Financial Accounting Standards Board

Proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Financial Instruments (Topic 825) and Derivatives and Hedging (Topic 815)*

Feedback Summary – Three-Bucket Impairment Model (July 2012)

Introduction

1. At the April 2012 joint Board meeting, the Boards completed joint deliberations (thereby reaching tentative decisions) on the primary aspects of the core three-bucket impairment model. At that time, the FASB staff indicated that it had already received a number of questions about the basic principles in the model and, as a result, had begun developing application guidance to clarify those principles.

2. Beginning in late April and continuing through July, the staff held outreach sessions with preparers, auditors, and regulators. The purpose of those outreach sessions was to understand (a) whether the model would be operable, auditable, and understandable and (b) whether the draft application guidance sufficiently clarified the principles in the model. Furthermore, the staff performed limited outreach with users and received unsolicited informal feedback from a variety of stakeholders. The table below summarizes the number and type of stakeholders who have provided feedback:

Type of respondent	Number
Preparers—Lending Institutions	5
Preparers—Other	2
Industry Organizations	1
Public Accounting Firms	4
Users	7
Regulators	4
Total	**23**

Summary of feedback received

3. The feedback received from stakeholders was consistent among all of the respondents. As a result, the staff has not segregated the feedback by type of stakeholder.

4. All stakeholders generally agreed that further clarification of the principles in the model is necessary. They noted that application guidance would assist in achieving greater consistency and comparability, particularly given the degree of judgment inherent in the "transfer notion" and the measurement of expected losses. Beyond merely indicating that further clarification of the principles is necessary, however, most stakeholders expressed a broader concern about the operability of the model and indicated that comparability may actually be reduced as a result of the model. Those concerns are expressed in the paragraphs that follow.

5. **Central concern about dual measurement approach**—Most of the concerns expressed about the model relate to the compromise between the Boards that led to the use of two different measurement objectives (that is, 12 months of expected losses and lifetime expected losses). The need for two measurement outcomes necessitated articulation of the Bucket 1 measurement objective and development of a transfer notion, both of which have proven problematic.

6. **Arbitrary nature of Bucket 1**—"12 months of expected losses" is an arbitrary construct based primarily on the Basel concept of a 12-month probability of default (PD). As a result, the staff has struggled to define the Bucket 1 measurement objective as anything other than a specific calculation based on the Basel 12-month PD concept. Some expressed concern that there is no conceptual basis for 12 months of expected losses as a measurement objective.

7. **Inoperability of the transfer notion**—Despite the staff's and the Board's best efforts, feedback from stakeholders has consistently noted that the "transfer notion"[1] is still a relatively ill-defined threshold. Concern was expressed that there is no

[1] The transfer notion refers to when (a) there has been a more than insignificant deterioration in credit quality and (b) it is at least reasonably possible that some or all of the contractual cash flows will not be collected.

sufficient operational guidance around the "transfer notion," which will put enormous pressure on the judgments to be made. Absent sufficient operational guidance, preparers and auditors expressed concern that it will be difficult to determine that the judgment made with regard to the "transfer notion" is the right one and would not be second guessed. Furthermore, stakeholders expressed concern that there will be considerable diversity in practice with the model, given the lack of guidance on the "transfer notion" and differing views about the future.

8. The staff heard a variety of interpretations and views on the terms *more than insignificant* and *reasonably possible,* as well as different views on whether the transfer notion is always met for a pool of financial assets (because it is almost always at least reasonably possible that all of the contractual cash flows of a pool of assets will not be collected). The staff has attempted to address these issues in the draft application guidance, although we understand that the IASB does not intend to include comparable application guidance in IFRSs. The concept of "reasonably possible" has been explained as the inflection point when the likelihood of cash shortfalls begins to increase at an accelerated rate as an asset deteriorates.

9. Some stakeholders noted that this interpretation is inconsistent with another joint decision.[2] Others noted that the "reasonably possible" notion has not been defined in a manner that will promote consistent application or comparable results, as is further evidenced by the interpretation noted above.

10. Finally, some expressed concern or confusion with hypothetical fact patterns in understanding whether (and how) the fact pattern affects the measured 12-month expected loss in Bucket 1 or whether the fact pattern instead indicates that some portion of a portfolio should transfer to Bucket 2.

