New on the Horizon: Impairment of financial assets managed in an open portfolio

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Limited re-exposure of proposed financial instruments impairment model

We welcome the IASB’s and FASB’s (the Boards) efforts to develop a single proposal on one of the key elements of a future impairment model for financial instruments. It is particularly encouraging to see the Boards consulting jointly, although it has meant significant changes to the two separate models that they had each previously developed. This combined approach acknowledges the huge importance of trying to achieve a converged solution, particularly for banks. However, the new proposals would require entities to make loss estimates across a number of different time periods, including both the foreseeable future and the life of a portfolio.

The proposed changes are intended to respond to the concerns about operationality and complexity of the previous IASB impairment proposals issued in November 2009, for example by removing expected losses from the calculation of interest income. They also respond to concerns from non-financial sector entities by scoping out trade receivables from the project until the revenue recognition exposure draft is re-deliberated.

While it is encouraging to see these important aspects of the impairment model re-exposed for comment, there are many other elements of the project that are still to be deliberated by the Boards and will need to be included in their final standards. These include impairment for assets that are not part of an open portfolio, measurement of impairment and interest recognition. There is still a great deal to do; the IASB faces a significant challenge to finalise the standard by 30 June 2011.

Andrew Vials
KPMG’s global IFRS Financial Instruments leader
KPMG International Standards Group
1. Highlights

The Boards published a Supplement to ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the supplement) on 31 January 2011. The supplement sets out common proposals for accounting for impairment of financial assets managed on an open portfolio basis. The supplement retains the expected loss concept proposed in Exposure Draft ED/2009/12 *Financial Instruments: Amortised Cost and Impairment* (the exposure draft) while aiming to address operational concerns that were raised. The supplement also incorporates additional changes enabling the Boards to satisfy, in part, their objectives for this project.

An IASB-only appendix requests comments relating to three areas:

- the scope of IAS 39 *Financial Instruments: Classification and Measurement* and IFRS 9 *Financial Instruments*;
- presentation of interest and impairment in the statement of comprehensive income; and
- disclosures relating to open portfolios of financial assets.

The impact of the supplement is limited to financial assets measured at amortised cost and managed on an open portfolio basis.

**Overview of the proposals**

**Joint IASB/FASB proposals**

- Expected credit losses would be estimated separately for the ‘good book’ and the ‘bad book’.
- The differentiation between the books would be based generally on internal credit risk management, subject to a principle that financial assets should be transferred to the bad book if their collectibility becomes so uncertain that the entity’s credit risk management objective changes from receipt of contractual payments to maximising recovery.
- The impairment allowance at each reporting date would be the sum of the good book and the bad book allowances.
- The good book impairment allowance would be the higher of:
  - the time-proportional expected credit losses; and
  - the credit losses expected to occur within the foreseeable future, which should be no less than 12 months.
- The bad book impairment allowance would be the entire amount of expected credit losses over the remaining life of the portfolio.
- Expected loss estimates would be based on all available information, including expectations of future changes in economic and market conditions based on reasonable and supportable information.
- Under the time-proportional method, expected loss estimates can be undiscounted or discounted. If discounted estimates are used, then the rate can be any reasonable rate between the risk-free rate and the effective interest rate (EIR), as used for the effective interest method in IAS 39.
- ‘Foreseeable future’ is the period over which specific projections of events and conditions are possible and credit losses can be reasonably estimated on these bases.
Overview of the proposals

IASB-only proposals

- Extensive disclosure requirements, which include:
  - separate reconciliations for loss allowance accounts;
  - disclosures to enable understanding of the estimates made in determining the impairment allowance; and
  - explanation of how internal credit risk management impacts the estimation of expected losses.
2. Background

2.1 Overview of the IAS 39-replacement project

The IASB is revising its accounting requirements for financial instruments. The objectives of the project include improving the decision-usefulness of financial statements for users by simplifying the classification and measurement requirements for financial instruments. This project aims to replace the existing standard, IAS 39.

The IAS 39-replacement project, and in particular its timeline, is driven in part by requests for reform from the G20 and other constituents. Following the G20 summit in April 2009, the Leaders’ Statement called on accounting standard setters, including the IASB and the FASB, to work urgently with supervisors and regulators to improve standards on valuation guidance and loan loss provisioning and achieve a single set of high-quality global accounting standards. Following the conclusion of their September 2009 summit, the G20 leaders reiterated this message and called on the international accounting standard setters to complete their convergence project by June 2011.

The IAS 39-replacement project has three main phases:

- Classification and measurement of financial instruments – the first chapters of IFRS 9 (IFRS 9 (2009)) were published on 12 November 2009 and addressed financial assets. On 28 October 2010 the IASB updated IFRS 9, through publication of IFRS 9 (2010), to address financial liabilities. See our publications Insights into IFRS, chapter 3.6A, and First Impressions: Additions to IFRS 9 Financial Instruments (published in December 2010) for further information on this section of the standard.

- Amortised cost and impairment of financial assets – the exposure draft was published on 5 November 2009. See our publication New on the Horizon: ED/2009/12 Financial Instruments: Amortised Cost and Impairment for further information on the exposure draft. The supplement was issued on 31 January 2011 and is the subject of this publication. It is a result of deliberating jointly with the FASB the responses received on the exposure draft related to impairment in open portfolios. The IASB plans to finalise this second phase by June 2011.

- Hedge accounting – Exposure Draft ED/2010/13 Hedge Accounting was published in December 2010. It proposed significant changes to the current general hedge accounting requirements, but would retain some of the existing guidance in IAS 39. See our publication New on the Horizon: Hedge Accounting issued in January 2011 for further information on this exposure draft. The IASB plans to issue a standard covering this area by June 2011. The IASB’s proposals on portfolio or macro hedging are expected during the second quarter of 2011 with a final standard on this topic expected during 2011.

