

STAFF PAPER

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REGIASB Meeting

Project	Impairment		
Paper topic	Feedback Summary		
CONTACT(S)	Manuel Kapsis	mkapsis@ifrs.org	+44 (0)20 7246 6459
	Jana Streckenbach	jstreckenbach@ifrs.org	+44 (0)20 7246 6473

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Introduction

1. By July 2012 the IASB and the FASB had finished deliberating all joint matters in developing the general framework of the three-bucket model¹.
2. In August the FASB directed their staff to explore an alternative expected loss model that (a) does not use a dual-measurement approach and (b) reflects all credit risk in the portfolio at each reporting date (see the summary of that decision in the appendix to this paper). The FASB decided to explore an alternative model in response to the feedback received from US constituents about the three bucket model.

¹ On completion of developing the model the boards tentatively agreed that it was only necessary to distinguish between assets with a 12 month allowance balance and those with a life time expected loss balance. Thus essentially the model is now a '2 bucket model'. However, because everyone is familiar with the '3 bucket' description and because a third stage of deterioration (ie incurred losses) triggers a change in the way interest revenue is presented we have used the '3 bucket' description for the purposes of this paper.

3. Throughout the deliberations on the three-bucket model, IASB members and IASB staff have conducted ongoing outreach to discuss the boards' tentative decisions. Matters raised during those meetings have been reported to the Board on a timely basis and reflected in the staff analysis during the deliberations.
4. In recent months, the IASB staff have had more detailed discussions with our constituents including discussions based on the following materials:
 - (a) a staff working draft summarising the board's decisions on the three-bucket model supplemented by examples.
 - (b) a paper summarising the three-bucket model and a lifetime day one loss model, supplemented by a number of examples that illustrated the effect on the balance sheet and income statement of each of those models.
5. The primary purpose of these recent outreach activities was to receive:
 - (a) feedback on whether the three-bucket model would be operational;
and
 - (b) feedback on whether the three-bucket model or a lifetime day one loss model provides more useful information.
6. The purpose of this paper is to provide the Board with detailed feedback received from that outreach and to discuss the next steps.
7. Prior to the most recent outreach, we had received feedback that more clarity was required to determine when full lifetime expected losses should be recognised in the three bucket model. The Board's preference had been to establish a broad principle describing the point assets move to lifetime losses, supported by examples. The staff draft sought to clarify the application of the principle with the use of examples.
8. This paper provides information about the detailed feedback that we received. In summary the key messages were:

- (a) Support from a majority of respondents for an impairment model that distinguishes assets that have deteriorated from those that have not.
- (b) However, additional costs and complexity arise from making the distinction between assets that have deteriorated and those that have not. The Board needs to ensure that the benefits of the information resulting from that distinction exceed the costs of obtaining it.
- (c) Regarding the criteria that determine when lifetime expected losses are measured:
 - (i) The concept of ‘more than insignificant deterioration in credit quality’ should more clearly capture deterioration that is substantive rather than any deterioration.
 - (ii) Clarity is needed about the level of credit quality when it is considered reasonably possible that contractual cash flows will not be paid in full.
- (d) The application of the criteria to retail loans is particularly difficult given the way such assets are managed and the information that is available – requests were made to consider and clarify the relevance of delinquency information in making that assessment.
- (e) Some question the conceptual merits of the model, in particular the 12 month expected loss measure particularly in the absence of convergence and would prefer that we reconsider the Supplementary Document (without a floor for the good book) or the original IASB ED.

Background

- 9. For a summary of the Board’s tentative decisions reached in developing the three-bucket impairment models, see Agenda Paper 5B.
- 10. This paper divides the feedback into two main categories of respondents: users of financial statements and others. ‘Others’ includes prudential regulators, audit

firms, banks with various degrees of sophistication and some accounting standard setters. The messages from the second group tended to have a common theme, however where differences arose we have sought to reflect that in the summary.

User Feedback

11. The staff received feedback from 13 buy-side and sell-side analysts from different organizations and geographical regions.
12. The input from the analysts was based on a description of the three-bucket model and examples of the application of that model and a lifetime day one loss model.
13. While many respondents noted that a lifetime loss approach would be easier to understand, **the majority of the analysts we spoke to favoured the three-bucket model instead of the lifetime day one loss model.** However, some favoured a lifetime loss approach while others preferred the approach in the original IASB Exposure Draft (ED). The majority of respondents were concerned about the high degree of judgment involved in both models and requested high quality disclosures to enable them to assess those judgments.

