
Project **Financial Instruments: Impairment**

Topic **ED Session – EAP Feedback**

Introduction

1. Shortly after the publication of the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (ED), the Expert Advisory Panel (EAP) was set up with the objective to explore how operational challenges of the expected cash flow (ECF) approach might be resolved. The EAP held six public meetings during the ED's eight-month public consultation period (November 2009-June 2010). In addition, there were numerous meetings and conference calls that EAP members organised between the public meetings.
2. The purpose of this paper and its appendix is to provide a summary and to inform the Board of the EAP discussions. This paper does not ask the Board for any decisions.
3. Appendix A contains a document¹ prepared by the IASB team of participating Board members and staff. The document summarises the main issues that the IASB team² has heard and learnt and is set out as follows:
 - (a) Part I - objectives of the panel and acknowledgement of the contribution of EAP members; and
 - (b) Part II - summary of the main issues that the IASB team has heard and learnt from the EAP.

¹ This document has also been posted on the IFRS public website.

² The team comprises some IASB members and staff that participated in the EAP meetings.

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

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4. The staff intends to walk-through each of the specific operational issues summarised in Part II of Appendix A at this board meeting. We will stop after each issue to answer your questions and to discuss the particular issue to ensure that:
 - (a) all board members understand the issues: and
 - (b) to identify areas for further analysis in future board meetings as the ED is redeliberated.

Significant operational issues

5. To reduce the implementation challenges (including cost) and operational complexity for entities, the EAP highlighted three significant operational issues and suggested simplifications and expedients that the Board should consider when finalising any impairment model.
6. The first significant operational issue is using lifetime expected loss (EL) in estimating cash flows. The EAP advises that it is operationally simpler to estimate cash flows that are not expected to be received by using lifetime EL data and deduct those cash flows from the contractual cash flows to arrive at estimated expected cash flows as described in the ED. We learnt that many financial institutions use EL data in one form or another in their internal management systems (eg under the internal ratings based approach under BASEL II, pricing or internal performance measurement, or for determining some economic capital related measures).
7. The second significant operational issue is ‘decoupling’. We learnt that financial institutions typically store accounting and EL data separately. An integrated EIR calculation as proposed by the ED would require significant investment in integrating the two systems. The EAP advises that the ECF approach as proposed by the ED however could be simplified by breaking down the integrated EIR calculation into two separate parts thereby ‘decoupling’ the use of contractual return and expected loss information (ie sourcing information from accounting systems and risk systems separately).

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8. The third significant operational issue is the application to open portfolios. The EAP advises that loans or other debt instruments are typically managed in an open portfolio setting, where instruments are grouped based on current common characteristics without reference to historical characteristics or time of origination. The data required for the calculation as proposed in the ED would require systems to carry forward historical information from the date of initial recognition. This requires significant systems investment as existing systems do not typically maintain information on an instrument's initial lifetime EL estimate.

Appendix A

Amortised Cost and Impairment

Expert Advisory Panel (EAP)

Part I – Acknowledgement

A team comprising some International Accounting Standards Board (IASB) members and staff (the IASB team) completed six scheduled meetings with the EAP during the IASB's public consultation period for the exposure draft *Financial Instruments: Amortised Cost and Impairment* (IASB ED).

The objectives of the EAP, as set out in the request for members, were:

1. to advise the boards on how operational challenges of the IASB's expected cash flow (ECF) approach might be resolved; in particular:
 - (a) how best to address process-driven implementation issues – the EAP is expected to provide analyses and develop practical solutions for this purpose.
 - (b) what guidance would be useful to be provided by the boards and in what format (educational guidance or as part of authoritative literature).
2. to assist in organising and running field testing of any proposals made by the Board.

This document summarises what the IASB team have heard and learnt from the EAP on specific issues and suggested solutions developed by the EAP.

We would like to emphasise some particular operational challenges that have been highlighted by the EAP in its discussions as being especially significant. In discussing these operational issues, the EAP has also discussed possible simplifications to the ECF approach described in the IASB ED.

The particular operational issues that we have noted (which are described in detail in the following sections of this document) are:

- 'decoupling' of contractual return and expected loss information (sourcing information from accounting systems and risk systems separately);
- estimation of expected cash flows indirectly by treating as a reduction of contractual cash flows those that are expected not to be received by use of lifetime expected loss;
- application to open portfolios; and
- alignment whenever possible to entities' risk management practices.

