The new impairment model

US financial institutions weigh in on the new impairment model being developed by the FASB and IASB

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Introduction

The last few years have been among the most turbulent ever in the financial services sector. The credit crisis has highlighted the need to strengthen accounting recognition of credit loss allowances and disclosures of credit quality. Specifically, the current incurred loss model applied under US GAAP has been criticized for recognizing losses too late. Many believe the accounting could be improved by incorporating a broader range of credit information, such as forecasts, into an entity’s estimation process. However, one constant is expected to remain: the allowance for credit losses is one of the most subjective and challenging estimates in a bank’s financial statements.
In response to the credit crisis, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (together, the Boards), proposed significantly different credit loss accounting models. Many financial institutions urged the Boards to work together to improve credit loss accounting and to achieve a common approach to enhance comparability between institutions reporting under US GAAP and IFRS.

As a result, the Boards are expected to issue a new joint exposure draft (ED) during the second half of 2012. This ED is expected to propose the “three-bucket” model the Boards have been developing.

In simple terms, the Boards currently are proposing that financial assets (e.g., loans, debt securities) would migrate from Bucket 1 to Bucket 2 or 3 if evidence supports deterioration in credit quality to a certain level from initial recognition. Financial assets in Bucket 1 would carry an allowance to cover losses on the portion of financial assets for which a loss event is expected over the next 12 months. Financial assets in Bucket 2 and 3 would carry allowances to cover full lifetime expected losses. The Boards have discussed distinguishing between Bucket 2 and Bucket 3 by the level at which the allowance is calculated. Bucket 2 allowances would be calculated at a portfolio level, and Bucket 3 allowances would be calculated at an individual loan level.

We surveyed credit risk and accounting policy executives at 14 US financial institutions in December 2011 to learn their reactions to the three-bucket proposal. The financial institutions included in the survey have assets from $6 billion to more than $2 trillion; eight financial institutions have assets less than $100 billion and four have assets greater than $100 billion but less than $350 billion. The majority of responses were collected before the Boards’ December 2011 and January and February 2012 meetings, during which they made key tentative decisions. A summary of these decisions is included in the “Summary of Boards’ tentative decisions to date” section following the survey responses.

Our goal was to determine how financial institutions view the Boards’ direction, including whether they think it is operationally viable and consistent with current internal credit risk management practices.

Please refer to the “Definition of terms” in the back of this document for a detailed description of key terms used throughout this survey.
Key themes

Respondents generally supported the three-bucket approach as a step toward a final, converged model. Officials at the institutions we surveyed believe that the approach is simpler than previous proposals and could be made operational.
The institutions’ responses highlight a number of important points and themes.

Alignment with internal credit risk management practices is important
Respondents support aligning the proposal with how they manage loans. Some respondents said an effective solution to the debate over whether to use a “relative approach” or an “absolute approach” could be resolved with a hybrid solution of a relative approach with an absolute overlay. The tentative decisions reached by the Boards in December essentially create such a hybrid approach. Nonetheless, institutions will find it challenging to implement the principles-based transfer criteria proposed by the Boards at the same December meeting.

Community banks appear to like bright lines to align their credit risk functions and related accounting. Most other institutions prefer the flexibility of a principles-based approach, but they agree that such an approach may lead to diversity in practice.

The effect of the three-bucket approach on reserves is uncertain
While institutions acknowledge that one of the Boards’ goals is for banks to accelerate the recognition of credit losses, the institutions are uncertain about whether the three-bucket approach would accomplish that goal. Most believe this new approach would need to be field-tested to accurately ascertain the effect on allowances and any other practical and operational challenges. Given the cost and effort involved, most of the institutions we surveyed did not want to field-test a new model until it reaches the ED stage. The Boards would need to allow sufficient time in the comment period for thorough field-testing.

A new model should improve accounting for purchased impaired loans
Institutions expressed concern that accounting for purchased loans under current US GAAP is overly complex, difficult for financial statement users (as well as preparers) to understand and inconsistently applied to assets of similar risk at the time of purchase. Most of the banks surveyed indicated the simplest solution would be to account for purchased loans, regardless of credit quality, in a manner similar to originated loans.