The IASB has adopted a phased approach to this project in order to accelerate the replacement of IAS 39 and address the consequences of the financial crisis as speedily as possible, while giving interested parties an opportunity to comment on the proposals in accordance with the IASB’s commitment to due process.

2.2 Summary of the Boards’ original impairment proposals

The exposure draft proposed changes to accounting for impairment of financial assets, which included:

- Replacement of the IAS 39 incurred loss model for the assessment of impairment of financial assets measured at amortised cost with an expected cash flow approach (ECF approach).

- Under the ECF approach, recognition of a credit-related loss would not require an entity to identify any specific loss event(s) or impairment triggers. Rather, an entity would estimate the expected credit losses initially at inception of the asset and then re-estimate the losses at each measurement date.
No gain or loss would be recognised at inception, and the initially expected losses would reduce the EIR. Any gain or loss on a subsequent re-estimation would be recognised immediately in profit or loss.

- The effect would have been that the allowance for credit losses was built up and recognised over the expected life of the assets. However, any revisions to the initial estimates would have been recognised immediately.

The IASB’s primary objective of the exposure draft was to reflect the initial expected credit losses as part of determining the EIR as this was considered more reflective of the economic substance of lending transactions. The IASB believed the amounts recognised in the financial statements should reflect the pricing of the asset applied when an entity makes lending decisions, i.e. the interest rate charged, which considers expected credit losses.

The feedback received by the IASB on the exposure draft indicated overall support for the expected loss model. However, constituents were concerned about the operationality of the proposals, particularly as they related to financial assets managed on an open portfolio basis.

The FASB published its proposals for impairment accounting as part of the Proposed Accounting Standards Update Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities issued in May 2010. The proposals followed the FASB’s primary objective to ensure that the allowance balance was sufficient to cover all estimated credit losses over the remaining life of an instrument. Accordingly, an entity would estimate cash flows not expected to be collected from a financial asset and recognise related losses immediately. The cash flows would be estimated on an assumption that the economic conditions existing at the end of the reporting period would remain unchanged for the remaining life of the financial asset. The FASB considered that its objective for this project would address the concern related to current impairment guidance that loss reserves tend to be at their lowest level when they are most needed at the beginning of a downward economic cycle – ‘too little, too late’.

The FASB received mixed comments on its proposals for immediate recognition of expected credit losses. While many respondents opposed the approach, users generally supported it. The vast majority of respondents did not agree with the proposals to preclude entities from including in their expected loss calculations consideration of changes to economic conditions beyond the reporting date. However, most investors thought that it was very difficult, if not impossible, to forecast credit losses over a long period of time and they supported limiting the period of predictions to, for example, two to three years, which they thought would result in more reliable information.

### 2.3 Reasons for publishing the supplement

The Boards have published the joint proposals as part of their commitment to enhancing international comparability in the accounting for financial instruments. The joint model presented is a variant of the Boards’ original proposals and has features that partly satisfy each of the Boards’ primary objectives outlined above.

The proposals in the supplement deal with one of the most challenging aspects of accounting for impairment of financial assets and the feedback received will form the basis for deliberating the remaining areas of the project.

The supplement also contains an IASB-only part, which seeks feedback on the scope of IAS 39 and IFRS 9 and presentation and disclosure requirements relating to the jointly proposed model. The IASB has published this separate appendix as it facilitates understanding of the proposals as a whole. As the proposals allow entities flexibility in linking recognition of impairment to their internal credit risk management processes, adequate disclosures of how this flexibility has been applied is an essential part of the proposals.

Comments on the revised proposals are due to the IASB by 1 April 2011.
3. **Scope**

3.1 **Joint supplementary document**

The scope of the joint document is limited to recognition of impairment of financial assets managed on an open portfolio basis. In an open portfolio assets are added and removed on an on-going basis through origination, purchase, sale, transfer, repayment or write-off. For the IASB, these proposals would apply to such financial assets only if they are measured at amortised cost.

There are many aspects of the impairment project that are not included in the supplement and that have yet to be deliberated by the Boards. These include:

- impairment of financial assets not managed in an open portfolio, assets evaluated individually, debt securities, purchased loans and short-term receivables;
- measurement of credit losses, for example, whether it should be based on discounted cash flows and whether the loss estimate should be an expected value;
- the objective of amortised cost accounting and its interface with the measurement of impairment;
- recognition of interest income;
- wider disclosure requirements; and
- the effective date of the impairment proposals and whether early application would be available.

### Observations – Scope of joint proposals

While it is welcomed that the Boards have decided to allow interested parties to comment on these important aspects of accounting for impairment, the lack of a wider context for this limited re-exposure means that it may be challenging for the respondents to assess the full implications of the proposals in providing their feedback. Such wider context includes measurement of expected losses and recognition of interest income.

### Observations – Definition of credit loss

One of the areas that is still to be deliberated is the measurement of credit losses, including whether measurement should be based on discounted or undiscounted cash flows. Any decision in this area is likely to impact on what cash flows are to be included in the estimation of losses, e.g. whether they are to include both interest and principal or principal only. In addition, if expected losses were to be calculated on a discounted cash flows basis, then it is unclear how such measurement would relate to discounting discussed in section 4.6.

Excluded from the scope of the IASB’s proposals are short-term trade receivables without a stated interest rate that are so short-term that the effect of discounting is immaterial.
Observations – Exclusion of short-term receivables

As a consequence of the proposals in the exposure draft, which included the initial recognition of trade receivables within its scope, related revenue would have been recognised net of expected losses. However, short-term receivables have been excluded from the scope of the supplement and the impairment project as a whole until the issues related to their initial recognition have been re-deliberated as part of the revenue recognition project. This is likely to be welcome by many entities, particularly those outside of the financial sector.

