International Financial Reporting Standards

Impairment Accounting

The views expressed in this presentation are those of the presenter,
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Background and Exposure Draft

(ECF Model)

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IAS 39 replacement – phase II

July 2009:

IASB publishes Request for Information on the Feasibility of the ECF approach (RfI)

September 2009:

Comment period ended for RfI.

IASB deliberations on the ECF approach

November 2009:

IASB publishes ED *Financial Instruments: Amortised Cost and Impairment*

December 2009:

Formation of Expert Advisory Panel (EAP)

First EAP meeting

December 2009 – June 2010:

EAP meetings and outreach

June 2010:

Comment period for ED ends.

July 2010:

IASB re-deliberations begin.

End of 2010 – first half of 2011:

IASB intends to issue final standard on impairment

Amortised Cost and Impairment – scope

- **Phase I - classification and measurement determines the categories**
  - *which* financial assets would be at amortised cost
  - *one* impairment model—for amortised cost
- **Phase II - the impairment phase addresses the impairment *method***
  - *what* that impairment model would be

Current state:
Incurred loss impairment

IAS 39: *incurred* loss approach for financial assets

- What does that mean?
  → Impairment loss only recognised when:
    – Trigger (loss) event occurs
    – Impact can be reliably estimated
- Consequence:
  → Expected losses not recognised before trigger events

Incurred loss criticisms

Criticisms of the *incurred* loss approach include:

- Overstates interest revenue before trigger event (front-loading)
- Does not reflect the underlying economics of the transaction
- Triggers inconsistently applied
- Loss recognition too late

Proposed impairment method: Expected cash flow (ECF) approach

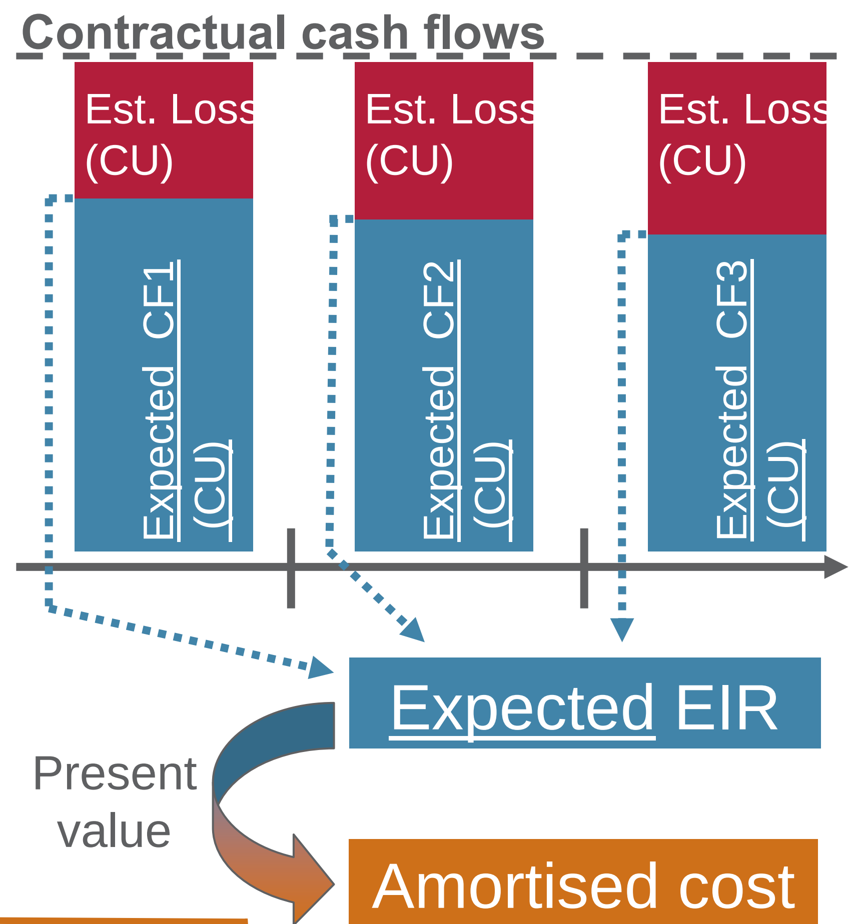
Main outcomes of the ECF approach include:

- Eliminates front-loading of interest revenue
- Better reflects underlying economics (eg pricing of instruments when lending decision is made)
- Earlier recognition of impairment loss

Proposed impairment method: Expected cash flow (ECF) approach (cont'd)

Carrying amount

- Amortised cost
  - *Integrated* measurement
  - PV of remaining *ECF*
  - Discounted at *expected* EIR



Amount has a clear meaning!