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We will consider how best to address these issues and incorporate suggested solutions into the further development of the impairment accounting approach.

The IASB team would like to acknowledge the dedication and contribution of the EAP members in identifying the operational issues and providing thoughtful solutions. We wish to thank all EAP members for their valuable contribution to our process. The practical and experienced insights from EAP members on the operational aspects of the ECF approach have proved very useful and are most welcome.

Next steps

In developing the impairment approach the Board will consider this input along with other input we receive from comment letters and the ongoing outreach activities with constituents. We will also work with the US Financial Accounting Standards Board (FASB) aiming to achieve a common solution.

While the purpose of the panel was not to address accounting issues or provide an overall opinion on the approach specified in the ED or any other approach, in further developing the IASB's impairment approach the staff will consider suggestions from the EAP on alternative expected loss impairment approaches as well as the EAP's comments on the ECF approach.

We are grateful for the EAP's offer to continue to work with us to help evaluate the operational issues. We will look for appropriate opportunities to draw upon the practical expertise of the EAP members as the impairment approach is developed.

Part II – Summary of EAP discussions

The following summarises the main issues that the International Accounting Standards Board (IASB) team of participating Board members and staff have heard and learnt. This summary does not constitute minutes of the EAP meetings. The discussions of the EAP will be considered along with the responses to the IASB Exposure Draft and feedback from outreach activities during the Board's redeliberation process after the end of the comment period.

Introduction

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- A1. Since the publication of the Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (IASB ED), the IASB and its staff have engaged in extensive outreach activities to solicit feedback on how the operational challenges of the proposals might be resolved. As part of our outreach activities the EAP was set up in December 2009. The EAP has held six public meetings between December 2009 and June 2010. This document presents a summary of the main matters that the IASB team ('we') have learnt from the work of the EAP.³
- A2. The FASB also participated in the EAP. For more details on the FASB related discussions, please refer to the FASB website.

Operational issues discussed

- A3. From the EAP discussions (and our other outreach activities) we have learnt how some of the operational issues associated with the Expected Cash Flow (ECF) approach proposed by the IASB can be addressed. We learnt that two overarching issues that could be addressed are estimating the lifetime expected loss (EL) of a financial asset and the allocation of initial expected credit losses (by 'decoupling').
- A4. We learnt that the most challenging operational issue relates to the implementation of the ECF approach to open portfolios. The EAP advised that portfolios are typically organised, managed, and analysed by grouping loans or other debt instruments based on current common characteristics rather than based on historical characteristics or time of origination, in other words based on open rather than closed portfolios. Consequently, existing risk systems generally can not provide the closed portfolio calculations of initial EIR or EL, with periodic updates for changed expectations, envisaged by the ED. That implies calculations proposed in the ED would have to be implemented at the

³ The staff and some Board members have continued its work to reach out to preparers, auditors and regulators both on a one-to-one basis and on a group basis.

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individual instrument level, but existing systems rarely if ever maintain information that would allow calculation or retrieval of an instrument's initial lifetime loss estimate. The EAP advised that the systems changes required in order for institutions to determine and retain an initial lifetime loss rate, and to make on-going 'one-time' adjustments as loss expectations evolve over each instrument's life, would be significant. In its redeliberation, the Board will consider the costs and benefits of implementing the ECF approach with the input from both the EAP and users of financial statements and considering comment letter feedback.

- A5. With the goal of achieving the underlying objectives of the ED in a more cost-effective manner, EAP members identified less complex approaches to measuring and recognising expected losses that would not require retention and tracking of initial loss estimates.
- A6. In addition, we also received input on a number of other operational aspects. The following sections set out a high level summary of what we have discussed.

Estimating lifetime expected loss

- A7. We learnt that estimating future cash flows as proposed in the ED can be simplified by allowing the use of estimated lifetime EL (ie estimating the cash flows we do not expect to receive).
- A8. We learnt that for banks using the BASEL II parameters under the internal ratings based⁴ (IRB – particularly the advanced version) approach, Basel II EL can be used as one possible starting point for estimating EL for the life of the financial asset. However, the time horizon for the EL would have to be adjusted to reflect the financial asset's lifetime EL. In addition, the IASB ED does not

⁴ Under the internal ratings based approach, banks assess their assets for risk weighting purposes based on their internal risk management systems for regulatory capital purposes.