However, it is unclear whether all short-term receivables or just short-term trade receivables would be excluded from the supplement’s scope. In paragraph 1, short-term receivables without a stated interest rate that are so short-term that the effect of the time value of money is immaterial, are excluded. This may indicate that the exception would be wider than just short-term trade receivables. Whereas, for example, paragraphs IN20 and BC33 refer to short-term trade receivables and, in particular, paragraph BC33 states that the reason for the exclusion is that the relevant revenue recognition proposals have not yet been deliberated.

Observations – Effective date and early application

The supplement does not include information on when the impairment proposals for financial instruments would become effective or whether early application would be permitted. The effective date for IFRS 9 is currently 1 January 2013 and early application is permitted.

The Boards have recently requested views on the effective dates for a number of standards that are due for completion in 2011. The comment period for the consultation ended on 31 January 2011. The Boards were seeking views on how to sequence the effective dates in order to reduce the burden of change for interested parties. Allowing entities to phase in implementation of different standards and/or permitting early application would help to ease the operational burden but may also lead to reduced comparability between entities and for the same entities from year to year. The operational burden would be particularly heavy for first-time adopters of IFRS as they would have to implement successive changes in a short period of time.

3.2 IASB’s Appendix Z

The IASB has issued Appendix Z (the appendix) in order to facilitate understanding of the proposals as a whole. The appendix seeks feedback on the scope of IAS 39 and IFRS 9 and on presentation and disclosure requirements related to items within the scope of the joint part of the supplement. The FASB has not yet deliberated the issues contained in the appendix.
4. Impairment in open portfolios

4.1 Overview

SD 2, 3

The Boards propose that for the purpose of determining the impairment allowance, financial assets that are managed on an open portfolio basis would be split into two groups: the good book and the bad book. The split would be based on the degree of uncertainty about collectibility of cash flows from the assets.

SD 2

Under the proposals, the impairment allowance at each reporting date would be made up of the following two components:

1. for financial assets in the good book, the higher of the following:
   - the time-proportional amount of the total expected lifetime credit losses for the portfolio; and
   - a loss estimate based on the amount of credit losses expected to occur within the foreseeable future, being no less than 12 months; and

2. for financial assets in the bad book, the total amount of lifetime expected losses.

Observations – Overview of the proposals

Some aspects of the proposals in the exposure draft were criticised for representing a significant operational challenge and entailing substantial implementation costs. The IASB worked together with an Expert Advisory Panel (the EAP) of credit specialists from a range of financial institutions to find a solution to these issues, and the model currently proposed is a result of these efforts. The FASB also participated in this process and the meetings of the IASB and the EAP were observed by regulators.

The proposed model and in particular the concepts of good book and bad book groups, aims to capture the way many entities manage credit risk. The model therefore links financial reporting to the way credit risk is managed. The IASB observed that this approach was directionally consistent with the other phases of the project to replace IAS 39, for example, classification of financial assets and hedge accounting, which are, or are proposed to be, reflective of an entity’s business model and risk management.

As the proposals aim to link recognition of impairment to entities’ internal credit risk management, the proposed model offers scope for significant judgement on how it is implemented. As a result, this may lead to a reduction in comparability between different entities. However, in responding to these proposals, interested parties need to carefully weigh-up the advantages of linking the impairment model to internal risk management processes against the disadvantage of a potential reduction in comparability between different reporters. Interested parties should take into consideration that the determination of impairment through the estimation of future cash flows is an inherently subjective area that often requires a high degree of judgement, particularly for larger wholesale assets.

4.2 Expected credit losses

SD B5

Under the proposals, expected credit loss estimates would reflect all available information, both internal and external. They would include:

- historical data;
- data on current economic conditions; and
- reasonable and supportable information relating to forecasts of future events and economic conditions that is consistent with currently available information.
The supplement does not mandate a specific approach for developing the expected loss estimates. However, it indicates that entities may vary their approach depending on the length of time over which the estimates are made. Thus, for shorter time periods entities may develop projections based on specific inputs, such as forecast information, while for longer time periods they may revert to long-term average loss rates.

**Observations – Loss estimates**

The guidance in the supplement on estimating expected credit losses is limited. This would give entities flexibility to follow their internal credit risk processes, but may result in reduced comparability between entities.

Some entities may have data available for only relatively short periods whilst others may have a long history of data. The type of historical data may vary for individual entities across different portfolios.

Judgement would be required to determine what type of data about future economic conditions may be considered to be reasonable and supportable. At any one time, a number of different economic forecasts may exist that may be considered to provide support for the entity's estimate. To the extent that those estimates originate from reputable sources, they all could be argued to meet the reasonable test.

As the measurement of credit losses is excluded from the scope of the supplement, the proposals do not specify whether the expected credit losses would be determined using probability-weighted outcomes or the most likely outcome. The exposure draft would have required that expected credit losses be determined using probability-weighted outcomes.

### 4.3 The good book and the bad book

The concept of the good book and the bad book emerged during the discussions between the IASB and the EAP, and the IASB’s outreach activities. The IASB staff’s publication *Amortised Cost and Impairment Expert Advisory Panel* indicates that most financial institutions often manage financial assets by differentiating between the good book and bad book. Financial assets in the bad book were typically managed more actively and frequently on an individual basis, with more analysis performed. In contrast, statistical approaches at the portfolio level were more typically applied for the good book assets.