ECF approach

Main features:

- **interest revenue** is recognised on the basis of expected cash flows *including* initial expected credit losses
- **impairment** results from an *adverse change* in credit loss expectations
- **reversal** of impairment loss when expectations change *favourably*
- **re-estimation** of expected cash flows each period end

Presentation

Presentation (face of income statement)

- Gross interest revenue (before initial EL)
- – Allocation of initial EL
- = Net interest revenue*

- +/– Effect of changes in expectations

- – Interest expense

* Can be considered the economic interest revenue (ie credit cost adjusted)

Disclosure

Disclosure

Expected credit losses

- Allowance account
- Estimates and/or changes in estimates
- Loss triangle
- Others

Quality of assets

- Reconciliation of changes in non-performing assets
- Stress testing
- Vintage information

Feedback on Exposure Draft

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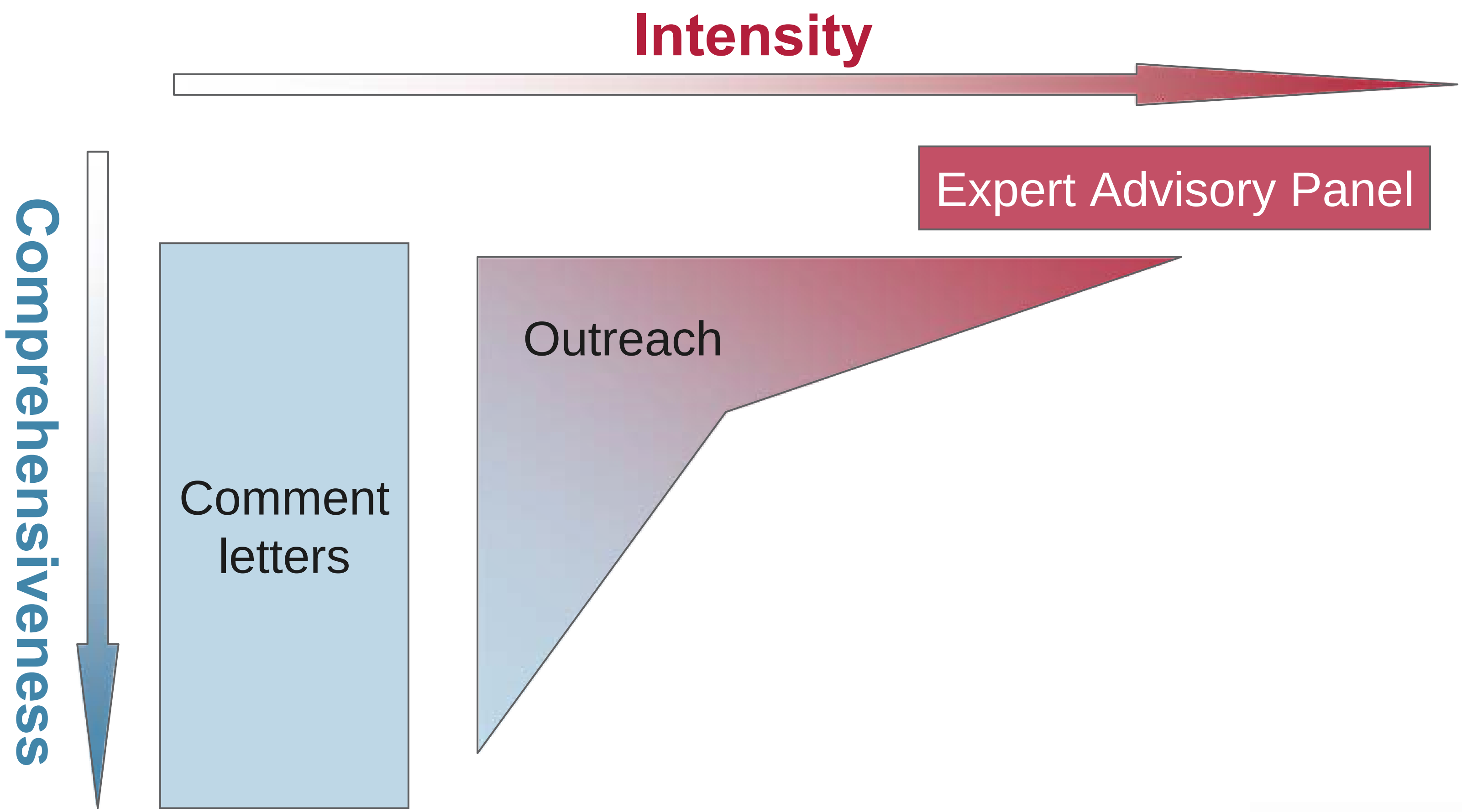
Feedback on ED – sources