Usefulness of information

14. The majority of the analysts favoured the three-bucket model because it better reflects the economics of lending than a lifetime day one loss model. They were concerned that a lifetime day one loss approach does not depict economic reality and distorts profit and loss, leading to a smoother loss profile over the life of a loan.
15. Some users specifically expressed concern that lifetime expected losses recognised on initial recognition does not consider the future interest income that compensates for those expected losses and therefore overstates the loss.

16. The analysts who preferred the three-bucket model also stated that information about changes in credit quality is important to them and thought that the three-bucket model provides a better understanding of changes in credit quality compared to the lifetime day one loss approach. This is because it is more sensitive to changes in credit deterioration. Not only are the expected loss estimates updated, but also the change in measurement to a full lifetime loss when assets deteriorate sufficiently.
17. Some users stated that recognising lifetime losses on day 1 is too prudent and that it seems to address the objectives of prudential regulators rather than the objectives of general purpose financial reporting.
18. Several analysts were concerned that a lifetime day 1 loss might influence management behaviour inappropriately, leading to restrictions on loan growth, either by volume or maturity, in difficult economic times or in order to increase management's compensation.
19. Some analysts did however favour the lifetime loss approach. They did so for different reasons:
 - (a) Concern about the discretion and judgement involved when changing the allowance to reflect full lifetime losses in the three-bucket model;
 - (b) The specification of '12 months' expected losses' in the three bucket model. The analyst who made this objection believed that the amortised cost classification reflects a 'hold to maturity' strategy, in which case it would be preferable to see total losses based on an assessment over the holding period rather than an (arbitrary) 12 month perspective;
 - (c) one analyst stated that they believe that lifetime losses recognised on day one reflects how business is actually done.
20. Other analysts did not support either the three-bucket model or the lifetime expected loss model. They favoured the approach in the original ED, which distinguished between the initial expected credit loss and subsequent changes in loss expectations. Concern was expressed that lifetime expected losses do not

consider the future interest income and therefore overstate the loss on initial recognition. On the other hand, the three-bucket model would result in artificial volatility caused by changing the allowance measurement not just to reflect the change in loss expectations but also the change from 12 month's losses to lifetime expected losses. Those users suggested that if the IASB does not revert to the approach in the original ED, it should either keep the current incurred loss model or require disclosures that differentiate between initial and subsequent changes in credit quality.

Management judgement

21. Users were concerned about the management judgement involved to determine when assets move to lifetime expected losses. They requested that more clarity be provided on when items move to lifetime expected losses, to increase consistent application and comparability. However, there was no support for introducing a bright line to clarify when assets should move to lifetime expected loss because of the uncertainty and judgement that would still be needed to assess whether the bright line criteria is satisfied.
22. For the lifetime loss approach, some users criticised the judgement necessary in estimating lifetime expected losses for all long-term instruments from initial recognition.

Disclosure

23. In order to assist analysts in the event that the IASB and FASB ultimately finalise different approaches, many requested that lifetime losses be disclosed for assets with allowances measured based on 12 months' expected losses. However, those users who were already concerned about the level of judgement involved questioned how reliable such disclosures would be.
24. Most of the users requested reconciliation of the allowance from period to period to understand if changes in the allowance relate to new originations or changes in credit quality of existing loans.

Feedback from others

25. This section summarises the feedback received from prudential regulators, audit firms, banks with various degrees of sophistication and some accounting standard setters.
26. **Most of these respondents supported a model that distinguishes assets that have deteriorated from those that have not. However, almost all respondents were concerned that the distinction is currently too unclear to identify the assets for which lifetime allowances are recognised and requested that the board make a clearer distinction.**
27. Some noted however that the benefit of such a model probably does not outweigh its cost if assets move to lifetime expected losses based on any deterioration (ie a ‘hairtrigger’). They felt that the small resulting difference in allowance balance compared with a full lifetime loss model would not justify the incremental cost of identifying assets that have deteriorated in credit quality. Some think that in the absence of convergence, we should go back to supplementary document (SD) without a floor for the good book or back to the original ED.

