

Staff preliminary observations on the IASB's tentative decisions relating to its supplemental impairment model

The scope of the forthcoming supplemental document is financial assets managed on an open portfolio basis. It excludes financial assets that are not managed in an open portfolio, for example, trade receivables, closed portfolio assets, individually managed loans, whether fixed or variable rate instruments.

1. Application of the 'good' book/'bad' book methodology

- 1.1 As mentioned in the memo, paragraph 3, the IASB tentatively decided to base its supplemental impairment model on a 'good' book/'bad' book approach (Agenda paper 8.3 explains this method). Paragraphs 11 and 12 of Agenda paper 8.3 notes that the criteria for determining when a loan is moved from the entity's 'good' book to its 'bad' book differs across entities and is based on their credit risk management practices.
- 1.2 In particular, Agenda paper 8.3, paragraph 16, notes that "For this particular financial institution 'potentially bankrupt borrowers', 'effectively bankrupt borrowers' and 'bankrupt borrowers' are more actively managed in its 'bad' book. For this particular financial institution, specific/individual provisions for EL are created for borrowers in the 'bad' book. For 'normal borrowers' and 'borrowers requiring caution', EL are provided for on a collective basis (i.e. at the portfolio level). ...". Staff understand that this is consistent with the way most Australian lenders manage their open portfolio financial assets.
- 1.3 Staff note that:
 - (a) in assessing when impairments of financial assets have occurred, the notion of 'good' book/'bad' book and the AASB's recommended IBNR model are probably similar. The AASB recommended in its comment letter to the IASB's earlier impairment proposals in ED/2009/12 the use of an incurred but not reported (IBNR) impairment model. The IBNR model uses general information about the economic environment, such as rates of unemployment, rates of employment participation, asset price inflation and rates of economic growth, to infer the occurrence of specific events that give rise to impairment losses, and is akin to the approach currently used by many Australian banks;
 - (b) a proposed impairment model that is based on an entity's management of assets (in this case, the 'good' book/'bad' book concept) is consistent with the IASB's previous decisions to align the classification of financial assets under IFRS 9 with the entity's business model; and
 - (c) some Australian lenders calculate impairments on their 'good' books based on the risk-rated and roll-rate methods, which involves applying probabilities of default on the outstanding balance of the loans. The probability calculation is based on their historical loss patterns. Specific provisioning, whereby loans are assessed individually, is applied on their 'bad' books and judgement is applied to decide whether partial or full credit losses are recognised.

Question for the Board:

Does the Board have any preliminary views on the 'good' book/'bad' book approach?

2. The notion of ‘reasonable and supportable’ information

2.1 The IASB has tentatively decided an entity should recognise an impairment allowance for ‘good’ book assets that is the higher of:

- (a) the time-proportional¹ expected credit losses; and
- (b) the credit losses expected to occur within the foreseeable future, and no less than 12 months after an entity’s reporting date.

For credit losses expected to occur within the foreseeable future, the IASB tentatively decided that an entity should make its best estimate for a period for which ‘reasonable and supportable’ information exists to support specific projections.

2.2 The meaning of ‘reasonable and supportable’ and, in particular, whether it has any connection with the IASB’s recently developed notion of ‘verifiability’ in the context of the Conceptual Framework is not yet clear.

2.3 For example, should a bank consider the possible impacts of the closing of a factory today on the basis that it expects this event will affect factory employees who have borrowed from the bank and will probably lead to lower levels of economic activity that will in turn affect suppliers to the factory who have borrowed from the bank? Based on discussions Australian lenders, there are varying interpretations of using ‘reasonable and supportable’ information. In the case of the example, one view is that there is no observable data in relation to default payments (hence, no reasonable and supportable information), and therefore impairment losses relating to loans to staff and suppliers of the factory should not be recognised. A second view is that, based on historical evidence, the closing of the factory is the observable evidence that future cash flows on loans to the factory employees and suppliers will be affected. A third view is similar to the second view, except that historical evidence shows that the closing of the factory also leads to lower levels of general economic activity. Staff consider that the second and third views are consistent with the notion of the IBNR approach to impairment.

2.4 Staff note that, in its comment letter on ED/2009/12², the AASB argued for a distinction between (i) information that provides the basis for determining that particular events have already occurred and which gives rise to impairments (or reversals of impairments) from (ii) forecast information, which goes beyond a cost model and the IBNR approach. (Paragraph 1.2.7, page 5)

Question for the Board:

Does the Board have any preliminary views on the notion of ‘reasonable and supportable’ information?

¹ Under the (lifetime) time-proportionate approach, the expected loss is allocated over the total life of the portfolio of the ‘good’ book by building up an allowance that at each measurement date is equal to a proportion of the current expected loss estimate determined on the basis of the portfolio time period that has passed (i.e. the life-to-date) divided by the total life.

² http://www.aasb.gov.au/admin/file/content106/c2/AASB_submission_to_IASB_-_ED_2009-12_Amortised_Cost_and_Impairment.pdf

3. Eligible range of discount rates for discounting expected losses

- 3.1 The IASB tentatively decided that when discounting expected credit loss amounts, an entity may use as the discount rate any 'reasonable' rate between (and including) the risk-free rate and the (contractual) effective interest rate as used in IAS 39.
- 3.2 Staff consider this as an issue of consistency if free-choice within a range is given in determining the rate to discount the expected losses. Staff also note that the IASB has not yet discussed any requirements to disclose the discount rate and the rationale for the choice of discount rate.

Question for the Board:

Does the Board have any preliminary views on the range of discount rates for discounting expected losses?

4. Potential for multiple financial asset impairment models

- 4.1 One of the main concerns raised by the AASB and many others in relation to ED/2009/12 is the application of the model to short-term trade receivables. ED/2009/12 was focused on dealing with financial institutions and potentially forces non-financial institutions to adopt an overly complex measurement process for trade receivables.
- 4.2 To address those concerns, the IASB decided that short-term trade receivables should be excluded from the scope of the forthcoming supplemental document. Instead, the IASB decided that short-term trade receivables should be considered when the measurement of revenue is decided as part of its project on Revenue from Contracts with Customers. The IASB has flagged it might consider the following impairment approaches for short-term trade receivables:
- (a) the impairment model developed as a result of the forthcoming supplemental document for financial assets managed in open portfolios;
 - (b) the proposed expected cash flows model in the IASB ED/2009/12;
 - (c) the IAS 39 'incurred loss model'; or
 - (d) a separate model that the IASB might subsequently develop.
- 4.3 The AASB's ED/2009/12 submission³ also argued against creating new impairment models, and suggested the use of IAS 36 *Impairment of Assets* impairment model could be employed to achieve recognition of impairment losses across all financial assets measured at amortised cost (paragraphs 1.1.1 to 1.1.5). With the development of the supplemental impairment model, it appears there will be a proliferation of impairment models. Staff are concerned about the IASB's increasingly piecemeal approach to revising its Standards on financial instruments.

Question for the Board:

Does the Board have any preliminary views on the potential proliferation of impairment models?

³ http://www.aasb.gov.au/admin/file/content106/c2/AASB_submission_to_IASB_-_ED_2009-12_Amortised_Cost_and_Impairment.pdf