The IASB has learned from feedback received that the approach to differentiating between the two books varies between different entities. In addition, the credit risk criteria applied in differentiating tends to involve less judgement for large volume and low value assets and more judgement and subjectivity for large wholesale items. Therefore, the Boards decided not to develop detailed specific criteria for transferring a financial asset between the two books, but rather to allow entities generally to apply their own risk management criteria for this purpose.

The supplement provides an underlying principle for differentiating between the two books; if collectibility of a financial asset becomes so uncertain that the entity’s credit risk management objective changes from receiving regular payments to the recovery, then the asset should not be in the good book.

Entities that do not manage credit risk using a good book/bad book approach are still to allocate their financial assets into these two groups for the purposes of determining the impairment allowance. The supplement gives examples of criteria that may be used for this purpose: overdue status, the expected return falling below the risk-free rate and classification of a loan as doubtful or problematic.
Observations – Differentiation between the good book and the bad book

Under the supplement entities would differentiate between the good book and the bad book on the basis of their internal credit risk management while also providing a general principle. Under the general principle it is no longer appropriate to allocate an asset to the good book if its collectability becomes so uncertain that the entity’s credit risk management objective changes from receiving regular payments to recovery.

The supplement gives examples of activities that are consistent with the objective of recovery of cash flows. These include the creditor taking action such as enforcement of security, debt restructuring or attempting to recover cash flows from an uncollateralised asset by making contact with the debtor. The above examples of management activities relating to the bad book usually take place long after the initial identification of credit problems in an asset. In particular, recovery of the collateral (especially for retail lending) is often one of the last steps in the recovery process.

It may be questioned whether these examples should be revised so that, irrespective of the individual entities’ internal risk management processes, assets are transferred to the bad book earlier, e.g. when they are first identified as problem assets.

In addition, the supplement suggests that, as an example, entities may comply with the general principle by transferring assets when management identifies them as doubtful. The term doubtful is interpreted differently in various countries and therefore may lead to very different interpretations of when it is no longer appropriate for an asset to be included in the good book.

4.4 Allowance for the good book

4.4.1 Overview

Under the proposals, the loss allowance for the good book would be the higher of:

- the time-proportional amount; and
- the amount of credit losses expected to occur within the foreseeable future, which would be not less than 12 months (the ‘floor’ amount).

These proposals are a common approach in an area where the IASB’s and the FASB’s original proposals differed. Recognition of expected losses on the time-proportional method is more consistent with the IASB’s objective, while a full recognition of losses expected for the foreseeable future is more consistent with the FASB’s objective. Although the proposals would allow the Boards to achieve at least part of their objectives, the resulting model would require entities to carry out two expected loss calculations in order to determine the higher amount.

If entities were to find that in practice the losses expected in the foreseeable future were almost always higher than the time-proportional amount, then a question may arise whether this additional burden is justified. Potentially a similar accounting result might be achieved by simply requiring that the loss allowance is always equal to losses expected in the foreseeable future.

Under the time-proportional method, the credit loss expected for the remaining weighted average life of the portfolio would be allocated over its total expected weighted average life, considering the portfolio’s weighted average age.

The total expected life of a portfolio would be based on the time that the individual financial assets within the portfolio are expected to be outstanding from inception to maturity. In determining the total expected life, an entity would consider prepayments, extensions and similar options, as well as
defaults. The proposals do not prescribe a specific methodology for calculating a weighted average age or weighted average life of a portfolio and assume that these are commonly understood concepts in practice.

**Observations – Methodology**

The allocation of expected credit losses over the expected life of a portfolio is intended to approximate the original proposals in the exposure draft, while aiming to address its operational complexity, which would have required the EIR to be estimated net of expected losses.

**Observations – Determining weighted average expected age/life**

Determining the weighted average expected life of different portfolios and their weighted average age may be challenging, particularly for entities that have many different assets with characteristics preventing them from being included in the same portfolio. Entities would need to keep a record of historical origination and maintain sufficient data to enable them to estimate expected maturity. Additional complexity may arise for financial assets without defined maturities, such as credit card receivables and overdrafts.

**Observations – Impact of changes in expected life of the portfolio**

One of the factors affecting the amount of the time-proportional loss allowance would be the expected life of a portfolio. For a given amount of expected losses, the size of the allowance at the measurement date would reduce in line with an increase in the portfolio’s estimated life. For example, if the portfolio’s weighted average age is three years, then the required allowance would be less if the weighted average total life was six years (allowance equal to three-sixths of the total expected loss) than if it was five years (allowance equal to three-fifths of the total expected loss).

The estimated average life of a portfolio of prepayable financial asset may increase or reduce in line with factors other than credit risk. For example, during an economic downturn, there is likely to be a smaller number of competitive loan offers available in the market and borrowers may have less incentive to switch to different loans. This could cause the expected life of the portfolio to increase and, in the absence of changes in any other factors, this would reduce the amount of the loss allowance required. An opposite effect would be caused by borrowers repaying their fixed rate mortgage loans earlier than previously expected, for example, due to a fall in interest rates. It is recognised that such market changes are likely to cause the total amount of expected loss to change, which may result in a compensating impact.

**4.4.2 Methods for allocating expected losses over the life of the portfolio**

The proposals allow entities to choose one of the following methods for allocating the expected credit losses over the weighted average life of a portfolio:

- a straight-line approach (discounted or undiscounted); or
- an ‘annuity’ approach.

The decision on this issue was reached by the IASB only and the FASB still has to deliberate it.