Lifetime day one model

28. Most respondents support our attempt to distinguish assets that have deteriorated from those that have not. They did not support a model that recognises lifetime losses on day one for all assets, because it does not reflect the economics of lending, would create disincentives to long-term and high-risk lending and may lead to reductions in new lending in tough economic conditions.
29. In addition, those respondents think that the lifetime day one loss model focuses on the adequacy of the allowance balance which should be the focus of prudential regulators rather than accounting standard setters.

30. Most respondents noted that the lifetime loss model is less complex than the three-bucket model. They view the three-bucket model as more complex due to the requirement to determine when to switch between 12-month and lifetime expected losses, and the requirement to perform two measurements.
31. Similarly, some audit firms stated the lifetime expected loss model would be easier to audit because it would not require assessment of when to change to or from a full lifetime loss measure.
32. The prudential regulators have not expressed a formal opinion on the three-bucket model at this stage. However, their preliminary feedback was mixed. Some, particularly in the US, favour a lifetime expected loss model. This is primarily because they fear that the three-bucket approach may actually reduce allowance balances relative to those recognised today. Some were concerned that the three-bucket model, unless more clearly articulated, could enable entities to avoid recognising lifetime expected losses on a timely basis. However, others agreed that a differentiation based on deterioration is important and appropriate, particularly in the context of general purposes financial statements.
33. Some banks who supported the three-bucket model provided conditional support noting that if our criteria resulted in assets moving to lifetime expected losses based on any deterioration whatsoever, resulting in very similar allowance balances to a full lifetime loss model, then the costs of the three-bucket model probably do not outweigh the benefits compared to a lifetime loss model.

Three-bucket model***12-month expected loss²***

34. Many support the use of a 12-month expected loss measure. Some do so because it provides some offset to contractual interest rates (ie a proxy for a yield adjustment). Also there is support on operational grounds from some because it will enable them to make use of information that they already use for prudential purposes. However, others were still confused by what is being measured and some disagreed conceptually with the inclusion of this concept in the model. The latter criticism is more pronounced now that the FASB are deliberating a new model and thus we are unlikely to achieve convergence. Further details are set out below.

a) Clarifications

35. Some respondents were still confused by the measure and how it would be applied. They asked that the Board:
- (a) provide an example of the 12month's expected loss calculation.
 - (b) clarify what constitutes a loss event/default and whether the regulatory definition of default could be used when measuring 12 month's expected losses. They also stated that it would be helpful if the Board clarifies that a broader or narrower definition of

² 12 months expected losses are all cash shortfalls expected over the lifetime (that is, the full loss content) that are associated with the likelihood of a loss event in the next 12 months; that is, the losses being measured are not only the cash shortfalls over the next 12 months. Various approaches can be used to estimate the expected losses, including approaches that do not include an explicit "12-month probability of a loss event" as an input.

default/loss event could be used in calculating 12month's expected loss because they cause a counteracting effect.³

- (c) clarify the interaction with the regulatory parameters because some respondents were confused about the similarities and differences between the 12-month expected loss measurement and current regulatory requirements in Basel II.⁴

b) Operational feedback

36. Some less sophisticated banks mentioned that they do not actually calculate a 12-month expected loss for regulatory purposes—the regulator provides them with guidance on how much to book for their provision. Thus those banks would need to incur significant costs to upgrade their systems to calculate a 12month's expected loss. However, the staff notes that system upgrades would be inevitable for those banks regardless of the details of the final expected loss model.

³ The Boards have previously noted that using a consistent set of assumptions, the narrower definition of default/loss event would increase the probability of default but result in a lower average severity (eg LGD) and vice versa for a broader definition of default.

⁴ During the deliberations of the three bucket model, the board noted that entities could leverage existing credit risk systems, in particular Basel II, in calculating the 12 month's expected loss allowance, but that there are important differences between the Basel II calculations for regulatory capital purposes and the 12-month expected loss measure for financial reporting purposes that would require adjustments, for example:

(a) For Basel II parameters, an entity considers loss expectations through-the-cycle rather than assessing expected losses based on a point in time estimate.

(b) The Basel II framework requires the downturn of 'loss given default' (ie 'stressed' LGDs, or worst-case scenarios), whereas expected loss for financial reporting purposes shall be based on the probability weighted average (eg downturn, base case, upturn).