Feedback via different channels:



Feedback on ED – overview

Key themes

- Strong support for expected loss (EL) approach
  - Incurred loss conceptually flawed
  - Rejection of fair value and through-the-cycle approaches
- Operational concerns regarding ECF model
  - Reflects EAP discussions
    → decoupling, open portfolios, lifetime EL etc.

Operational concerns – decoupling

Organisational and IT structure

Separated infrastructure ⟷ integrated calculation

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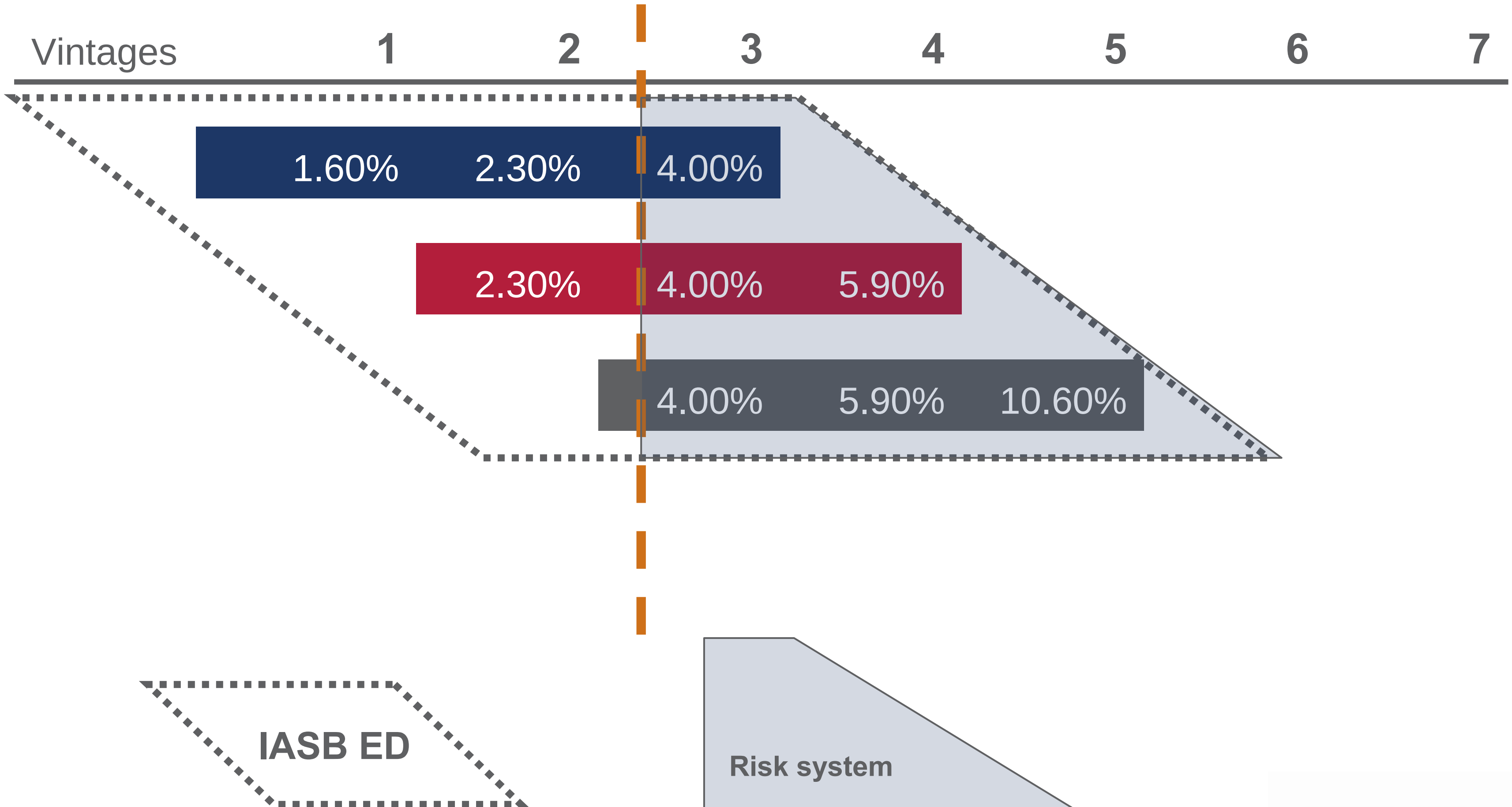
Operational concerns – open portfolios

