Key thoughts of the Financial Instruments Working Group on Impairment of Financial Assets Measured at Amortised Cost

The purpose of this paper is to identify issues the Working Group might raise in its presentation at November 2011 meeting with a view to encouraging a useful and constructive debate among AOSSG members and IASB members.

Views provided in this paper are preliminary and based on feedback by some, and not all, AOSSG Financial Instruments Working Group members.

1 Is it a cost model or cost-plus?

There are two measurement bases in IFRS 9—fair value and amortised cost.

The cost model is applied in IAS 36 *Impairment of Assets*. Under IAS 36, impairments are recognised if there is an indicator of impairment and the recoverable amount is determined to be lower than carrying amount. Impairment reversals are made if the circumstances that gave rise to the impairment no longer apply.

The context for the IASB's work is the G20 recommendation that the IFRSs be amended to help ensure earlier loan loss recognition than occurred in the build-up to the GFC. However, it is not clear whether the IASB will effectively be going beyond the cost model in its proposals to have losses recognised earlier. If it is, the model might be better characterised as cost-plus, or some hybrid of measurement models.

The possible requirement to recognise 12 months of losses on 'good' loan books in the absence of indicators of impairment seems to go beyond a cost model. This requirement would also make the IFRS 9 impairment model difficult to apply to financial assets of entities other than banks, as many such entities adhere strictly to cost measurement.

The Working Group recommends that the IASB adhere to a cost model and apply an incurred but not reported model (IBNR) approach to recognising loan losses. This approach is consistent with a cost model and, as noted in the AOSSG submission on the IASB's 2009 ED on impairment, would include losses up to reporting date and involve entities considering all available information relating to past events and existing conditions and their implications for the collectability of cash flows.

In recent IASB meetings, the term Expected But Not Reported (EBNR) loss model has been discussed. This notion may be similar to the Working Group's thinking on a well-articulated IBNR approach. That approach would result in earlier loss recognition in those jurisdictions in which entities seemed to focus too much on identifying specific impairment events under the current IAS 39 amortised cost approach.

2 Should the proposed impairment model be based on a 'through the eyes of management' approach?

The IASB has been considering models under which entities would need to categorise loans into three buckets—effectively:

* loans for which no significant additional information is available since inception (Bucket 1);
* loans for which credit loss expectations within a whole portfolio have deteriorated (Bucket 2); and
* loans for which deterioration of credit loss expectations within a specific loan or borrower has occurred (Bucket 3).

Requiring such specific buckets might be costly for entities to implement because it may not be consistent with the way those entities manage their loans. (Entities may need to have two information systems—one for management and another for financial reporting.) It may also be difficult to identify criteria that would enable all entities to consistently identify the various specified buckets.

One possible solution identified by the Working Group is to have a broader notion of the classes of loan assets for impairment purposes that can be related to the way in which different entities manage their portfolios. For example, entities could be required to identify the way they classify loans for the purposes of managing credit deterioration and to justify providing anything less than life-time losses on each relevant class.

3 Is it appropriate to recognise a 12-month loss on 'good book' loans?

The IASB has been considering models under which loans are classed in different buckets, and 12-months or more of losses would be recognised for 'good' loans and life-time losses for other loans.

One approach would be to presume that, because of the nature of 'good' loans and the fact that the contractual (interest) return on those would have been priced commercially at inception; they should not be regarded as being impaired. Based on this presumption, no impairment losses should be recognised on good loans and the 12-month loss projection is not appropriate.

An alternative view is that there will be impairments even on 'good' loans but, if that is the case, why not provide for life-time losses?

One possible reason for only seeking to provide for 12 months of losses is simplicity. Another is that life-time losses are not reliably measurable but, if that's true, how can life-time losses be reliably measured on 'bad' loans?

The Working Group recommends that the IASB examine the conceptual arguments and bases its proposals on the outcome of that examination. The Working Group considers that, if the IASB adheres to its current thinking (see issue 1), it would mean recognising life-time losses

even for good loans. This is because there is no conceptual basis for a 12-month cut-off for loan loss recognition.

4 How should loans that are of low credit quality at initial recognition be treated?

If the IASB proposes two, three or more buckets for loans, is the notion of what constitutes bucket one (the 'good' loans) an entity-based or market-wide notion?

An entity may have a business model that involves originating loans to borrowers with poor credit history and charge commensurately high interest rates. In the context of that entity, those loans could be regarded as 'good' provided the entity's experience with them remains commensurate with their pricing. The same could be said of an entity with a business model that involves acquiring 'troubled' loans in secondary markets for deep discounts.

An alternative view is that loans should be classified consistently across entities according to their credit quality. In this case an entity with a business model that involves originating loans to borrowers with poor credit history would not have any good loans. A concern with this view is that no distinction is made between 'bad' loans that started out as good loans and bad loans that started out bad and for which the entity is being compensated through higher contractual interest returns. A further concern is how to determine a market-wide notion of 'good' loans that can be consistently applied. Credit ratings are not universally obtained for loans and different rating agencies may allocate different ratings to the same instruments.

Furthermore, the impact of collateral on the allocation of loans to particular buckets is not clear. Should the existence of collateral impact on the allocation of loans into particular buckets?