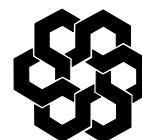




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This document is provided as a convenience to observers at the joint IASB-FASB meeting, to assist them in following the Boards' discussion. It does not represent an official position of the IASB or the FASB. Board positions are set out in Standards (IASB) or Statements or other pronouncements (FASB).

These notes are based on the staff papers prepared for the IASB and FASB. Paragraph numbers correspond to paragraph numbers used in the joint IASB-FASB papers. However, because these notes are less detailed, some paragraph numbers are not used.

INFORMATION FOR OBSERVERS

IASB/FASB Meeting: March 2009, London

Project: Loan Loss Accounting

Subject: Cover paper (Agenda paper 7)

INTRODUCTION

1. At the March 2009 Joint Meeting, the staff will ask the boards to discuss alternative approaches to loan loss accounting. We ask for the boards' advice on how, or whether, we should proceed with further work, rather than decisions about specific approaches. We do not intend to focus on fair value of loan books, because that alternative has been more fully explored elsewhere. We do intend to focus on the discussion in papers a and b below.
2. Our approach is predicated on our expectation that the Financial Stability Forum (FSF) and perhaps the G-20 will ask the IASB and FASB to include loan loss accounting among the financial instruments topics to be considered on an expedited basis. The FSF working group on provisioning, for example, recommended (among other things):

Under the current accounting requirements of an incurred loss model, a provision for loan losses is recognized only when a loss impairment event or events have taken

place which are likely to result in nonpayment of a loan in the future. Identification of the loss event is a difficult and subjective process that results in a range of practice and, potentially, a failure to fully recognize existing credit losses earlier in the credit cycle. Earlier identification of credit losses is consistent both with providing financial statement users transparency into changes in credit trends and regulators with the prudential objectives of safety and soundness. Therefore, the FSF recommends that standard setters give due consideration to alternative approaches to recognizing and measuring loan losses that incorporate a broader range of available credit information, including a fair value model, an expected loss model and dynamic provisioning. In addition, the current disclosures on loan loss provisioning should be assessed to determine adequacy and potential improvements on the information being provided. Moreover, any alternative to the current provisioning model must be assessed to determine whether it can be effectively implemented by preparers and whether it would provide better information than the existing requirement. [From the 12 February draft.]

3. Background papers for this discussion include the following. We suggest that you read them in the order listed.

- a. Loan Loss Provisioning – Analysis of Alternatives

This paper began life in late January as a discussion of loan loss accounting targeted on a wider audience than would be expected of a usual Board paper. It starts simple and stays there, but it hits the key points on the incurred and expected loss models. I am the author of this paper and, so far, the “we” refers to “me.” Again, I wasn’t sure where it would go when I wrote it.

- b. Impairment – incurred loss model

Peter Clark wrote this paper to capture his concerns about the incurred loss model. Much of the material is similar to my paper, but from a somewhat different perspective.

- c. Spanish Provisions Under IFRS

This paper and the accompanying slide presentation were distributed to the FCAG at its February meeting.

- d. Credit Growth, Problem Loans and Credit Risk Provisioning in Spain

This paper is published on the website of the Spanish central bank under the heading “Dynamic Provisioning in Spain.”

- e. Earnings and Capital Management in Alternative Loan Loss Provision Regulatory Regimes

A more recent study of loan loss provisions published by the Spanish central bank in 2006. The authors reach somewhat different conclusions about the usefulness of the statistical approach than appear in item e.

THE RANGE OF ALTERNATIVES

4. Despite all the attention given to loan loss accounting, the staff has been able to identify only four approaches:
 - a. The incurred loss model required by IFRS and US GAAP and described in papers a and b above.
 - b. An expected loss model. One implementation of that model is described in papers a and b above. There may be others, but the staff has yet to identify or describe them.
 - c. Dynamic provisioning, although we have yet to identify a concise definition of the term; and
 - d. Fair value.

Incurred Loss Model – Criticisms

5. As Peter observes in paper b, the principal criticism of the incurred loss model is that it asks accountants to identify an event, or collection events, that cause a credit loss in a particular loan. That may be possible in simple situations, but is not possible for high volume or complex lending. Attempts to clarify the model's application, like the 1998 *Joint Interagency Statement* from US bank and securities regulators have been difficult to develop. IFRS currently include about 4800 words of guidance on financial instrument impairment, most of which is devoted to loans and receivables. Despite that, the FSF working group on provisioning recommended additional clarifying guidance.
6. Perhaps as a consequence of the difficulties just described, loan loss accounting has long been criticized as a tool for earnings management. There is academic research that supports that criticism, but it is not obvious that other systems are either more or less open to manipulation.
7. In the current environment, critics of the incurred loss model maintain that it prevented banks from reporting "known losses" that were inherent in loan portfolios. The staff

observes that there is no way to verify those assertions, or to test whether managements would have booked larger as the bubble inflated. We might suggest that the institutional behaviours that created the bubble were incompatible with adding additional loan provisions. Our suggestion would be just as impossible to verify.