Under the straight-line approach, an entity determines the time-proportional expected credit loss by multiplying the entire amount of credit losses expected over the remaining life of the portfolio by the ratio of the portfolio’s age to its expected life.
Example – Straight-line approach using undiscounted expected losses

Portfolio Z has a weighted average age of three years and a weighted average life of five years. The entity determines the time-proportional expected credit losses using the straight-line approach and expected losses are undiscounted. The amount of allowance calculated under the time-proportional method would be as follows:

<table>
<thead>
<tr>
<th>Step</th>
<th>Description</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Estimate expected credit losses for the remaining expected life (two years) of portfolio Z</td>
<td>100</td>
</tr>
<tr>
<td>2</td>
<td>Allocate this expected credit losses estimate (100) over the total weighted average life of the portfolio (five years) on a straight-line basis to determine the annual amount</td>
<td>(100 / 5) = 20</td>
</tr>
<tr>
<td>3</td>
<td>Convert the annual amount to a time-proportional amount by multiplying it by the average age of the portfolio (three years)</td>
<td>(20 x 3) = 60</td>
</tr>
</tbody>
</table>

Time-proportional allowance balance as at the measurement date* 60

* This amount would be compared to the total losses expected in the foreseeable future and the higher of these two amounts would be the balance of the good book loss allowance account for this portfolio as at the measurement date.

Observations – Straight-line approach using discounted expected losses

Under the discounted method the amount of loss recognised is likely to be smaller than the undiscounted amount, therefore there may be an incentive to adopt a discounted method. However, the discounted method would involve estimation of the timing of expected losses and therefore would require more effort in terms of data compilation and computation.

Under an annuity approach, an entity determines the time-proportional expected credit loss amount by converting the entire amount of credit losses expected over the remaining life of the portfolio into annuities and accumulates these annuities for the portfolio’s age. An annuity approach by definition uses a discounted estimate of expected credit losses.

Observations – Choice of allocation methods

The supplement does not specify whether an entity needs to consistently apply one allocation method to all its financial assets managed on an open portfolio basis or whether it can select different methods for different portfolios.

Observations – Steady-state portfolio

For a steady-state portfolio, the composition of the portfolio, its weighted average life and weighted average age would remain stable. This means that, in the absence of changes to economic and other factors, the amount of the required loss allowance is also likely to remain constant. In such a scenario, the profit or loss impact would be created by origination and acquisition of new assets, and roll-off and write-off of older assets. Thus, in a steady state, the loss allowance created for the older loans would be transferred gradually to the bad book or written off, and the allowance for new loans would be created to maintain the same overall allowance level for the whole portfolio.
Example – Increased estimate of expected credit losses

If the amount of the expected credit losses increases, then the application of the time-proportional method would result in a partial catch up. A portion of the increase would be recognised in profit or loss immediately based on the ratio of the weighted average age of the portfolio to its weighted average life.

For example, Company E has a portfolio with a weighted average age of three years and a weighted average life of five years. E revises its expected loss estimate for this portfolio from 100 to 120. E uses the undiscounted straight-line method to allocate expected losses.

The allowance required at the measurement date would be three-fifths of the expected loss of 120, i.e. 72, an increase of 12 from the previous expectation of 60, i.e. 3 / 5 x 100. This means that out of the total increase in expected credit losses of 20, 12 would be recognised in profit or loss immediately and the balance of 8 would be recognised over the remaining life of the portfolio.

In contrast, under the exposure draft, the full amount of change in the expectation, i.e. 20, would be recognised immediately.

4.4.3 Credit losses expected to occur within the foreseeable future

Under the proposals, the credit loss allowance should be sufficient at all times to cover credit losses expected to occur in the foreseeable future.

Observations – Losses expected early in the life of the portfolio

Under the methodology of calculating expected losses proposed in the exposure draft, losses would be recognised over the expected life of the portfolio. For portfolios of assets in which losses occur early in a portfolio’s life, such an approach could have led to delayed recognition of losses when compared to the incurred loss model of IAS 39. The floor proposed by the supplement aims to ensure that losses expected to occur in the near future are fully provided for.

Observations – Determination of when the losses are expected to occur

It is not clear at which point in time losses would be regarded as ‘occurring’. For example, Company D has a portfolio of homogeneous assets for which losses are estimated using statistical techniques. D has determined that it takes 18 months from the moment an asset is first considered problematic to the ultimate recovery, for example through disposal of the collateral, or write-off. It is not clear whether the loss for this asset would be included in the loss estimate for the foreseeable future by reference to the time when it first became problematic or when the actual loss is expected to be realised.

One potential solution to this issue may be to align the definition of when losses are expected to occur with the timing of transfer of assets from the good to the bad book.

The supplement defines the foreseeable future as the time period over which specific projections of events and conditions are possible and can be used as the basis for reasonable estimates of expected credit losses. In order to estimate losses expected to occur in the foreseeable future, an entity may use similar data sources to those used in estimating expected losses over the entire life of the portfolio. The differentiating factor is the entity’s ability to forecast the events and conditions that will exist in the foreseeable future period.
Observations – The ability to make specific projections

The definition of foreseeable future offers significant scope to exercise judgment. Different entities are likely to have different views on the length of time over which they can make specific projections. It could be that more sophisticated entities would be able to make specific projections over longer periods than less sophisticated ones. This may lead to situations in which entities with more advanced credit risk management systems would carry larger allowances for expected losses than other entities.

Observations – Projections outside of the foreseeable future period

Paragraphs B12 and B13 of the supplement define the foreseeable future as the time period in respect of which specific projections of events and conditions are possible and such projections can be used as the basis for reasonable estimates of expected credit losses. Paragraph B7 provides guidance for calculation of expected losses over the entire life of a portfolio. It explains that for shorter and medium-term time periods entities may develop projections of expected losses on the basis of specific inputs, such as forecast information, and beyond such periods, they could revert to long-term average loss rates.