Institutions have concerns about applying the approach to other assets
Respondents believe that current US GAAP for credit impairment of debt and equity securities is appropriate and adequate. Further, they expressed concern about how the three-bucket model would be applied to instruments other than loans. The institutions indicated that, in their experience, different impairment models make sense because of the different characteristics of the underlying instruments. All respondents expressed concern that the Boards would pursue a one-size-fits-all approach without adequate testing and debate about how the approach applies in various situations.
All 14 of the US financial institutions we surveyed said the three-bucket credit impairment approach would significantly affect their processes for estimating the allowance for credit losses as well as the allowance levels themselves. The respondents were invited to participate in this survey because of their active monitoring of the impairment deliberations. Additionally, our sample of financial institutions included large, regional and community banks.

The survey results are summarized below, with graphs to illustrate the responses, as appropriate. We have highlighted items of most interest and emerging trends.

**Question 1a. Does the institution believe the three-bucket approach could be operational?**

Even though most institutions agree that the three-bucket approach could be operational, some do not think it has any distinct advantages over a two-bucket approach or even today’s incurred loss model. Several of the institutions that said the three-bucket approach could be operational indicated that the Boards need to provide both (1) basic principles about the assets to be included in each bucket and (2) examples supporting those principles to promote consistency of application.

All the institutions surveyed indicated a need for significant field-testing of any proposed model. While certain institutions have attempted to analyze the effects of decisions made to date, most have indicated such an effort requires too much time, money and effort to effectively execute until a definitive model is proposed in an ED. Further, the institutions believe any ED comment period should allow for field-testing over a sufficient period of time to accurately ascertain the effect on the allowance and any other practical and operational challenges.

Significant time must be allowed for field testing of any proposed impairment model, given the cost and effort that is expected to be involved in transition.
Question 1b. Does the institution believe the three-bucket approach could be an improvement?

Most institutions surveyed pointed out that whether the proposal will accelerate loss recognition depends primarily on how loans are classified between Bucket 1 and Bucket 2 and 3. While the Boards’ tentative decisions made during the December 2011 meeting provided some clarity about when assets transfer out of Bucket 1, the model is still subject to further deliberations and, perhaps more importantly, interpretation by individual institutions and their regulators.

Several institutions expressed concern that the Boards’ deliberations may suggest that an allowance would be derived solely by quantitative measures. The institutions surveyed noted that most US financial institutions carry a “qualitative reserve” component within their allowance for credit losses. These US financial institutions base their quantitative allowances on historical losses, adjusting the total quantitative allowance (rather than individual loss rates) for qualitative factors, such as economic trends and other items. These institutions are concerned about their ability to incorporate these sorts of qualitative adjustments into the more granular historical loss rates assumed by the Boards or provide for similar qualitative adjustments.

Other institutions commented that precluding a qualitative allowance could decrease the overall reserve for banks applying US GAAP, as the resulting decrease might more than offset any increase in the quantitative reserve that results from the introduction of the three-bucket approach.

Adjusting historical loss rates at granular levels for qualitative factors (e.g., future expectations) could be challenging.
Question 2. Would you prefer Buckets 2 and 3 remain separate or should they be merged into one bucket?

Some of the institutions surveyed think that Bucket 2 and 3 should be merged because they have the same measurement objective. These institutions favor combining Bucket 2 and 3 because this approach would be more in line with existing credit risk monitoring functions. For example, consumer loans typically are not evaluated individually from acquisition through charge-off and, thus, would rarely be evaluated in Bucket 3. Similarly, some institutions argued that credit losses on commercial loans are rarely assessed at the portfolio level and thus would never be evaluated in Bucket 2.

Overall, most institutions either agree with or are indifferent to the separation of Bucket 2 and Bucket 3. These institutions are more concerned with when loans would transfer to either Bucket 2 or Bucket 3 (see Question 6) and how they would estimate the associated portfolio-level remaining lifetime expected losses (see Question 9).

Question 3. How do the proposed buckets align with how the institution currently monitors credit risk?

Current credit monitoring processes often result in commercial loans being assigned a risk rating and group consumer loans into pools with common risk characteristics, driven primarily by loan type and delinquency. Further, many commercial loans rated “substandard” or below and all troubled debt restructurings, whether consumer or commercial, are individually evaluated for impairment under the applicable provisions of ASC 310-10. Loans not individually evaluated for impairment are evaluated collectively for impairment under ASC 450-20.
All of the institutions surveyed believe that at least two of the three buckets would align well with their current credit monitoring processes, with six of the institutions asserting that their current processes would align well with the three-bucket approach.