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use a through-the-cycle⁵ EL, but does not prohibit the use of long run averages to determine management's best estimate of EL. For smaller financial institutions the use of a loss rate approach was proposed. The EAP discussed that management should be able to use the best estimate using all available information, which may result in a combination of forecasts for shorter term estimates and long run averages for estimates relating to periods in the more distant future .

- A9. We also learnt that some financial institutions use lifetime EL data information (determined using historic information as well as management's expectation of changes in conditions) for different purposes (eg pricing, internal performance measurement or for determining some economic capital related measures). It was stated that most banks do not have lifetime EL, as deriving lifetime EL information involves significant uncertainty. In addition, EL is typically not subject to the same rigour of verification or audit processes as data used for regulatory purposes today.
- A10. We learnt that entities can use EL curves from rating agencies and other sources to estimate EL. The EL curves could then be adapted to the creditors' specific business environment and circumstances.
- A11. In determining the EL we learnt from the EAP that entities should consider and use the best available information. We learnt that the type of information that constitutes the best available information could differ both between entities as well as internally within an entity. We learnt that estimating EL for financial assets quoted on active markets can use implied spread data (if the institution's internal risk assessment is in line with the credit loss expectation reflected in market spreads) and hence may be no more difficult than estimating fair values.
- A12. We learnt that many entities can reasonably estimate expected losses in the 'short term' based on historical information which is adjusted for management's

⁵ A through-the-cycle estimate uses statistical parameters derived from historical credit loss data that covers a full economic cycle or several economic cycles.

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expectations of future conditions and changes in the credit characteristics of the portfolio. This period differs between entities (varies e.g. between one to two years). The difference in range is largely due to differences in systems, customer base/products offered and economic environments. For financial products with longer maturities entities may revert to a long term average loss rate as representing their best estimate of lifetime EL. These long term average estimates are less accurate. (Actual credit losses are uncertain and fluctuate around EL in the short and long term. This over- and under-shoot compared to EL is the subject of a capital adequacy debate and has not been discussed at the EAP).

- A13. The EAP discussed that any final requirements should remain principle-based and avoid detailed rules. This could allow EL estimates to be consistent with other predictions that management uses, for example management financial information (which may be over a shorter time horizon than the maturity of individual assets). Aligning the data used for external reporting with those used for internal reporting and management makes the data more robust (thus better facilitating audits).

‘Decoupling’

- A14. Under the IASB ED, interest revenue is recognised at the effective interest rate (EIR). The EIR is an internal rate of return calculation taking into account the expected cash flows (including any expected credit losses) over the remaining life of the financial instrument. In other words, the calculation of interest revenue under the IASB’s ED requires entities to take into account the expected credit losses at inception.
- A15. We learnt that in practice, the ECF approach would give rise to operational difficulties because financial institutions and others typically store comprehensive contractual and accounting data (in particular effective interest rate data) and EL data information in separate systems (‘accounting’ and ‘risk’ systems). These operational difficulties were a major concern raised by

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members of the EAP. (The ECF approach proposed by the IASB features an integrated EIR calculation that would require integration of the data in the accounting and risk systems.)

A16. We learnt that the ECF approach (*as an approximation*) could be simplified by ‘decoupling’ – separately sourcing the information in accounting systems (interest revenue as determined today under IAS 39 *Financial Instruments: Recognition and Measurement* that excludes EL estimates) and the information in risk systems. Such an approach would adjust the interest revenue calculated in the accounting system using an allocation profile for expected credit losses derived from EL data in the risk system. However, applying decoupling does not resolve the full set of operational complexities that were highlighted in the EAP discussions.

A17. We learnt that the following two ‘decoupling’ approaches (developed by the EAP) would avoid the complexity of an integrated EIR calculation while providing a close approximation to the ECF approach:

- the annuity approach to EL measurement; and
- the simplified approach using three building blocks for EL.

A18. Under the **annuity approach to EL measurement**, a separate discounted cash flow (DCF) calculation is used for EL. This DCF calculation is used to allocate the initial EL over the life of the instrument by converting the present value of the EL into an annuity, which is recognised in profit or loss (as a periodic charge). Subsequent changes in EL result in an adjustment to the present value of EL, which is immediately recognised in profit or loss.

A19. We learnt that this approach is flexible and can be applied to a wide range of instruments, including:

- fixed rate bullet loan or bond;
- amortising fixed rate loan;
- floating rate loan; and
- credit commitment (with fixed periodic fee).

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A20. One advantage of this approach is that it also works for loan commitments, where an internal rate of return (IRR) calculation often does not work. The approach would also significantly simplify the approach for floating rate loans.