The combination of these paragraphs may be read to indicate that for periods beyond the foreseeable future, entities would commonly revert to long-term average loss rates to calculate expected credit losses. To the extent that entities are able to utilise specific forecasts, the resulting estimates of expected losses would be included in the foreseeable period. However, if specific forecasts are not available, then entities may not be able to claim that their expectation of changes in future events and conditions is reasonable and supportable and therefore may have to revert to the long-term averages.

Some entities may not have data on long-term averages in respect of some or all of their open portfolios. In some regions or countries, the pace of economic development has recently been so fast that historic data may be of limited use, for example, in countries with significant growth in demand for retail banking products, such as credit cards.

Observations – Different estimates required

The requirement to estimate expected credit losses for the foreseeable future would add operational complexity to the impairment proposals, as it would have to be calculated in addition to making a remaining lifetime estimate of losses for a portfolio. Furthermore, estimates of expected losses over a different period may be required for regulatory purposes. For example, under the requirements of the Basel II Advanced Internal Rating-Based Approach, banks would commonly be required to calculate expected losses over a 12-month period.

Entities will need to understand the interaction of impairment provision levels with regulatory capital requirements. In certain jurisdictions, accounting impairment provisions that exceed regulatory capital requirements, as may be the case following implementation of the supplement’s proposals, can only be added back when determining Tier 2 capital, as opposed to Tier 1 capital. Additionally, the Tier 2 add-back amount may be limited in certain circumstances.

These capital implications should be assessed by an entity in the context of its jurisdictional requirements and specific circumstances. It may also be useful to understand potential input from local regulators on the definitions and good book/bad book differentiation criteria proposed in the supplement.

The foreseeable future period would be fairly constant for a particular portfolio. However, it may differ for different portfolios. It also may be shorter than or equal to the expected life of a portfolio.
Observations – Changes to the foreseeable future period

The supplement assumes that the foreseeable future for a particular portfolio would be fairly constant and would not be expected to change significantly from period to period. However, during times of economic turbulence or crisis, it might be argued that the ability to make specific projections of events and conditions and to make reasonable estimates based on specific projections is considerably reduced. Often deteriorating economic conditions and recessions are associated with increased uncertainty. This view could lead to the counterintuitive result that, as economic conditions worsen, the foreseeable future might be considered shorter with the possible effect of reducing the overall impairment allowance for the good book. This may occur even though the amount of losses expected in the foreseeable future and over the total life of the assets may both increase.

Observations – Interaction between the foreseeable future and the time-proportional period

When the average remaining life of the portfolio is the same as the foreseeable future period, it may not mean that the losses estimated to occur in the foreseeable future would be the same as losses estimated to occur over the remaining average life of the portfolio. For example, a portfolio has a weighted average remaining life of two years and expected losses for that period of 100. The foreseeable future has been determined to be two years. Some of the assets in the portfolio would have maturities beyond the next two years and losses on those assets may be expected to occur beyond two years. These losses would therefore be outside of the foreseeable future period. Accordingly, the estimate of losses expected in the foreseeable future may be different to 100.

Observations – Length of the foreseeable future period

In order to implement the proposals in the supplement, entities would have to exercise significant judgement to determine the length of the foreseeable future period for each of their open portfolios of financial assets. At each measurement date they would have to review their decisions to ensure that the period remains valid.

A key issue for many interested parties will be whether the additional effort associated with determining portfolio-specific foreseeable future periods and the possible impact on comparability produces information that is more useful than requiring a floor based on a simple fixed-time period, for example, 12 or 24 months. If it is considered more useful, then a subsequent issue is whether the additional costs justify that benefit.
4.5 Allowance for the bad book

Under the proposals, the entire amount of credit losses expected in respect of assets in the bad book would be recognised in the impairment allowance.

**Observations – Estimating expected losses for the bad book**

Assets in the bad book are typically managed separately from the entity’s other assets and there is often more specific information collected by the entity in respect of them, which may facilitate the credit loss estimation process.

4.6 Discount rate

The proposals do not specify what discount rate entities should use if they chose to calculate the expected loss amount on a discounted basis. The proposals allow the use of any reasonable rate that falls between, and including:

- the risk-free rate; and
- the EIR under IAS 39.

By giving entities flexibility in the selection of an appropriate discount rate, the IASB is aiming to reduce the operational complexity of the calculations and thus encourage the use of the discounted amounts.

This issue has not yet been deliberated by the FASB.

**Observations – Determining the discount rate to use**

Using a discount rate that is a rate other than the risk-free rate necessitates calculation of the EIR for the portfolio to ensure that such a rate is within the required range. The IASB notes that determining an EIR for an open portfolio is operationally complex. Therefore, entities that would wish to calculate expected losses on a discounted basis may be more likely to use the risk-free rate.

4.7 Transfer of the allowance between the two books

Under the proposals, financial assets would be transferred between the good book and the bad book on the basis of the entity’s internal credit risk management.

When an entity transfers a financial asset between the two books, in either direction, it would also transfer the related portion of the loss allowance. The portion of the loss allowance that would be transferred is the time-proportional amount relating to the asset. The FASB has not yet deliberated this issue.

In determining the time-proportional amount for the transferred asset, an entity would consider the age and life of the individual financial asset, since it may not be equal to the weighted average age and weighted average life of the portfolio.

After the financial asset is transferred between the books, an entity would re-estimate the amount of expected credit losses for both the good book and bad book and adjust the loss allowance amount as necessary. In the Basis for Conclusions, the Boards stated that, “the ending allowance balance and period impact on profit or loss would not differ simply because of the timing of the transfer within that period”.
Observations – The amount of loss allowance transferred with the asset

Under the proposals, the amount of loss allowance transferred together with the transferred asset would be the time-proportional amount. An alternative approach would be to transfer the full amount of losses expected in the foreseeable future. As at the time of the transfer the total balance of the loss allowance in the good book would be the higher of the time-proportional amount and the losses expected in the foreseeable future, it may be argued that either of these above approaches would have some merit. It also may be argued that choosing to transfer the time-proportional amount increases the complexity of the calculations. This may be the case as in addition to calculating total expected losses in respect of the transferred asset, the total expected life of the asset and its age would also have to be individually determined.