Open portfolios vs closed portfolios



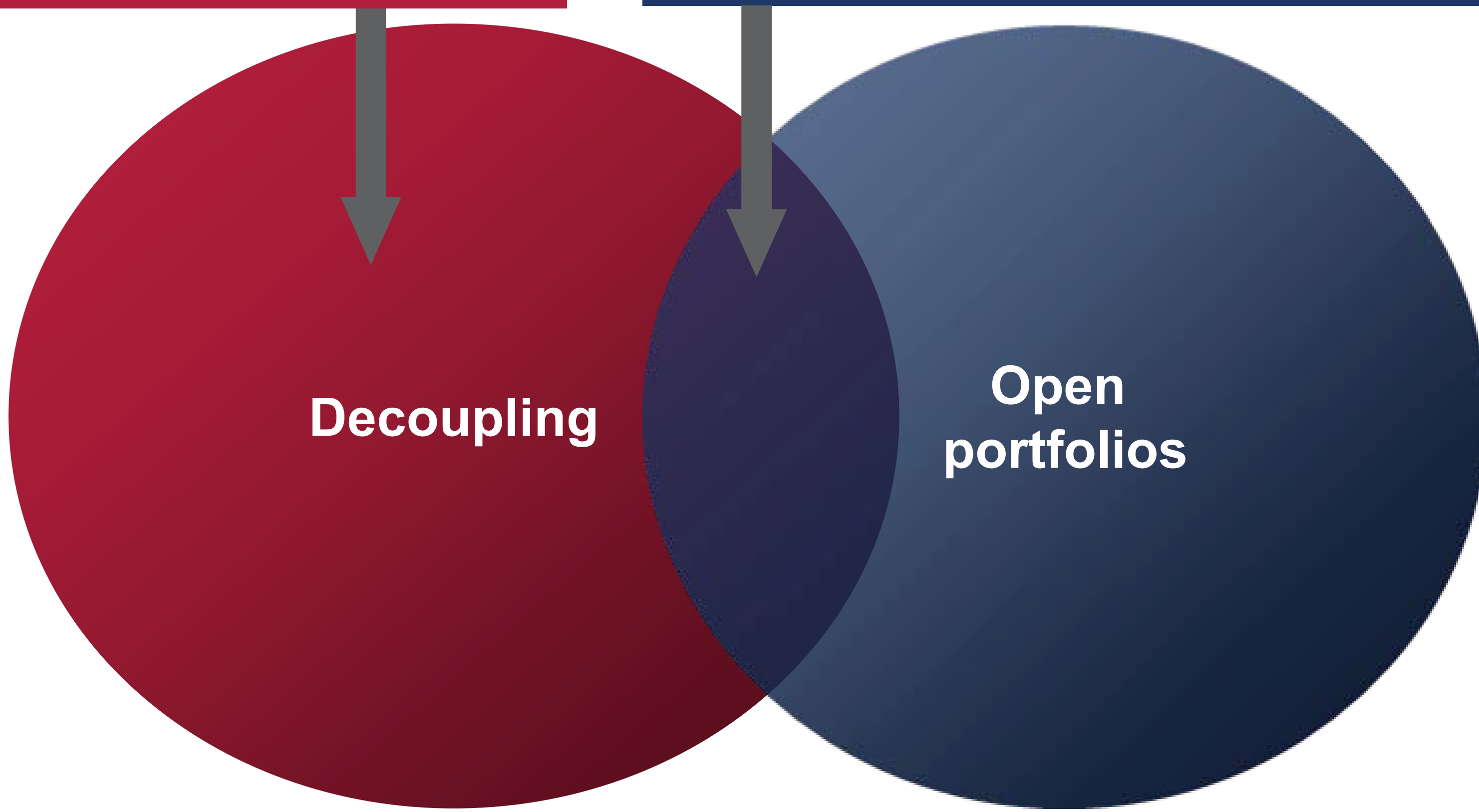
Decoupling ⟷ open portfolios

Decoupling that includes T_0 data

→ Approximates IASB ED

Decoupling that does *not* include T_0 data

→ Does *not* approximate IASB ED



Feedback on ED – overview (cont'd)

Key themes (cont'd)

- Non-financial institutions
  - Applicability to trade receivables
- Conceptual concerns
  - Probability weighted outcomes
  - (In-)Consistency with 'cost' measurement
  - Changes in estimates

Recognition of the *initial* EL

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Over the life of the asset

Year 1 Year 2 Etc…

- reflects initial pricing decision
- avoids 'front-loading' of interest revenue

Immediately to profit or loss

Year 1 Year 2 Etc…

- 'day 1' loss
- 'back-loading' profitability

Subsequent changes of estimates

Over the life of the asset

Year 1 | Year 2 | Etc…