Most institutions that said two of the three buckets aligned well with the current process noted that Buckets 1 and 3 are clearly aligned with their ASC 450-20 and ASC 310-10 loans, respectively. These institutions expressed concerns that identifying Bucket 2 loans would be challenging and may not necessarily align with current credit monitoring processes. Accordingly, credit risk monitoring systems and processes would have to change.

Most of the institutions indicating that all three buckets aligned well with their current credit monitoring processes asserted that the only modification to their current processes would be to decide at what risk rating (commercial loans) or delinquency status (consumer loans) loans would migrate out of Bucket 1. In discussing this question, institutions expressed the following:

- Some institutions agree that commercial loans with a "special mention" risk rating would not automatically fall into Bucket 2, while others believe that all "special mention" loans would fall into Bucket 2. Under current US GAAP, most "special mention" loans are not considered to be impaired.

- Most institutions expressed concern about how a consumer loan portfolio should be evaluated and how consumer loans would migrate to Bucket 2. There was consensus that delinquency would result in a loan migrating from Bucket 1 to Bucket 2. However, several institutions said other factors should also be incorporated, such as refreshed FICO scores and loan-to-value ratios. Currently, some institutions incorporate these additional factors into the collective credit loss estimates under ASC 450-20 to varying degrees. If there is a requirement or expectation that factors other than delinquency need to be considered in evaluating which loans are classified in Bucket 2, then some institutions may have to change their credit monitoring processes.

- Most institutions do not think that consumer loans would migrate from Bucket 2 to Bucket 3. Rather, the loans would either “cure” (return to Bucket 1) or be charged off while still in Bucket 2. This is because most estimates of credit losses on consumer portfolios occur under ASC 450-20 and are typically calculated on a pool basis. Even consumer loans that are determined to be troubled debt restructurings and considered impaired under ASC 310-10 are typically measured on a pool basis under the provisions of that standard. In other words, an individual evaluation of loss is not typically performed on consumer loans under current US GAAP.
Question 4a. **Do you support an absolute or relative risk approach for allocating loans to buckets?**

An absolute approach would involve classifying assets according to a measure of absolute risk, such as point-in-time probability of default (PD) or credit grading. This could lead to some loans being recognized initially in Bucket 2 or 3, which would require recognition of full remaining lifetime expected losses on day one. A relative approach, on the other hand, would require all assets to be initially placed in Bucket 1 regardless of credit quality and the transfer among the buckets based on changes in credit quality since origination. For example, a loan's credit risk must deteriorate before it migrates out of Bucket 1, which could lead to situations where the absolute risk of a loan in Bucket 2 is lower than the absolute risk of loans in Bucket 1.

The majority of institutions surveyed support an absolute approach to credit risk classification. They believe that an absolute approach aligns with current processes, under which credit risk is assessed at a point in time. Some institutions said elements of the relative approach exist in their allowance methodology. For instance, banks have higher allowances on consumer loans that are 60 days delinquent than on current loans, yet neither the current nor delinquent loans are reserved for their remaining lifetime expected losses. Further, several institutions pointed out that current information systems would have to be modified to capture a larger amount of data and, more often, to apply a relative approach to credit risk classification.

Two institutions likened their current processes to the relative approach, but both noted that because they do not originate loans that would be in Bucket 2 under an absolute approach, the distinction between the two approaches is not particularly important. Further, several banks noted that their characterization of their current process as being akin to the absolute approach did not apply to their purchased credit-impaired loans (see Question 5).

Question 4b. **Which approach (absolute or relative) is closer to your current approach?**
Question 5. How should loans purchased with credit impairment be treated upon acquisition? Should such loans be categorized in Bucket 1 upon purchase?

Current US GAAP (ASC 310-30) treats loans or debt securities for which it is probable, at acquisition, that the acquirer will be unable to collect all contractually required payments receivable differently from both purchased loans that do not meet that criterion and originated loans. Currently, the yield used to recognize income represents the excess of expected cash flows over the acquisition cost for loans or debt securities where full contractual collection is not expected at the time of purchase. That is, purchased loans with evidence of credit deterioration since original underwriting follow an “expected” cash flow model rather than the “contractual” cash flow model used for loans not within the scope of ASC 310-30. Because the ASC 310-30 model takes into consideration all contractual cash shortfalls, it reflects remaining lifetime expected losses of both principal and interest.