For the assets in the bad book, the amount of allowance at all times would be the total expected losses rather than the time-proportional amount.

As the allowances for both books have to be re-estimated, i.e. trued-up, at each reporting date, a question arises as to whether information about the amount of allowance transferred between the books has relevance for users. As mentioned above, the ending allowance balance and period impact on profit or loss would not differ simply because of the timing of the transfer within the period. However, the amount of the allowance transferred between the two books may have an impact on a respective book’s profit or loss charge and so may be of relevance.

The proposals provide the following illustration of how to determine the amount of the loss allowance to be transferred from the good book to the bad book:

<table>
<thead>
<tr>
<th>Portfolio</th>
<th>Nominal amount to transfer to bad book</th>
<th>Expected loss over remaining life on transferred amount</th>
<th>Weighted average age of transferred amount</th>
<th>Weighted average life of transferred amount</th>
<th>Allowance transferred from good book</th>
<th>Additional allowance needed for bad book</th>
</tr>
</thead>
<tbody>
<tr>
<td>T</td>
<td>300</td>
<td>50</td>
<td>4 years</td>
<td>5 years</td>
<td>40</td>
<td>10</td>
</tr>
<tr>
<td>S</td>
<td>200</td>
<td>40</td>
<td>2 years</td>
<td>5 years</td>
<td>16</td>
<td>24</td>
</tr>
<tr>
<td>R</td>
<td>250</td>
<td>50</td>
<td>2.5 years</td>
<td>5 years</td>
<td>25</td>
<td>25</td>
</tr>
<tr>
<td>Q</td>
<td>400</td>
<td>75</td>
<td>3.5 years</td>
<td>5 years</td>
<td>52.5</td>
<td>22.5</td>
</tr>
<tr>
<td>P</td>
<td>150</td>
<td>100</td>
<td>1.5 years</td>
<td>10 years</td>
<td>15</td>
<td>85</td>
</tr>
<tr>
<td>O</td>
<td>500</td>
<td>80</td>
<td>4 years</td>
<td>10 years</td>
<td>32</td>
<td>48</td>
</tr>
</tbody>
</table>

SD IEZ18
In respect of portfolio T above, the allowance to be transferred from the good book and the additional allowance that has to be created within the bad book are calculated as follows:

<table>
<thead>
<tr>
<th>Step</th>
<th>Calculation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Determine the age and life of the individual transferred asset</td>
<td>4 years and 5 years, respectively</td>
</tr>
<tr>
<td>Estimate expected credit losses over the remaining expected life of</td>
<td>50</td>
</tr>
<tr>
<td>the individual transferred asset</td>
<td></td>
</tr>
<tr>
<td>Transfer the time-proportional amount from the good book to the bad book</td>
<td>40*</td>
</tr>
<tr>
<td>Re-estimate the amount of expected credit losses for portfolio T in</td>
<td>10</td>
</tr>
<tr>
<td>the good book and adjust the impairment if necessary</td>
<td>(50 - 40)</td>
</tr>
<tr>
<td>Re-estimate the amount of expected credit losses for the bad book</td>
<td></td>
</tr>
<tr>
<td>and adjust the impairment allowance</td>
<td></td>
</tr>
</tbody>
</table>

* In this example, it is assumed that company B applied the straight-line approach for undiscounted expected losses in determining the time-proportional amount.

4.8 Effective interest rate

The exposure draft proposed an approach that integrated impairment determined on an expected loss basis into amortised cost measurement by requiring inclusion of the initial estimates of expected losses into the calculation of the EIR. The IASB received feedback that this approach would represent a significant operational challenge and would require substantial costs and time to implement.

The time-proportional method proposed in the supplement is designed to provide a simplification of the originally proposed method in the exposure draft. This follows the IASB’s decision to decouple the computation of the EIR from the consideration of credit losses for assets managed on an open portfolio basis.

Observations – Decoupling EIR from expected loss calculations

The supplement does not state whether the IASB’s decision to decouple the EIR from the consideration of expected losses would apply also to financial assets not managed as part of an open portfolio. The IASB’s Appendix Z seeks feedback on whether the determination of the EIR should be separate from the consideration of expected losses.
5. Scope of IAS 39 and IFRS 9 (IASB only)

The IASB’s Appendix Z requests feedback on the following aspects of the scope of IAS 39 and IFRS 9:

- whether loan commitments that are not measured at fair value through profit or loss should be included in the scope of the impairment requirements proposed in the supplement; and

- whether the proposed impairment model requirements would be operational if applied to loan commitments and financial guarantee contracts.

Loan commitments and loans are often managed using the same business model and information systems. The IASB has received feedback from constituents urging the alignment of impairment requirements for all credit exposures irrespective of type, i.e. whether they are loans or loan commitments.

In the exposure draft on insurance contracts, the IASB proposed that all issued financial guarantee contracts should be brought within the scope of the proposed IFRS on insurance contracts, rather than IAS 37 Provisions, Contingent Liabilities and Contingent Assets or IAS 39. There was a general concern from banking institutions on this change in how financial guarantees are scoped in or out of standards. Many of the respondents preferred to have scoping provisions similar to IFRS 4 Insurance Contracts, which provide an accounting policy election, or scoping based on the business model of the issuer. The IASB has not yet re-deliberated the responses and acknowledges that there is uncertainty about which requirements will apply to these contracts.

