Financial Accounting
Standards Board

International
Accounting Standards
Board

401 Merritt 7, PO Box 5116, Norwalk, CT 06856, USA
Tel: +1 203 847 0700
Fax: +1 203 849 9714
Website: www.fasb.org

30 Cannon Street, London EC4M 6XH, United Kingdom
Tel: +44 (0)20 7246 6410
Fax: +44 (0)20 7246 6411
Website: www.iasb.org

INFORMATION FOR OBSERVERS

IASB/FASB Meeting:	**March 2009, London**
Project:	**Impairment**
Subject:	**Incurred Loss Model (Agenda paper 7B)**

Purpose of this paper

1. This paper summarises two concerns about the incurred loss model for loan losses:

   (a) The model is internally inconsistent. Expected losses are implicit in the initial measurement of a loan asset, but the subsequent accounting ignores changes in expected losses until a loss is 'incurred'.

   (b) The model relies on a distinction between 'incurred losses' and 'future credit losses'. That distinction is often arbitrary.

The model is internally inconsistent

2. At inception, the carrying amount of a loan asset can be regarded as the contractual cash flows, discounted at the contractual interest rate. The contractual interest rate can be regarded as (a) the risk free rate plus (b) a return to cover expected losses plus

(c) a premium for bearing the risk that actual losses may be more than the expected losses.

3. It follows that, an inception, the carrying amount of the loan asset includes a deduction for expected losses.

4. (An alternative analysis leads to the same answer: the initial carrying amount equals the expected cash flows discounted at [the risk free rate plus a premium for bearing the risk that actual losses may exceed the expected losses.])

5. Because the initial carrying amount implicitly includes a deduction for expected loan losses, it would be incorrect to set up an allowance for expected loan losses at inception. That would be double counting. (That double counting is not a feature of the model in IAS 39, but is a feature of some proposals by regulators.)

6. After initial recognition, the incurred loss model does not permit the lender to recognise an impairment until a loss is 'incurred'. This has two consequences:

   (a) The lender accrues interest at the full contractual rate, even though the lender expects not to receive the full amount. In effect, the lender accrues interest at a higher rate than was implicit in the initial carrying amount.

   (b) The initial carrying amount includes a deduction for expected losses. The lender does not account for subsequent changes in that expectation until a loss is deemed to have been incurred.

7. The appendix contains an example that illustrates these points.

What is an incurred loss?

8. The incurred loss model requires an entity:

   (a) to recognise an impairment loss if a credit loss has been incurred

   (b) not to recognise an impairment loss for losses 'expected as a result of future events' [IAS 39.59] or 'future credit losses that have not been incurred' [IAS 39.63]

9. Loan losses occur because of a chain of events. It is rarely, if ever, possible to pick out one of those events and say that the loss occurred at that time. Thus, any attempt to

distinguish between loan losses that have already occurred and future loan losses will often be arbitrary. Of course, IAS 39 gives some guidance on assessing when a loss has been incurred and we could add to the guidance if we wished. Any guidance we add will depend on whether we wish to encourage earlier or later recognition. We will find no way to derive that guidance from the notion of an incurred loss, which in many cases may be arbitrary.

10. If it is not possible, even in principle, to say when a loan loss occurred, it is not possible, even in principle, to distinguish an incurred loss from a future loss.

Appendix

The following material was developed for the IASC's Steering Committee on Present Value. It was in a draft chapter discussing amortised cost.

11.1 Example 11.1 illustrates one of the difficulties that may arise if loans are measured based on contractual cash flows and contractual interest rates.

Example 11.1 – Allowances for Loan Losses, Expected Credit Losses

This example is an extension of examples 2.5 and 2.7 [reproduced below for information]. Bank A is planning to make 1,000 loans of 1,000 each for one year to customers of similar credit-worthiness. Past experience shows that 5% of similar borrowers do not repay anything and a further 5% repay only half of the principal and interest. Bank A believes that this experience will continue. The contractual interest rate is 19%. Interest is payable annually.

After 9 months, Bank A has identified no individual borrowers that are likely to default. However, Bank A still believes that the historical loan loss experience will continue, and that it is unnecessary to change the originally determined adjustment relating to (i) expected defaults and (ii) the risk that actual defaults may be greater than originally expected.