Many institutions stressed the need for a consistent model that could be applied to all purchased loans, regardless of credit quality at the time of purchase. The determination of when a purchased loan meets the credit-impaired threshold is highly subjective and, in practice, has led to what amounts to an accounting policy election and inconsistency in application between institutions. Institutions also noted that users of their financial statements were often confused by the disclosures required by ASC 310-30. They also cited operational difficulties with accounting for purchased loans under ASC 310-30.

Most institutions surveyed believe that purchased credit-impaired loans currently accounted for within ASC 310-30 should be categorized in Bucket 1 upon purchase. Some of them said Bucket 1 was just a possible classification for purchased credit-impaired loans, and that if specific loans met the threshold for classification in either Bucket 2 or 3 at the time of purchase, such classification should not be precluded. These institutions are more interested in consistently applying the three-bucket approach across all loans.

In general, institutions approached this question with concrete suggestions for how to improve the accounting for loans purchased with credit deterioration. The most common suggestion was that the acquiring company be required to carve out of its purchase price the amount embedded as a credit discount and establish that amount as the allowance for credit losses. At the acquisition date, such a credit allowance represents the full remaining lifetime expected losses. Credit losses realized subsequent to acquisition would be charged against the allowance, thereby obviating the need to provide for further reserves (unless credit deteriorates further).
Question 6. Would the institution like to see “bright lines” for migration cues provided in application guidance, as applicable to different loan types?

Views on whether bright lines should be incorporated into the guidance differ based primarily on the size of the institution. The larger institutions we surveyed prefer that the requirements be based on principles rather than bright lines. Given the varying priorities and expectations of regulators, investors and analysts, these larger institutions believe not all financial statement users would agree on where bright lines ought to be established. Because institutions have varying loan portfolios and risk management processes, applying bright lines may be difficult or even inappropriate in some circumstances.

Regional institutions were split on whether bright line guidance is appropriate. One institution said that even if the Boards and regulators were to agree on a consistent risk-grading hierarchy for commercial loans (to line up with each of the three buckets), institutions would still apply significant judgment during loan grading. Two of the respondents believe that bright lines would weaken the principle underlying the guidance. An official at another institution stated that while the institution believes the accounting guidance should be principles-based, it would rather have bright lines established by the Boards than by regulators, auditors or industry. The regional institutions believe that regardless of whether the final guidance is based on principles or bright lines, regulators and auditors will each establish bright lines and interpretations of their own. The conflicting interpretation could be avoided if the Boards clearly establish migration cues.

Finally, community banks see the most benefit from bright lines, with respondents favoring more rigid guidance. Establishing clear guidance on migration from Bucket 1 to Bucket 2 or 3 would encourage consistent application among institutions as long as the migration cues consider when a loan should be placed on non-accrual status. These institutions caution that many users of financial statements have grown accustomed to terms such as “non-accrual” and “impaired.” The final guidance would need to be clear about which buckets encompass these loans and when a loan meets the “non-accrual” or “impaired” definition. These institutions still believe risk ratings and delinquency are the best factors on which to establish migration cues.

Regardless of whether bright lines are established, all institutions agree risk rating and delinquency are the best cues for commercial and consumer loans, respectively, and should be used in the application of the principles developed by the Boards. An official at one institution commented that the principles-based guidance should provide example indicators for loan types to help define the Boards’ expectations for the type of loan in each bucket. Respondents also agree that additional disclosures should be required describing the institution’s application of the principle (i.e., its policy on migration).
Question 7. Based on your interpretation of the Boards’ tentative decisions to date, would entry into Bucket 2 or 3 be earlier, later or the same as current definitions of impaired loans?

Officials at 12 institutions told us that they would expect loans to be transferred into Bucket 2 or 3 earlier than when a loan is classified as impaired under current US GAAP. There is an expectation that the Bucket 2 definition would promote earlier recognition of impairment as compared with current practice.

Two institutions had yet to develop clear views because their current impairment practices may already capture loans that they believe would be in Bucket 2. However, these institutions had not yet determined whether Bucket 2 allowances, which would require full lifetime expected losses, would be more extensive or the same as their allowances under current guidance.

While the majority of banks in our survey believe principles are better than bright lines, they also agree that diversity in practice will develop over time through industry application and the influence of regulators and auditors. This potential for inconsistency in application should be addressed by transparent disclosure requirements.
Question 8. How would your calculation of “remaining lifetime expected losses” under the proposal differ from your calculation of an ASC 310-10 impairment reserve today for individual loans?