- could result in a rate below risk free (even negative)
- counter-intuitive: lower discount rate for a higher risk asset

IASB ED

Immediately to profit or loss

Year 1 | Year 2 | Etc…

- reflects change in credit quality
- carrying amount is always the PV of the current ECF discounted at the (original) effective interest rate
- change in estimates that reflect gains or losses are not allowed to be deferred (other IFRSs)

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Feedback on ED – overview (cont'd)

Key themes (cont'd)

- Other themes
  - Presentation and disclosure too onerous
  - Practical expedients (no sufficient relief)
  - Definitions (NPLs, write-off,…)
  - Convergence with the FASB
  - Due process

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Re-deliberations

Alternatives and Outlook

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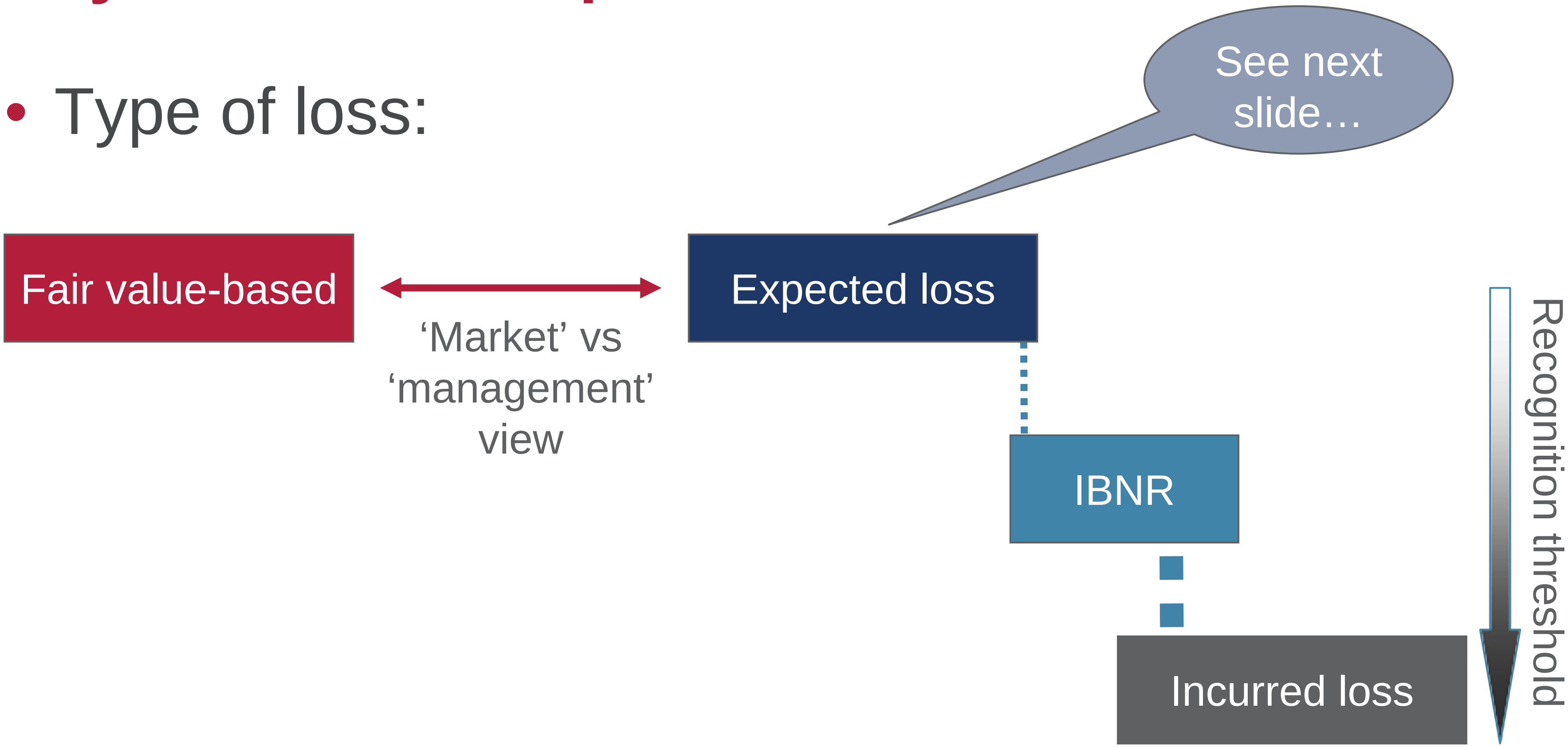
Alternative impairment models