Using the contractual cash flows (1,190,000) and the contractual interest rate (19% annual corresponds to 4.44% for three months), the present value of the future cash flows is 1,139,000, which is more than the expected gross cash flows that will occur in three months. Using the expected cash flows (1,100,000) and expected return (10% annually per Example 2.5, which corresponds to 2.41% for three months), the present value of the future cash flows is 1,075,000.

	'000
Amount lent	*1,000*
Contractual interest	*190*
Contractual cash flows	*1,190*
Less: expected defaults (5% + [5% @ 50%])	*(89)*
Rounding	*(1)*
Expected cash flows	*1,100*

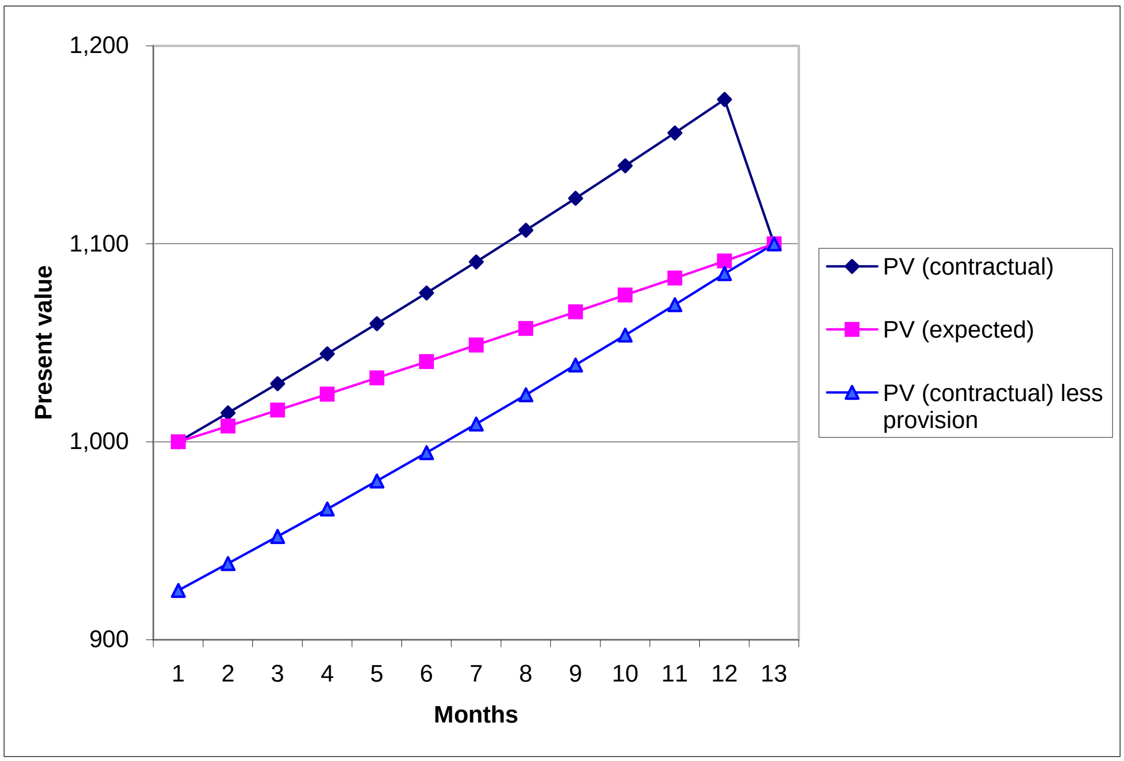
11.2 Chart 11.1 shows the same group of loans in a graphical format.

(a) The upper line marked PV (contractual) shows the present value of the same group of loans at the end of each month, using the contractual cash flows (1,190) and the contractual interest rate (19%). This method of computation is also equivalent to traditional cost-based measurement that accrues interest on the face amount of the loan at the contractual rate. It is assumed that the bank has no information about defaults by specific borrowers until the end of month 12, when repayment is due. By the end of month 7, the present value determined on this basis already exceeds the nominal amount of the cash flows that the enterprise expects to receive on maturity.

(b) The middle line marked PV (expected) shows the present value of the loans at the end of each month, using the expected cash flows (1,100) and the expected return (10%). The present value increases gradually until it reaches the nominal amount of the cash flows on maturity (month 12).