Officials at almost all the institutions surveyed said their current calculation of impairment under ASC 310-10 would not be substantially different from a model that requires the measurement of “remaining lifetime expected losses.” Some institutions pointed out some practical issues and uncertainties related to the measurement of impairment on individual loans:

- Opinions differ in the industry about whether expected cash flows should include or exclude interest payments in measuring impairment under the proposed model. For impairment measurement under ASC 310-10, all contractual cash flows, whether principal or interest, are included in the projection of expected cash flows. However, some argue that nonaccrual policies would typically prevent the accrual of interest once that interest is not deemed to be collectible, and that the recorded reserve should only reflect the losses on assets already recorded (for instance, the recorded investment in the loan plus any accrued interest).

- There is also a concern that the proposed model would require impairment to be calculated as the difference between the loan's recorded investment and the present value of expected cash flows, if that present value were to be calculated based on a market rate of interest. ASC 310-10 currently requires discounting at the loan’s effective interest rate. Some believe that requiring impairment to be measured on a market rate of interest would reduce comparability and be difficult to implement.

- Consumer loans, except those identified as troubled debt restructurings, are scoped out of the impairment measurement under ASC 310-10 and are reserved for through an aggregate method under ASC 450-20. Several institutions noted that, even when measuring impairment on consumer loans identified as troubled debt restructurings, they use the provision in ASC 310-10-35-21, which allows the measurement of impairment on an aggregate basis. That is, impairment on consumer loans is not required to be measured on an individual basis under current US GAAP. If consumer loans are required to be classified in Bucket 3, many institutions said this would necessitate a significant change in their current process for measuring the allowance for credit losses. Several institutions expressed a view that consumer loans should always be reserved on an aggregate basis within either Bucket 1 or Bucket 2 until they are paid off or charged off.
Question 9. **How would you calculate “remaining lifetime expected losses” for a pool of loans?**

The Boards have tentatively decided that loans classified in Bucket 2 would be reserved at their remaining lifetime expected losses on a pool basis.

The institutions surveyed believe current methods for measuring impairment under ASC 450-20 could be modified to project losses over a longer time horizon. For instance, losses are currently projected to be realized over 12-month, 18-month or 24-month periods; those time periods would need to be adjusted to include the remaining life of the loans. Further, a static pool approach would likely be the most practical method of performing this projection.

However, several institutions pointed out that this works best for consumer loans. They said they do not believe this would be a practical or appropriate method to measure remaining lifetime expected losses on a pool basis for commercial loans. Most believe commercial loans should always be classified in Bucket 3 once it is determined that they no longer qualify for classification in Bucket 1.
Question 10. Do you believe the three-bucket approach could be applied to other financial assets, such as debt securities?

Many respondents said the three-bucket approach could not be applied to other financial assets, such as debt securities. Others said the Boards have not provided sufficient detail on how the approach would be applied to debt securities for respondents to have a position at this time.

Generally, respondents feel that the current impairment method for debt securities is operational and sufficient, with credit losses from debt securities recognized in earnings (if classified as trading) or when a debt security is other-than-temporarily impaired (if classified as available-for-sale or held-to-maturity). While there may be potential for the three-bucket approach to be used for debt securities that are classified as held-to-maturity, most respondents said debt securities are not assessed for credit in the same manner as loans, and applying the same approach to both for assessing credit losses is not appropriate. Additionally, most debt securities are carried at fair value, which already considers credit risk.

Only two respondents said the three-bucket approach could be used for debt securities. If the three-bucket approach were applied, credit ratings would seem to be the appropriate indicator for migration from one bucket to the next; however, respondents also noted the following challenges:

- Additional scrutiny has been placed on the degree to which entities should rely on third-party credit ratings.
- Credit ratings are not available for all securities.
- The use of credit ratings is prohibited by the Dodd-Frank Wall Street Reform and Consumer Protection Act for regulatory purposes.