(c) Basel II parameters have floors that would need to be removed for accounting purposes.

c) Conceptual feedback

37. Some responses addressed the conceptual basis for the 12 month measure. Those respondents expressed concern that recognising 12 months' expected losses on day one does not reflect the economics of lending. They also believe that the 12-month expected loss was chosen as a compromise with the FASB to achieve convergence and thus should be reconsidered, given that the FASB is not planning to pursue this model.
38. Some of those respondents have suggested that in the absence of convergence we should go back to the supplementary document without the floor for the good book (ie only the time proportional approach for the good book and lifetime losses for the bad book). A few said that because convergence is now unlikely, the IASB should go all the way back to the original ED which has a strong conceptual foundation.

The recognition of lifetime losses – criteria

39. In the three-bucket model, an entity shall measure the impairment allowance for an asset at lifetime expected losses if, at the reporting date, the probability of not collecting all contractual cash flows:
- (a) has increased more than insignificantly since initial recognition; and
 - (b) is at least reasonably possible.
40. Most respondents raised concerns that these criteria are not sufficiently defined. They believe that it is essential to clarify the criteria to enable easier understanding, improve the likely consistency of application and also, if possible, to ease the burden of implementation (see operational concerns in paragraphs 57 and 58).
41. A few preferred to keep the criteria at a principles level and allow judgement in implementing and interpreting the criteria.

a) Clarifications

42. Below we look at the two components of the criteria in turn.

More than insignificant deterioration

43. Most respondents were unclear about how much deterioration should be properly regarded as ‘more than insignificant’. Many were concerned that these words could be interpreted as catching essentially any determinable deterioration with the result that assets of low credit quality on origination would quickly be transferred to a lifetime loss measure.
44. While most agreed that we needed to ensure that we capture more ‘meaningful’ deterioration there were a wide variety of suggestions made about what change should be made to the criteria to achieve this.
45. Those respondents who think further guidance is necessary made the following suggestions:

- (a) a one-step change in internal credit grade.

This suggestion was made on the basis that a bank would not introduce steps in their grading system that are ‘insignificant’. Taking this approach, the criteria would be dependent on the specific level of detail of a bank’s grading system (ie a movement down a grade would be presumed to be ‘more than insignificant’). However, banks themselves noted that this would disadvantage entities with more sophisticated credit risk systems because those entities would probably have an accelerated recognition of lifetime expected losses on their loans.

- (b) A change in internal credit grade the magnitude of which would depend on the credit quality at origination.

So, a smaller change in grades would be required to meet this criterion for poorer quality loans compared to the change required for a good credit quality loan (eg, a decrease by 5 grades for a good loan would reflect a ‘more than insignificant deterioration’, while a decrease by only 1 grade for a poor credit quality loan would be enough). This is more complicated but banks noted that this would be consistent with the exponential curve of the probability of default

(PD) whereby the slightest increase in credit risk for a poor quality loan is obviously significant.

- (c) a percentage increase (ie multiple) or an absolute (ie fixed) increase in the probability of default.

This raises the question of whether an increase from 0.01 per cent to 0.02 per cent should be treated the same as an increase from 10 per cent to 20 per cent (ie increase by 100 per cent), or alternatively, if the criteria should be based on an absolute increase in the probability of default (for example a change in the probability of default of 3 per cent).

- (d) internal risk management procedures.

For example, ‘more than insignificant deterioration occurs’ if the exposure is monitored more closely because of heightened credit risk compared to other loans. Banks noted that the benefit of this approach is that it builds on current risk functions and can be applied to both wholesale and retail loans. Some also noted that the distinction between the good book and bad book of the SD was a clear concept of when to recognise lifetime losses. Others noted however that an approach based on the way assets are managed may be lagging.

- (e) change in pricing due to an increase in credit risk (assuming the issuer were to newly originate the loan).

At least reasonably possible

46. The board’s intention was not to capture assets where the probability of default is de minimus. Rather, its intention was to capture assets whose probability of default is high enough that adverse economic conditions and changing business or financial circumstances could lead to the inability to fully recover cash flows in the medium to short term. The intention was certainly not to capture investment grade assets. Similarly, the entire portfolio would only meet the criterion “reasonably possible” if its absolute level of credit risk is high.