A21. We also learnt that under the annuity approach the calculation of the annuity can be simplified in the following scenarios:

- for financial instruments with a single period cash flow or with a maturity of one year or less (e.g. overdrafts, short-term revolving facilities and letters of credit), the annuity amount charge is equal to or can be approximated by the undiscounted EL;
- for financial instruments with multi-period cash flows that have constant conditional periodic credit losses the annuity is the periodic credit loss;
- if the expected loss EL is not expected to change markedly (i.e. remain stationary) over the remaining life of the portfolio, the annuity can be approximated by the (geometric or simple) average loss; and would approximate the annuity charge; and
- for EL patterns that either have a constant growth rate or that change linearly over time the annuity can be determined using a closed form solution.

A22. Under the **simplified approach using three building blocks for EL**, the calculation is disaggregated into the following three building blocks:

- allocation of initial EL;
- an experience adjustment (ie the difference between actual cash flows/losses and the last estimate for the current period); and
- adjustment for changes in future expectations.

This approach uses EL as an indirect way of determining the amortised cost carrying amount and hence does *not* need any explicit, direct estimate of expected cash flows.

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A23. We learnt that this simplified approach provides a good approximation for the following types of instruments:

- bullet loans and amortising loans;
- fixed and floating rate instruments; and
- changes in credit loss expectations and changes in forward rates.

A24. However, we also learnt that both of the above approaches would still require carrying forward historical information from the date of initial recognition (the initial EL), which is difficult for most systems (see paragraphs A26 to A39 below discussing ‘open portfolios’). Hence, any approach that involves retaining a link to the past, whether the initial cash flow estimate or the initial EL, amplifies the operational challenges. This would be particularly difficult in the context of transition requirements if those were to require reconstructing historical data.

A25. The EAP presented a prospective approach, dealing with expected loss without linking to past data, that would be more operationally expedient.

Open portfolios

A26. We learnt that an expected losses model that would allow the use of open portfolios will significantly reduce complexity for financial institutions.

A27. We learnt that currently, under Basel II, loans are reassessed and allocated to the portfolio that represents their current risk characteristics at the end of each period (based on PD and LGD) independently from the portfolio they belonged to previously and therefore loans are not tracked for their migration patterns. In particular, new loans are added and matured loans are removed from pools of similar risk characteristics continuously.

A28. Against this background, we have learnt that applying the ECF approach to open portfolios causes significant operational challenges that would result in significant implementation costs. This is because in revising expectations of losses on an open portfolio, it is hard to assess whether this change relates to the

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old loans that were already in the portfolio or as a result of new loans added since the previous EL estimate. This is an important distinction as under the ECF approach initial expected losses are to be recognised over the life of the instrument whereas the effect of subsequent changes is to be recognised in profit or loss immediately (the ECF approach uses the EIR for that distinction).

- A29. The EAP emphasised that strict application of the ECF approach (with or without approximations) would in essence require implementation on a closed portfolio or on a loan-by-loan basis.
- A30. In order to estimate statistical parameters, we learnt that portfolios typically need to include different vintages so as to achieve a sufficient sample size. However the portfolio used to determine statistical parameters for EL do not necessarily have to coincide with the portfolios used for the purpose of maintaining parameters that relate to the date of initial recognition of an item (e.g. the original EIR or an initial EL estimate).
- A31. We therefore learnt that a key operational difficulty of applying any EIR-based approach to open portfolios is that data relating to the time when each individual item was initially recognised has to be maintained (i.e. the related original EIR).
- A32. We learnt that the EIR calculation as proposed in the ED appears to require either closed pools or the use of a more complex pool approach that requires loans to be disaggregated and then aggregated for each measurement date. The EAP discussed different alternatives for tracking the original EIR or EL that differ regarding their respective operational complexity and data storage volumes. *Decoupling* the EIR calculation from the EL related calculation would be one of the crucial requirements in implementing an impairment model for open portfolios.
- A33. We learnt that most financial institutions today manage credit risk by differentiating between a performing ('good') book and a non-performing ('bad') book. A key operational issue is the treatment of the balance of the allowance account when loans move between the 'good' book and 'bad' book. The EAP discussed that loans in the 'bad' book are typically managed more

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actively (and frequently on an individual basis) and see more detailed analysis performed (resulting in a significant change in EL for the loan). Conversely, statistical approaches at portfolio level are applied for the ‘good’ book assets.