In general, the institutions surveyed said that, although the three-bucket approach could be applied to debt securities, it would provide implementation and practical challenges. Any potential benefit would likely not outweigh the challenges.
Question 11. **Would the institution prefer an allowance for Bucket 1 based on 12 months or 24 months of expected losses? Is there another time frame the institution believes is more appropriate?**

While the Boards have discussed a clear time frame of either 12 or 24 months, respondents expressed a variety of preferences, including a 12-month floor, a lifetime expected loss, 12 months for consumer loans and 24 months for commercial loans, and no clear time frame at all. Ultimately, the Boards tentatively decided on a more principles-based measurement for Bucket 1 (see the “Summary of Boards’ tentative decisions to date” section).

Respondents noted the following key considerations supporting their preferences:

- Regulatory expectations tend to evaluate capital to absorb 12 months of expected losses.
- A 24-month time period would increase the allowance, which respondents believe is a key objective of the project, and also reduce fluctuations in the allowance given the longer time period.
- A minimum 12-month allowance should be established, but institutions should not be precluded from a longer time period based on trends in their portfolio and changes in general economic conditions. Capping the time frame seems counterintuitive to the intent of the project.
- A lifetime loss was recommended by one institution because its management can see no basis for either a 12- or 24-month time frame.
- The appropriate time frame should be based on the loss emergence period for a loan or group of loans. Establishing a rigid time frame may not present an accurate measurement of loss.

Many respondents agree that the three-bucket approach should not be applied to debt securities.
At their joint meetings in December 2011 and January and February 2012, the Boards made several tentative decisions.

The 'three-bucket' approach
The guiding principle of this approach is the general pattern of the deterioration in the credit quality of financial assets. Under this approach, all originated financial assets would initially be classified in Bucket 1, regardless of credit quality.

Impairment allowance for Bucket 1
The Boards had previously agreed that the allowance for Bucket 1 would be less than remaining lifetime expected credit losses, while the allowance for Bucket 2 and Bucket 3 would represent the full remaining lifetime expected credit losses.

The Boards clarified that the allowance for financial assets in Bucket 1 would focus on the impact of loss events expected over the next 12 months (e.g., the probability of default in the next 12 months multiplied by the loss given default). These expected losses refer to shortfalls in all cash flows related to loss events expected to occur within the next 12 months, as opposed to the realized cash shortfalls expected in the next 12 months.

Recognition of lifetime expected losses
The Boards tentatively decided that financial assets would be transferred out of Bucket 1 based on two criteria: (1) when there has been a more than insignificant deterioration in credit quality since initial recognition and (2) when the likelihood of default is such that it is at least reasonably possible that the contractual cash flows may not be fully recoverable. Financial assets initially classified in Bucket 1 (i.e., all originated loans and purchased financial assets with no explicit evidence of credit deterioration) that are transferred to Bucket 2 or 3 would move back into Bucket 1 if the criteria requiring transfer out of Bucket 1 are no longer satisfied.

The assessment of when to recognize lifetime expected losses would generally be based on the probability of default, rather than whether a loss would actually be realized or the magnitude of the loss. Hence, the assessment would not take into account the value of collateral in determining the timing of loss recognition, although proceeds from collateral liquidation are reflected in the estimate of lifetime expected loss.

In addition, the Boards have asked the staff to develop examples to clarify the meaning of “reasonably possible” by considering both of the following:

- The differences in practice between US GAAP and IFRS when interpreting the term “reasonably possible”
- The likelihood that cash shortfalls begin to increase at an accelerated rate as an asset deteriorates (e.g., this may be the dividing line between investment-grade and non-investment-grade financial assets, which is equivalent to greater than 10% probability of default)

Under this approach, higher-quality assets would not transfer as quickly as lower-quality assets to the other buckets.

Differentiating factor between Bucket 2 and Bucket 3
The Boards tentatively decided to retain Bucket 3 because it would provide valuable information and that the “unit of evaluation” would be the differentiating factor between Bucket 2 and Bucket 3.

If the determination that the financial assets should transfer out of Bucket 1 was made on a collective basis, the assets would move to Bucket 2. If the determination was made on an individual basis, the assets would be transferred directly to Bucket 3. An entity would transfer assets from Bucket 2 to Bucket 3 if it starts to assess these assets individually.

Grouping of financial assets for impairment evaluation
The Boards tentatively agreed that “shared risk characteristics” should be used as a basis for when and how entities aggregate individual financial assets into groups in assessing whether transfer out of Bucket 1 is appropriate as follows:
• If there are shared characteristics for a subgroup that would indicate whether recognition of lifetime expected losses is appropriate, entities may not group these assets at a more aggregated level.