47. Most respondents were clear that the second criterion is an absolute credit risk test (ie it is satisfied when an asset is at or below a particular credit quality). However, they were not clear about the level of risk that would satisfy the criterion.
48. Some banks noted that statistically they would conclude that it is always reasonably possible that a loan may default. As a result, banks are concerned that the criterion could be interpreted as always being met causing lifetime expected losses to be recognised whenever deterioration is identified.
49. Some respondents were also unclear about how to apply this criterion to a portfolio. They noted that it will always be the case that an entity won't expect all contractual cash flows to be collected on a portfolio. Consequently, it seems that the criterion 'at least reasonably possible' would always be met or it would seem to be easier to meet on a portfolio basis than on an individual basis. This was not the intention – rather a portfolio is made up of items of similar credit risk so that the assessment on a portfolio basis for credit of a particular level is intended to be as if a single asset of such quality were being assessed – but this clearly requires clarification.
50. Given the uncertainty about the level of credit risk the Board intended to capture, some respondents suggested that a bright line be introduced. They think the criterion “reasonably possible” should be met if the asset has an absolute level of credit risk equivalent to a 12 month PD of 10 per cent (or an equivalent measure based on risk management processes, when an entity does not currently measure probabilities of default).
51. Some audit firms suggested that using similar words to those used by external credit rating agencies would provide further explanation of the meaning of “at least reasonably possible”. For example, that the assets need to “...face major ongoing uncertainties or exposure to adverse business, financial, or economic conditions, which could lead to the obligor's inadequate capacity to meet its financial commitment on the obligation” if the criterion is similar to the

distinction between an investment grade and a low speculative non-investment grade.⁵

52. Finally, respondents expressed some concern that the concept of “reasonably possible” might disadvantage longer-term lending if it is not acknowledged that the lifetime probability of default (PD) is higher for like credit quality assets due to their longer duration.⁶ However, this was not the Board’s intention.

b) Application to retail loans

53. Some audit firms and banks raised practical concerns about how the criteria could be applied to retail loans. For many retail portfolios data on probability of default or similar data is simply not available. Instead, those loans are typically managed on a delinquency basis. In particular many banks, especially smaller ones noted that no other information is available for assessing the credit risk of retail assets that is more forward-looking. In other words, delinquency measures are the triggers for, and key determinants of, collections and recovery actions for many retail portfolios. Consequently, those participants asked whether a customer delinquency-based approach could be used to assess whether assets need to move to lifetime losses.
54. Respondents that have the statistics to compare delinquencies and probability of defaults see high correlations. They argue that a delinquency-based criterion to move to lifetime losses constitutes an effective measure of credit deterioration for retail portfolios. They would argue that they could test both criteria for lifetime losses with delinquencies, noting clearly delinquencies show

⁵ See S&P (2009), General Criteria: Understanding Standard & Poor’s Rating Definitions, p. 12-13.

⁶ For example, assume a B rated asset with a five-year maturity. While its 12month PD would be approx. 1%, its (cumulative) lifetime PD would be 26.5%. Note that this example assumes forecast of PDs is the same as the historical average and used historical default rates from Moody’s. (Source: Moody’s Investor Service (2001): Special Comment: corporate Default and Recovery Rates 1920-2010, Exhibit 35).

deterioration and that the probability of default increases significantly if the borrower missed the contractual payments by 30 days.

55. Other respondents said that a delinquency-based approach need not be specifically addressed because they would simply work “backwards” from the criteria of lifetime losses to determine what delinquency measure it equates to in their portfolios.
56. Clearly, a disadvantage of specifically allowing delinquencies to be used to assess the criteria would be that it would risk making the model less forward looking than was originally desired (ideally we had hoped to capture expectations of delinquency rather than delinquency). In addition, a delinquency based model would not capture differences in asset classes or geographies. It would also mean that differences in application would be introduced for retail versus other assets. However, the staff notes that the latter would in effect reflect differences in risk management practice and there is clear operational advantage of developing an approach that leverages delinquency information.

c) Operational feedback

57. Banks were concerned that the impairment model would require data to be stored on the probability of default at initial recognition of an asset and a process would need to be established to compare that probability to updated data each period. Banks noted that the higher the absolute level of credit risk used in the second criterion, the more assets that would always satisfy the second part of the lifetime loss criteria. This would mean that it would be necessary to monitor deterioration (the first part of the criteria) to determine when lifetime expected losses should be recognised. This would increase the amount of tracking required and reduce the benefit the Board sought to provide by including two parts to the transfer test. However, the staff notes that this issue could be alleviated to some extent if some of the suggestions regarding deterioration were implemented. For example if delinquencies is given greater focus for retail portfolios.