(c) The lower line marked PV (contractual) less provision shows the present value of the loans at the end of each month, using the contractual cash flows (1,190) and the contractual interest rate (19%), after deducting an allowance for loan losses of 7.5%, to reflect the expected level of default. The allowance of 7.5% is based on past experience. It is applied to the entire portfolio, including the loans being considered in this example. This line starts at 966,000 (which is less than the amount originally lent) and increases gradually until it reaches the nominal amount of the cash flows on maturity (month 12).

Chart 11.1 – Loans: Expected Credit Losses



11.3 The effect demonstrated in chart 11.1 arises because the loans were all granted at the same time. In a real portfolio, mis-statements of older loans would be compensated by opposite mis-statements of new loans.

11.4 In the Steering Committee's view, lenders should measure loans based on:

(a) the expected cash flows from the loan; and

(b) discount rates that exclude any premium for expected losses.

11.5 *If this is done, a lender should not set up a general allowance for loan losses as well, as this would result in double counting of the expected defaults. The Steering Committee acknowledges that there may be costs associated with redesigning systems to incorporate expected cash flows. It may be necessary, on cost-benefit grounds, to look for approximations that will deliver similar information for users. Sub-issue 16D discusses a related issue - whether interest revenue should be reported net of expected credit defaults.*

11.6 *In principle, it would be possible to determine the present value of loans using contractual cash flows and the contractual interest rate, and then deduct an allowance for loan losses to reflect the effect of expected defaults. However, Chart 1 shows clearly that general allowances for loan losses that reflect the expected level of default are likely to understate the present value of the loans, particularly in the earlier part of the loan's term. The Steering Committee believes that it will not generally be appropriate for lenders to recognise a loss on initial recognition of a loan, unless the loan has been demonstrably underpriced. On the other hand, measurements that are made without deducting expected defaults that have not yet been identified specifically are likely to overstate the present value of the loans.*

Example 2.5 – Present Value of Portfolio of Risky Assets (Bank Loans)

Bank A is planning to make 1,000 loans of 1,000 each for one year to customers of similar credit-worthiness. Past experience shows that 5% of similar borrowers do not repay anything and a further 5% repay only half of the principal and interest. Bank A believes that this experience will continue. The annual risk-free rate is 6%.

In setting an interest rate for the loans, Bank A considers:

- the risk free-rate of 6%;
- the expected level of defaults; and
- the risk that Bank A has under-estimated the level of defaults that will occur. Assume that Bank A requires a 4% risk premium for taking this risk.

Bank A determines the required interest rate as follows:

Amount lent	*1,000,000*
Expected defaults (5% + [5% @ 50%])	*75,000*
Expected repayments of principal	*925,000*

Bank A requires a total return of 10% (6% risk-free rate plus 4% risk premium). To generate the required cash flow of 1,100,000 (1,000 X 1,000 X 1.10), Bank A must set an interest rate of 18.92% ([1,100,000 / 925,000] - 1) because the debtors that repay their loans must pay sufficient interest to cover the expected defaults of both principal and interest.

Example 2.7 – Contractual Cash Flows and Expected Cash Flows

This example uses the same data and assumptions as example 2.5. Bank A may determine the present value of the future cash flows from its loans in two ways.

Since the bank is lending 1,000,000 today, the present value under any method of computing the future loan repayments must be 1,000,000, assuming that the loans are priced on an arm's length basis and are not priced on a basis that cross-subsidises other transactions.

In the first method, the ***contractual cash flows*** *(1,190,000) are discounted using the* ***contractual*** *interest rate (19%). This gives a present value of 1,000,000.*

In the second method, the ***expected cash flows*** *(1,100,750) are discounted using a discount rate of 10% (the risk-free rate plus the required risk premium for unexpected defaults). Unlike the contractual interest rate, this rate does not include a premium for the expected level of defaults because expected defaults have already been eliminated in determining the expected cash flows.*

Contractual cash flows	1,190,000
Less expected defaults (7.5% of 1,190,000)	89,250
Expected cash flows	1,100,750

The expected cash flows of 1,100,750 discounted at 10% give a present value of 1,000,681. (The difference of 681 is due to rounding because the contractual interest rate of 19% is slightly different from the exact rate of 18.92% determined in example 2.5.)