Observations – Scope of IASB-only proposals: loan commitments and financial guarantee contracts

Currently, loan commitments are excluded from the scope of IAS 39 unless they are designated as at fair value through profit or loss, they can be settled net in cash or represent commitments to provide a loan below market rates. Credit losses on loan commitments outside the scope of IAS 39 are today recognised by applying IAS 37. Losses arising on financial guarantee contracts not measured at fair value through profit or loss are also recognised with reference to IAS 37.

As financial sector entities often manage credit risk arising from drawn and undrawn loan commitments and financial guarantees using similar systems and processes, many commentators argue that applying the same impairment rules to these contracts may result in more decision-useful information for the users of the financial statements.

Observations – Loan commitments in retail portfolios

For entities with retail/consumer lending portfolios, operationalising the proposals may be very difficult without considering associated loan commitments. For their internal credit risk management purposes when determining ‘exposure at default’ amounts for these types of financial assets, most entities consider the amount receivable and the undrawn amount of the commitment as one, given the nature of the impairment losses for these instruments.

For example, for a credit card receivable, banks may consider the full credit limit when estimating expected losses. This is because experience may indicate that when the credit card receivable becomes problematic often the full amount of the limit has been utilised.
6. Presentation (IASB only)

The IASB's Appendix Z proposes that the following line items would be presented separately in the statement of comprehensive income:

- interest revenue, calculated using the effective interest method; and
- impairment losses, including reversals of impairment losses.

**Observations – Presentation**

The proposed presentation is consistent with the existing practice of many financial institutions, which regard both net interest margin and impairment losses as important key performance indicators.
7. Disclosure (IASB only)

7.1 Overview

The proposed disclosure requirements are intended to be incorporated into IFRS 7 Financial Instruments: Disclosures. Accordingly, the general requirements in that standard would continue to apply, i.e. disclosures are made by class of financial instrument, where appropriate.

The supplement gives an example of the following classes of financial assets if the entity is a financial institution:

- government and central banks, further disaggregated into countries with AA ratings (or equivalent) and above, and countries with A ratings (or equivalent) and below;
- financial institutions;
- corporate;
- retail, further disaggregated into secured by real estate collateral, qualifying revolving retail, retail loans to small and medium-sized entities and other;
- securitised financial assets; and
- below investment-grade.

The supplement gives an example of the following classes for an entity which is not a financial institution:

- collateralised wholesale;
- non-collateralised wholesale;
- collateralised retail;
- non-collateralised retail; and
- credit card business.

7.2 Allowance account

Consistent with the exposure draft, the supplement proposes mandatory use of a credit loss allowance account. The following key disclosures are proposed:

- For the allowance account:
  - separate reconciliations of the allowance amounts for the good book and the bad book;
  - if losses expected to occur within the foreseeable future are higher than the time-proportional amount, then the amount of the excess; and
  - a reconciliation of the nominal amounts of assets in the bad book.

- For the good book, the following information for the current period and the previous four periods:
  - the nominal amount of the assets;
  - the expected lifetime credit losses;
  - the impairment allowance balance; and
  - any excess of losses expected to occur within the foreseeable future over the time-proportional amount.
7.3 Expected credit loss estimates

The supplement proposes that an entity would disclose information to explain the estimates supporting the loss allowance. This would include the following:

- for both the lifetime expected credit losses and credit losses expected to occur in the foreseeable future:
  - the basis of inputs and the estimation techniques used to determine the credit losses;
  - the time period used as the foreseeable future and how it was determined; and
  - an explanation of any changes in estimates and/or in the estimation techniques and the reason for the change;
- if a particular portfolio or geographical area has significant effects on impairment losses, then quantitative and qualitative analyses of these effects; and
- quantitative and qualitative information on how previous estimates of expected credit losses compare with the actual outcomes.

7.4 Credit risk management

The supplement proposes that an entity would disclose information about its internal credit risk management to enable readers of the financial statements to understand the relationship between how assets are managed and how credit losses are estimated. This would include:

- disclosure by credit risk rating grade of the nominal amounts of financial assets, the lifetime expected credit losses and credit losses expected to occur in the foreseeable future;
- description of the criteria use to distinguish between assets in the good book and the bad book; and
- information about internal credit ratings, i.e. if used and how those ratings relate to assets in the good book and the bad book and external ratings, if available.
Observations – Volume of the disclosures

The proposed disclosure requirements appear extensive. However, as the proposed model for recognition of impairment would allow substantial flexibility and significant judgement in how it is implemented, the disclosures aim to provide sufficient information to enable users to understand how that flexibility and judgement have been exercised.
About this publication

This publication has been produced by the KPMG International Standards Group (part of KPMG IFRG Limited).

Content

Our New on the Horizon publications are prepared upon the release of a new proposed IFRS or proposed amendment(s) to the requirements of existing IFRS. They include a discussion of the key elements of the new proposals and highlight areas that may result in a change of practice.

This edition of New on the Horizon considers the proposed requirements of the supplementary document on impairment of financial instruments related to ED/2009/12 Financial Instruments: Amortised Cost and Impairment.

The text of this publication is referenced to the supplement, including the IASB’s Appendix Z, the original exposure draft and to selected other current IFRSs in issue at 31 January 2011. References in the left-hand margin identify the relevant paragraphs.

Further analysis and interpretation will be needed in order for an entity to consider the potential impact of this supplement in light of the entity’s own facts, circumstances and individual transactions. The information contained in this publication is based on initial observations developed by the KPMG International Standards Group, and these observations may change.

Abbreviations

IASB: International Accounting Standards Board
FASB: US Financial Accounting Standards Board
G20: Group of Twenty

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