working on developing an approach for determining how assets would be allocated to each bucket and when assets would be transferred between the buckets. They have also been working on refining a method for calculating the allowance for Bucket 1.

The Boards have an aggressive timeline to develop the new approach, with the intention to publish a second exposure draft (or a review draft) for input from interested parties later this year. As it currently stands, the new approach represents a significant change from current practice under both IFRS and US GAAP.

¹ Only financial assets that are measured at amortised cost are within the scope of the IASB exposure draft *Financial Instruments: Amortised Cost and Impairment*. Therefore, for the IASB, the terms "financial assets" and "assets" in this publication refer to financial assets that are measured at amortised cost.

Transfers between buckets

A critical component of the approach is classifying newly originated and purchased assets into buckets for impairment calculation purposes and subsequently transferring assets between buckets based on changes in the credit quality of the assets. The Boards tentatively decided to pursue a “relative credit risk” approach, under which assets would move between buckets depending on changes in credit loss expectations.

Under the approach, all purchased and originated assets would be initially included in Bucket 1, irrespective of differences in credit quality. Bucket 1 would therefore include newly originated assets of high credit quality as well as newly originated assets of low credit quality.

Assets would move from Bucket 1 to Bucket 2 if the financial performance of the debtors deteriorates to the point that there is an increase in uncertainty about recovering all of the cash flows. Assets would be transferred from Bucket 2 to Bucket 3 if there is a further deterioration in the financial performance of a debtor and the entity does not expect to recover all cash flows. Bucket 3 consists of assets where credit losses are expected on individual assets.

The Boards have said that they would clarify how the concept of credit deterioration (and improvements) would be captured so that clear and well-defined principles can be developed for determining when a transfer between buckets should take place.

The Boards also clarified that entities would need to compare and contrast the current credit quality information with previous periods to ascertain if any changes have occurred.

How we see it

The Boards have not yet fully discussed how the approach would be applied in practice regarding when assets would be transferred between buckets. The Boards may explore several options that indicate period-over-period changes in credit risk, such as: a “watchlist” process that is used by most financial institutions; indicators based on a Basel framework; regulatory guidance used in various jurisdictions; performing, nonperforming or default borrower status; and internal credit risk grading systems or external credit risk ratings.

Given varying levels of sophistication among reporting entities and the variety of credit risk management techniques available, it will be challenging for the Boards to establish a “one-size-fits-all” approach. The Boards, nevertheless, need to come up with a broad principles-based framework that is consistent with their attempts to use an entity’s credit risk management system as part of its impairment accounting.

The Boards have yet to decide whether the allowance for Bucket 1 would be based on 12 months or 24 months of expected losses.

Measurement of credit loss allowance for Bucket 1

In an earlier meeting, the Boards tentatively decided that the allowance for Bucket 1 would represent 12 months of expected credit losses based on initial expectations plus the full effect of any changes in expected lifetime losses. The Boards asked the staff to perform some preliminary outreach among constituents to find out whether this approach is operationally feasible.

In the limited outreach undertaken by the staff, constituents said the approach was operationally complex and would require significant system changes, particularly because of the requirement to recognise the full effect of changes in expected lifetime losses. Constituents suggested that the lifetime calculation of the allowance for Bucket 1 should be as simple as possible.

Constituents also suggested that concerns about the adequacy of the level of the allowance for Bucket 1 could be relieved if assets were required to be transferred from Bucket 1 to Bucket 2 (where lifetime expected losses are required to be recognised) sooner. The Boards asked the staff to pursue an approach that would require an allowance for Bucket 1 based on 12 months or 24 months of expected credit losses (with no additional allowance required for Bucket 1 for the full effect of changes in lifetime expected losses). The Boards will discuss this at a future meeting.

The Boards also clarified that when determining the amount of expected credit losses for the next 12 (or 24) months, an “annual” loss rate would be used that reflects management’s estimate of credit losses that are expected to arise on the portfolio of assets in the next 12 (or 24) months. This is different from an “annualised” loss rate, which is calculated by dividing remaining lifetime expected losses by the remaining average life.

How we see it

The Boards’ joint decision to pursue options that would require entities to calculate an allowance for Bucket 1 equal to either 12 months or 24 months of expected credit losses introduces a bright-line rule that some entities may find easier to understand and implement. Certain regulatory reporting requirements already require financial institutions to compute losses expected in the next 12 months, and that data could be used for impairment accounting purposes.

Other open issues

The Boards intend to provide more clarity on the level of granularity at which asset portfolios need to be segmented for applying the new approach. The Boards believe that, with a greater level of granularity, the evaluation of credit losses should produce a result that better reflects both differences in credit risk characteristics of the assets in a particular bucket and changes in relevant factors that result in actual losses. The level of granularity would also have a direct effect on the operational complexity of the approach.

The Boards have focused mainly on credit risk management notions for commercial or wholesale loans in their development of the current approach. Consequently, they also need to investigate and discuss the application of this approach to other financial assets, such as consumer loans, debt securities and individually significant loans, that are managed for risk differently from commercial or wholesale loans. In addition, the Boards need to discuss disclosure requirements under the new approach.

What’s next

The Boards will continue to discuss and further develop the approach. They expect to publish a second exposure draft (or a review draft) for input from interest parties later this year.

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