8. On a more conceptual level, the incurred loss model treats loan losses as phenomena that are somehow disconnected from lending. As papers a and b observe, everything else that is directly related to a loan – prepayments, fees, and origination costs – is incorporated into the effective interest rate computations. Peter and I cannot identify any reason why that should be true, other than that it always has been.
9. In some cases, this divorce of loan loss accounting from loan accounting results in higher net income in early years and lower income in later years. That generalization, however, depends a lot on the characteristics of the loans and incidence of incurred losses. As noted in paper a, an incurred loss model might recognize losses more quickly than an expected loss model.

Expected Loss Model

10. Papers a and b describe one implementation to an expected loss model. In this approach, estimated future credit losses are adjustments of future cash flows used in computing an effective interest rate. They are treated in the same way as estimated future prepayments.
11. The staff, at least Peter and I, find the expected loss model more intellectually consistent and supportable than an incurred loss model. I use the term “intellectually” because there is nothing in the IASB *Framework* or the FASB Concepts Statements that would support characterizing either method as more “conceptual.” That said, paper a includes a discussion of practical difficulties with the existing IAS 39 requirements for the effective interest rate method. Requiring preparers to include, monitor, and adjust credit losses through the effective interest rate may be beyond the capabilities of many IASB and FASB constituents.
12. There may be alternative ways to develop a robust expected loss model without the level of computation and data accumulation noted in paper a. The key word in that sentence is “robust.” The staff would not recommend a loan loss model that was an unlimited earnings management device. In our view, the expected loss model as described is no

more or less susceptible to management manipulation than the existing incurred loss model.

Dynamic Provisioning and the Spanish System

13. The staff has yet to identify anyone who knows, or can explain, what *dynamic provisioning* means. It has a sort of biblical implication, as the story of Joseph and the years of fat and lean. Beyond that, it is hard to tell.
14. If you enter the term *dynamic provisioning* into Google, you receive about 239,000 hits. Roughly 238,950 of those appear to relate to a problem data storage unrelated to loans. The others focus on what we will call the *Spanish system*. Searches of the Social Science Research Network, a repository of academic work in process, and Google Scholar show a similar concentration on the Spanish system. It appears to be the only thoroughly articulated dynamic provisioning model.
15. A working paper published by the Bank of Spain¹ offers the best description I have found:

The former prescriptive rules are in sharp contrast with the discretion that bank managers enjoy in many other countries. On top of that, Spain is also known for being the only country that has developed and started to apply (from July 2000 onwards) a dynamic provision (the so-called statistical provision). A detailed explanation of its rational, objectives and mechanism is in Fernandez de Lis, Martínez and Saurina (2000)³. Essentially, during good times, Spanish banks have to set aside provisions for the expected losses that are embedded in expanding credit portfolios. The provisions made during those years are used to build up the so called statistical fund that might be depleted in bad times when the excesses of the last upturn appear in the form of impaired assets. The former is achieved by comparing every quarter the latent loss in the credit portfolio (i. e. a fixed parameter times the exposure) with the amount of specific provisions (which fluctuates significantly along the business cycle).

That difference, if positive, is charged into the P&L whereas, if negative, is written as income in the P&L statement (provided that the statistical reserve has been previously build up). *By design, the dynamic provision produces flat loan loss provision ratios (i. e. loan loss provisions over total loans) through the economic cycle.* It might be of interest to see if such a provision, with a clear stated objective and a transparent

¹ Pérez, Daniel; Salas, Vincente; and Saurina, Jesús. *Earnings and Capital Management in Alternative Loan Loss Provision Regulatory Regimes*. Bank of Spain Working paper 0614. 2006. The footnote reference in the passage is to Bank of Spain Working Paper 18. Both papers are included in the material for the March 2009 joint meeting.

mechanism (i. e. banks must disclose separately the amount of the statistical provision), has altered the behavior of Spanish banks in terms of income and earnings management. As Laeven and Majnoni (2003) indicate, the regulation of bank capital and loan loss reserves has to consider the incentives of banks to take into account macroeconomic shocks, together with the idiosyncratic ones in their loan loss provision decisions. This paper is interested in investigating if differences in loan loss provisions regulations and changes in regulation over time within a country affect the incentives of banks to manage income and capital. The next section presents the behavioral background that will guide the empirical analysis. [Emphasis added.]

16. Papers c, d, and e discuss the Spanish approach to dynamic provisioning. Unfortunately, the descriptions and assertions in the papers appear conflict with one another. The papers describe the Spanish system in algebra rather than the sort of worked examples that are more useful in standard setting debates. As a result, we know both too much and too little about the workings of the Spanish system.
17. The staff proposes to contact officials at the Bank of Spain, and arrange a meeting between their staff and ours. Our objective for that meeting is to outline specific questions and examples that would be necessary for the boards to properly evaluate the Spanish system.

RECOMMENDATIONS

18. The staff recommends that the boards incorporate the analysis of loan loss accounting as a separate work stream in the financial instruments project. That analysis would focus on loan losses in an amortized-cost framework to loan accounting. Fair value measurement generally is a different part of the financial instruments work. The papers presented for this meeting provide a starting point. The staff has (fairly obvious) leanings, but we have not done enough work to make specific recommendations to the boards. Given that, we are especially interested in additional information and analysis that Board members wish to have.