• If a financial asset cannot be grouped with other assets that have shared risk characteristics or if a financial asset is individually significant, entities would be required to perform an individual assessment.

• If a financial asset shares risk characteristics with other assets, entities would be permitted to choose either an individual or collective assessment.

The use of an ‘expected value’ in estimating losses

The Boards tentatively decided that clarification and guidance is needed about appropriate methods for estimating expected values. As such, they asked the staff to further analyze the following:

► Practicality and the need to identify practical expedients (e.g., the use of fair value of collateral for collateral-dependent instruments)

► Inappropriate avoidance of undesirable outcomes because the expected loss is not necessarily the same as the most likely outcome (e.g., when there is a low probability of default with high-loss outcomes, the most likely outcome when looking at an individual instrument or a small number of instruments could be no loss, even though an allowance would be required based on probability-weighted cash flows)

Application to debt securities, retail and commercial loans

The Boards tentatively agreed that no bright line would be prescribed when applying the credit deterioration model.

For debt securities, there would be no rebuttable presumption for recognizing lifetime losses when the fair value of the security is less than a specified percentage of the amortized cost basis for some specified period of time. While fair value information should be used as one of the indicators when assessing whether it is appropriate to recognize lifetime expected losses for debt securities, it would not be the sole indicator.

For retail and commercial loans, there would be no bright lines for the recognition of lifetime expected losses on the basis of delinquency, such as a specified number of days past due.

Loans purchased with evidence of credit deterioration

The Boards tentatively agreed that purchased financial assets with explicit evidence of credit deterioration would initially be placed in Bucket 2 or Bucket 3, rather than Bucket 1, where all other financial assets would initially be placed. These financial assets would never be eligible to move into Bucket 1. The Boards still need to define what would constitute such an asset.

The Boards also tentatively agreed that these purchased assets would initially be recorded at fair value (i.e., no allowance) on the balance sheet and an effective interest rate would be calculated to accrete from fair value to the expected cash flows. While these assets would be recorded net, the Boards decided that disclosure of the expected contractual cash shortfalls implicit in the purchase price would be useful so investors can compare originated and purchased portfolios.

An impairment allowance would be recognized if lifetime expected losses change from those assumed at acquisition. Increases in expected cash flows would be recorded as an adjustment to the reserve even if they exceed the previously recognized impairment losses.

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Progress to date with the three-bucket proposal is encouraging in that the Boards appear to share a single view of how to create workable principles.
What to expect next
The FASB and IASB's current technical plan anticipates an ED in the second half of 2012. A new ED would be expected to have up to a 90-day comment period. The Boards would then require a period of time to consider comments received, redeliberate as appropriate and draft a final standard.

The Boards still have a number of challenges to address, including:

- The applicability of the model to financial assets that may improve in credit quality and may warrant a transfer back into Bucket 1 (i.e., whether the approach is symmetrical)
- Application of the model to purchased financial assets (including those acquired in a business combination), trade receivables, lease receivables, commitments and guarantees
- Specific disclosures (although the Boards have emphasized that robust disclosures would be critical to ensure comparability among entities)

The effect of this proposal on banks would be very significant. Not only would banks face many operational challenges, but shareholders’ equity could be affected upon adoption of the proposal. We expect this to capture the attention of senior management and external stakeholders.
Planning for change with Ernst & Young

The institutions we surveyed clearly believe that any changes to accounting for impairment would significantly affect their organizations. The effects extend beyond the financial statements, disclosures and regulatory capital measures, into design and development of new impairment models and systems based on forecasted expected losses over the lifetime of loans. Successfully implementing this forward-looking loss forecasting requirement is the key challenge institutions will face.

Ernst & Young has been working with several institutions in assessing the financial, capital and operational impacts of the Boards’ various impairment proposals. This includes using our impairment tools to give early directional guidance for the range of financial and capital impacts.