Key features of impairment models

- Type of loss:



Overview – expected loss considerations

ISSUE	◄ TO BE CONSIDERED ►			
Which expected losses?	Over the life or shorter?	All EL or only ‘more-likely-than-not’ to occur (for single instruments)		Through-the-cycle or not
When are initial loss expectations recognised?	◄ Allocate over life ►			Upfront (likely be same treatment for changes in estimates)
	Integrated in EIR	Separately as an annuity	Separately straight-line	
How are changes in loss estimates treated?	Full catch-up to profit or loss in period of change	Partial catch-up to profit or loss	No catch-up (adjust prospectively)	Combination based on good/bad book
Allowance account floor?	No floor	Floor (eg ‘incurred’ losses)		

Discussions of alternative models

	EBF	Partial catch-up	BCBS	FASB
EL input	Lifetime EL (best estimate)			Lifetime EL ('frozen' outlook)
Initial EL	Over life (reset linear)	Over life (variations)	Over life (adjusted EIR)	Upfront (day 1 loss)
Changes in EL estimate	No catch-up (linear–fully prospective)	Partial catch-up (life-to-date, time proportional)	Full catch-up *or* EIR reset (↔ situation)	Full catch-up
Ceiling / floor	Ceiling: EL_t Floor: bad book	Ceiling: N/A Floor: bad book *[+ target good book LLA]*	Ceiling: A/C_0 Floor: EL of 'upcoming period'	Ceiling: A/C_0 Floor: N/A

Outlook…

Approach for re-deliberations (the ‘game plan’…)

- First develop an impairment model for *open portfolios*
  - Basic architecture
  - Details
- Ascertain whether that approach ‘fits all’…
  - Single instruments
  - Short-term trade receivables
  - Variable-rate instruments
  - Loan commitments
  - Other instruments
- Revisit presentation and disclosure

Outlook… (cont'd)

Topics to be considered in finalising the project…

- Probability weighting of possible outcomes
  - Expected loss = expected value?
- How does the impairment model fit into amortised cost?
  - 'Cost plus' vs present value notion
- Extent of guidance
  - Application guidance
  - Implementation guidance
  - Illustrative examples
- Scope: off balance sheet credit exposures…

Next steps and timeline

IASB	2009	2010	2011		
	Q4		Q1	Q2	H2
Impairment	ED	ED?	ED?	IFRS	

Re-exposure…?

FASB comment deadline: **30 Sept 2010** …?

Questions or comments?

Expressions of individual views by members of the IASB and its staff are encouraged. The views expressed in this presentation are those of the presenter. Official positions of the IASB on accounting matters are determined only after extensive due process and deliberation.