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[2] At the December 2011 joint Board meeting, the Boards tentatively decided that the severity of loss should not affect the transfer notion. The "inflection point" being referred to is based on a graph of PD (vertical axis) versus credit risk rating (horizontal axis). External credit rating agencies and U.S. banks rate assets based on both the likelihood of loss and the severity of loss. Therefore, when assessing whether the PD increased at a quicker rate as the credit risk deteriorated, the inflection point is inherently considering the severity of loss, which is counter to the decision indicated above.

11. **Concern about segregating static pools**—Some preparers expressed concern that the dual measurement approach under the model will force preparers to split existing pools into subgroups for purposes of measuring the appropriate reserve because the model requires two different measurement objectives (12 months of expected loss and lifetime expected loss) for assets that may currently reside in a single pool. As a result, preparers are concerned about instances in which groups of homogenous financial assets are evaluated at an aggregate level to estimate losses for the group (as a whole). For such groups, preparers may monitor the loss experience of the group (as a whole) and estimate credit losses based on how that loss experiences changes over time. The concern is that such pools would now need to be further segregated (at a minimum) into (a) the Bucket 1 component and (b) the Bucket 3 component.

12. **Failure to address concerns about purchased credit impaired (PCI) assets**—While it was noted that the tentative approach would reduce complexity by eliminating the need to perform a prospective yield adjustment for favorable changes in expected cash flows, a number of stakeholders expressed concern that the approach does not go far enough in simplifying the complexity with the existing model. They believe that the three-bucket model would still require "closed pools" for PCI financial assets. A number of stakeholders instead prefer an approach that would allow PCI financial assets to be integrated into open pools such that there would be a single impairment model (as opposed to a separate approach for PCI financial assets).

13. Several stakeholders expressed concern that the approach will not facilitate users' comprehension because banking analysts do not like the net method of presentation. It was noted that the net method of presentation hides the very amount (namely the approximate principal balance) that is owed by the borrower and that financial institutions are trying to collect. To that point, during the outreach activities for disclosure related to the three-bucket impairment model, a user indicated that it would be far better to apply to PCI loans the same accounting that is applied to originated loans that become impaired.

14. **Users' inability to interpret the credit impairment allowance**—Some expressed concern that the impairment allowance will be difficult, if not impossible, for users to interpret because it is not based on a single measurement objective. Specifically, they noted that it is difficult to answer the basic question of "what the allowance represents" or "what the net carrying value (net of the allowance) represents," given the dual measurement approach in the model.

15. **Failure to improve comparability**—Some are concerned that the level of complexity with the three-bucket model would be greater than it is under current U.S. GAAP and that it would allow too much judgment in determining which measurement objective should be followed. Furthermore, the lack of consistent application on the transfer notion (combined with the ability to transfer back to Bucket 1) may not provide comparable or transparent results to users of financial statements.

16. **Reserves may not reflect the appropriate amount of risk**—A number of stakeholders expressed concern that, under the three-bucket model, credit impairment reserves for loan portfolios may not reflect the appropriate amount of credit risk. For example, some stakeholders believe that the model would likely result in lower reserves than what U.S. banks currently record as "incurred losses." That is, the truncated *expected* loss for Bucket 1 may be less than the *incurred* loss required by existing U.S. GAAP (which is not limited to a one-year time frame). Furthermore, even when Bucket 2 and Bucket 3 reserves are added to the 12-month Bucket 1 measure, several stakeholders noted that the ultimate result would be a decrease in credit reserves for a number of U.S. financial institutions.[3]

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[3] These assertions are based on some financial institutions' projections using their interpretations of the Board's decisions reached to date.

17. **Support for a "lifetime credit loss" option—**Consistent with the concerns described above, some preparers expressed a preference for an option that would permit applying the "lifetime expected credit loss" measurement to all financial assets instead of trying to operationalize the "transfer notion" and Bucket 1 measurement approach.

18. **Potential unintended economic consequences—**Finally, one industry banking group noted that the model may lead to unintended economic consequences for U.S. markets as a result of all originated financial assets starting in Bucket 1. As a result, they indicated a preference for using the inherent credit quality of the asset for determining the credit impairment measurement objective.