Ernst & Young can bring its multidisciplinary team of accounting, tax, regulatory, systems and IT professionals to your company to assist in assessing what the impairment proposal means to you and how to adopt it. In the table opposite, we outline issues and steps you should consider concerning the implementation of the impairment proposal, and we indicate how Ernst & Young may be able to help you, from initial assessment through to adoption of the new accounting standard.
### Issues and steps

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<td>Gain an initial understanding of the proposed accounting changes and how organizations are planning for change.</td>
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| • Design and deliver a training and awareness session for company personnel on the accounting and risk implications of the impairment proposals.  
• Share insights of FASB views, including interpretations. |
| Perform a preliminary assessment of the impact of the proposed accounting changes on the company’s financial statements and regulatory capital. |
| • For non-audit clients, Ernst & Young can provide support through the use of a customized impairment impact assessment tool to quantify and analyze the initial directional impact of the accounting changes. For audit clients, Ernst & Young can use the tool to evaluate assessments made independently by company management.  
• Advise and provide input on:  
  ▶ Gathering necessary scoping information and baseline data to develop and calculate detailed impact assessments  
  ▶ Assessing the impact on key financial ratios and performance measures  
  ▶ Assessing the impact on regulatory capital  
  ▶ Identifying shortfalls in available reliable data and information to successfully build and implement forward-looking expected loss forecasting capabilities |
| Benchmark the company against peers and other industry participants. |
| • Provide observations of how others are approaching the new impairment proposals, problems being identified and solutions developed.  
• Assist in the evaluation of peers, competitors and industry disclosures and the expected impact on financial statements. |
| Assess existing processes for data availability, internal controls and IT systems capability. |
| • Provide observations and insights on leading practices regarding ways the company could design its business process, IT systems and internal controls to capture information necessary to apply the new or proposed standard. |
| Build point-in-time lifetime expected loss forecasting capabilities, with necessary controls and governance. |
| • Advise and provide input on:  
  ▶ Developing existing through-the-cycle expected loss models using scalar adjustments and refined data.  
  ▶ Leading forecasting and modeling governance processes and operational controls post-implementation. |
| Plan, design, develop and test new impairment models based on lifetime expected losses. |
| • Advise and provide input on:  
  ▶ Designing new models based on portfolios and products and testing for compatibility with existing processes and systems.  
  ▶ Embedding new models within organizational processes using experience of multiple previous implementations. |
| Advise management during the implementation. |
| • Advise management where new standards will require careful use of judgment and detailed audit trails of evidence of decision-making.  
• Review and provide input into accounting and risk manuals and policies selected by management.  
• Provide coordinated support to you of Ernst & Young’s subject matter resources (regulatory, tax, risk, etc.) on a global basis across your organization. |
| Communicate effect of implementation to stakeholders – analysts, regulators, shareholders. |
| • Advise on developing a communication plan.  
• Advise on drafting communications. |
The 2010 exposure draft (ED) – In May 2010, the FASB published a new ED on financial instruments, Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities. The ED proposed that impairment of loans would be based on all available information relating to past events and existing conditions, but would not consider potential future events beyond the reporting date for lifetime expected losses that would be recognized.

The good book/bad book proposal – The FASB and the IASB published a joint document on 31 January 2011. The FASB considers this joint document to be supplementary to the ED. This joint document proposed that loans should be recorded in either a good or bad book depending on credit quality.

Three-bucket approach – In July 2011, the FASB and IASB started deliberating a new model, where loans would be split into three buckets based on credit quality. This approach is the main topic of this publication.

Absolute approach – An application of the three-bucket approach whereby all loans would be placed in the bucket that corresponds to their credit quality at origination and at each subsequent reporting period (i.e., loans of similar credit quality would be in each bucket; loans could be originated and immediately classified into Bucket 2).

Relative approach – An application of the three-bucket approach wherein all loans would initially be placed in Bucket 1 regardless of their underlying credit quality and would then migrate to Buckets 2 and 3 based on changes in credit quality relative to the credit quality at origination (i.e., loans of varying credit quality could be in the same bucket).

Migration cues – Trigger points or thresholds signaling when a loan, or group of loans, should move from one bucket to another.

Watch list – The watch list is a management tool used by many financial institutions to heighten risk awareness and monitoring of potential problem loans.

Special mention – A special mention loan has potential weaknesses that deserve management’s close attention. If left uncorrected, these potential weaknesses may result in the deterioration of the repayment prospects for the loan or in the institution’s credit position at some future date. Special mention loans are typically not considered to be impaired as they do not expose an institution to sufficient risk to warrant such classification.

Lifetime expected loss (LEL) – A measurement of the cash flows that an entity does not expect to receive on a loan over the full lifetime.
Contacts

If you would like us to present the results contained in this report, or help you understand the proposal’s impact on your institution, please contact the following Ernst & Young LLP professionals:

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