58. The assessment for recognising lifetime expected losses is based on the lifetime probability of default. This caused banks to express concerns that entities would be required to determine both the 12-month probability of default and the lifetime probability of default for all assets with a 12 months' expected losses measure. The 12 month PD would be needed to measure the 12 month allowance and the lifetime PD would be needed to determine if lifetime losses would need to be recognised.

Disclosures

59. In contrast to the feedback from users outlined above, many non-user participants noted that the disclosure requirements are excessive and burdensome. The information needed to provide reconciliations is currently not identified in the accounting systems and banks were concerned about the significant costs to upgrade the systems for those disclosures and SOX controls.
60. Banks were also concerned that the disclosure requirements for modified loans would require them to track those loans until derecognition. In particular, banks question why users would be interested in disclosures for modified loans if those loans subsequently increase in credit quality so that 12-month expected losses are recognised.

Next steps

61. Based on the feedback received, the staff think the Board needs to clarify:
- (a) the concept of 'more than insignificant deterioration in credit quality' in such a way that it captures deterioration that is substantive rather than any deterioration.
 - (b) at what level of credit quality it is reasonably possible that contractual cash flows will not be paid in full.

62. The staff note that, if the Board wishes to clarify the above by providing a clearer point of reference, it would need to consider:

- (a) for the deterioration criterion, the difference between a percentage (or multiple) increase in the probability of default and an absolute (or fixed) increase in the probability of default.

Due to the exponential curve of the probability of default (PD) a percentage increase could result in good credit quality assets moving to lifetime losses quickly whereas a large deterioration would need to occur before poorer credit quality assets move to lifetime losses (see the distinction as explained in paragraph (c)).

- (b) the term structure of credit and whether a cumulative lifetime probability or a 12 month probability is used in making the assessment of whether lifetime losses should be recognised (see further at paragraph 58). If a cumulative lifetime probability is used, whether the absolute criterion should be scaled or weighted by the tenor of the credit exposure (ie whether the same probability of default is used irrespective of tenor – see further at paragraph 52).
- (c) the relationship between the two criteria and achieving the right balance between the two. That is, the higher the absolute criterion is set the less restrictive the relative criteria should be set and vice-versa.
- (d) the balance between the benefits and costs of making the distinction. Providing a clearer point of reference may increase the cost of implementing the model, as an entity would need to obtain more detailed information to be able to make the assessment rather than making a more general assessment supplemented with disclosure. It might be beneficial if the staff explain the role of delinquencies given the operational advantage an approach would have that leverages delinquency information especially given what the staff has heard about the credit information available for retail portfolios.

63. It would assist the staff in focussing their analysis if the Board could give guidance on what they would like the staff to investigate and any initial preferences Board members may have in relation to the staff's observations in paragraph 61 and the issues raised in paragraph 62.

Question for the Board

- 1) Does the Board wish to further clarify the criteria for recognition of lifetime expected losses?
- 2) What initial preferences does the Board have in relation to the issues set out in paragraph 62 and/or what issues would Board members like the staff to bring back for consideration?
- 3) In addition to the items listed above, are there any other issues the Board wants the staff to consider?

Appendix

FASB minutes of the August 1, 2012 FASB Board Meeting—Accounting for Financial Instruments: Impairment

Summary of Decisions Reached:

The Board discussed how it would like the staff to address stakeholders' significant concerns about the understandability, operability, and auditability of the three-bucket credit impairment model under development. The Board expressed concern that attempting to clarify the transfer notion and the Bucket 1 measurement concept may still result in a credit impairment allowance that is difficult for users to understand as a result of the dual-measurement approach in the three-bucket model. As a result, the Board directed the staff to explore an alternative expected loss model that (a) does not utilize a dual-measurement approach and (b) reflects all credit risk in the portfolio. Such an approach would allow the Board to leverage several key concepts that have been jointly deliberated and agreed upon with the IASB, while at the same time creating an impairment model that is more understandable, operable, and auditable. The Board indicated its intent to move forward expeditiously in deliberating such an alternative approach. The FASB has invited the IASB to monitor the deliberations on the alternative model and the FASB has committed to sharing its progress with the IASB early this fall.

The Board members voted unanimously in favor of the above decision.