- A34. We learnt that the catch-up adjustment in the IASB ED would require additional systems and data capture processes, which would create the need for multiple additional information fields (eg historic EL and EIR), maintained by historic time periods. Such changes would require significant investment. We learnt that it would be operationally easier to use a ‘good book/bad book’ approach with changes in expectations in the ‘good’ book relating to future periods recognised over the remaining life of the instrument, whereas changes in estimates for the ‘bad’ book are recognised immediately in profit or loss.
- A35. The EAP discussed different alternatives for the treatment of the movement of the allowance account between the ‘good’ book and ‘bad’ book. One alternative is the ‘rucksack’ approach that would result in a transfer of the proportional loss allowance attributable to the loan that is moved to the ‘bad’ book.
- A36. A second alternative is the ‘full allowance’ approach that would take the entire loss allowance needed in the ‘bad’ book for that loan from the ‘good’ book loss allowance (of the portfolio from which the loan was removed). Under the second alternative, the good book allowance could be evaluated against a one year EL floor and additional provisions for allowance are built-up as needed on a forward looking basis.
- A37. A third alternative is the ‘proportion of ELL’ approach. This is similar to the second alternative where by the entire loss allowance needed in the ‘bad’ book is taken from the ‘good’ book loss allowance. However, the allowance in the ‘good’ book under the third alternative always reflects the allowance based on the time-proportional ELL.
- A38. In order to determine the time-proportional ELL, the third alternative would require tracking of the weighted average total lifetime (WAL) and the weighted average life of portfolio (to date) (WAL to-date). We learnt that while system changes may be required for some entities, for many entities it is operationally

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feasible to obtain WAL and WAL to-date information on open portfolios. The required information can be gathered from origination or vintage information stored in systems or can be gathered by methods such as sampling. The operational challenges for obtaining and maintaining WAL and WAL to-date data are significantly less than maintaining original EIR or initial EL information. We learnt that there is a preference from EAP members in support of the third alternative.

A39. The three alternatives discussed above would require changes to the impairment model as proposed by the IASB.

Macroeconomic outlook and management judgement

A40. We learnt from the experience of the EAP members that there should be a transparent, disciplined, systematic and consistent methodology as well as an audit trail supporting the material assumptions and estimates and conclusions to support the adequacy of the loan loss provisioning level. We learnt that there should be a linkage between observed changes in conditions and the loss expectations.

A41. As noted in paragraphs A9 and A12 above, we learnt that for long term estimates a point in time estimate would likely include some longer term average data for that part of the estimate that exceeds the period for which entities can reasonably estimate expected losses with a reasonable degree of accuracy.

A42. We learnt that in dealing with arriving at the best estimates and updating estimates (see paragraphs A48 to A51) entities should establish an overall formal framework for procedures and put in place a set of comprehensive internal policies.

Implication of ‘actual losses’

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A43. We learnt that the definition of actual losses (in the sense of a loss status that triggers write-offs in financial statements) should incorporate the fact that different jurisdictions have different legal systems.

A44. We learnt that entities need to ensure that the definition of 'default' that they use for determining statistical parameters is consistent with the intended use of those parameters (which should not be confused with definitions of 'default' or actual losses for other purposes such as disclosures). Any approach that seeks to align regulatory treatment, especially definitions, will reduce operational complexity.

Lack of historical data

A45. We learnt that the following are the types of information entities could take into account as 'best practice' when there is a lack of historical data for estimating cash flows:

- Evaluate whether factors driving performance are similar to other loan types that may be used as a proxy for estimating expected cash flows.
- Assess rating agency or published industry data.
- Leverage management's estimate of expected losses used for pricing or risk management purposes.
- Use existing models or simplified approaches; such as, taking contractual cash flows and applying a constant probability of default (PD) and loss given default (LGD) over the life of the loans to reflect expected credit performance.
- Use an average or weighted average of PDs and LGDs if there are multiple similar product types.
- When actual performance data becomes available, assumptions based on management's judgment should be updated.
- Use existing Basel II data or use statistical techniques to infer losses.

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A46. We learnt that the above aspects had no particular order but that the most appropriate approach depends on the individual circumstances. These items may require further adjustments to reflect environmental or qualitative factors that are not present in the data or that may no longer be relevant to the cash flow estimation.

Correlation in portfolios

A47. We learnt that the correlation between items in a portfolio does not affect the EL, but can change the variability around that EL (i.e. it could change the shape of the distribution curve of possible outcomes). We learnt that some EAP members considered the effect of correlation more as a matter related to stress testing and hence a regulatory capital issue.

Estimating data from secondary sources

A48. We learnt that estimating data from secondary sources (i.e. external information such as rating agency reports) is appropriate when the data used suits its intended purpose. Entities must consider the reliability and timeliness of the source data and whether management judgement is still required.

Updating estimates

A49. The frequency of updating estimates depends on how frequently circumstances change and the difficulties involved in obtaining data. We learnt from the experience of EAP members that frequency of updates should be subject to formal internal policy and may be amended in line with market and other external events as required. The frequency of updates should be verified with external auditors based upon agreed materiality criteria and reporting thresholds.

A50. We learnt that guidance clarifying the treatment of subsequent events would be useful. During the EAP discussions a question was raised as to how an entity should consider information obtained post balance sheet date which relates to

IASB/FASB Staff paper

and provides additional information on the economic conditions or circumstances at the balance sheet date.

Uncertainty of estimates

A51. As proposed by the IASB, the EL is generally determined as the expected value of the possible outcomes (i.e. the ‘mean’). Hence, uncertainty is reflected in the range considered in arriving at the EL (i.e. this is the ‘best estimate’ for the purpose of determining any impairment). Therefore, once an entity arrives at its best estimate the entity should not make any further adjustments for uncertainty. This is consistent with the measurement at amortised cost, which does not involve an adjustment for changes in the risk premium over time.

Loan commitments

A52. We learnt that in practice, risk managers tend to assess and manage all exposures irrespective of whether they are (already) a balance sheet position or (still) only a commitment to lend (off balance sheet item). From a risk management perspective, an assessment will be made on the likelihood of the drawdown and the amount of EL if the drawdown is made. We learnt that the issues are similar to those for revolving facilities.

A53. We learnt that if an EL-based approach is also applied to off-balance sheet credit exposures, then a possible approach is to amortise the expected loss from the drawdown over the life of the loan commitment against fee revenue.

Estimates for nonrated instruments

A54. We learnt that a framework can be applied for implied ratings of non-rated instruments to determine an equivalent implied credit rating. We learnt that such internal ratings were typically easier to adjust and cheaper than external ratings and would also be suitable for some smaller financial institutions.

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A55. The framework is based on a matrix that considers the following factors:

- financial (free cash flows);
- business (scale of operation, market share, barriers of entry, volatility of earnings); and
- corporate governance, management (transparency and management track records).

Disclosure requirements and transparency

A56. We learnt that obtaining the information for some of the disclosures requirements as proposed by the ED maybe operationally challenging to obtain for some entities. For example, gains and losses from changes in expectations that would require expected loss data to be stored from date of inception. Similarly, loss triangle information might be difficult to provide for open portfolios because it also involves tracking of information for previous periods.

A57. We also learnt that it may be possible for some financial institutions to use information (possibly with some adjustments) currently produced for prudential purposes (eg information required under the Basel II Pillar 3 framework). For that purpose it would notably be important to align the definition of ‘non-performing’ with the definition of ‘default’ as used in the Basel II framework.

Transitional requirements

A58. We learnt that there are significant operational challenges with the transitional proposals as set out in the ED. These challenges include:

- rolling back systems to when the loans were first issued to determine what the EIR based on expected cash flows would have been at inception; and
- ratio analysis as proposed in the ED would still be challenging to implement for entities with large number of portfolios of loans.

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A59. We learnt that a practical transitional approach is prospective application where the EIR is reset going forward taking into account future credit losses only (carrying amount of loan will not be adjusted).

Simplifications for smaller banks and other financial institutions

A60. We also learnt that applying the ECF approach is operationally challenging for smaller banks and other financial institutions (including parts of larger groups that use the standardised approach⁶) and non-financial entities. We learnt that to apply the ECF approach, smaller banks and other financial institutions could for example pool and share data and credit loss statistics and use these as an input into simpler models and may not necessarily need to implement complex models. Applying a 'loss rate' technique to asset balances might also facilitate implementation of an impairment model for smaller banks and other financial institutions.

A61. We learned that insurers and, likely, other investors in financial instrument securities portfolios would also face similar operational challenges. While insurers tend to have the system capability that might enable the proposed ECF approach to be implemented, the implementation would require significant management judgment and incur significant costs. Hence practical expedients and simplifications are needed for the application of the approach to securities portfolios.

Use of loss rates

A62. We learnt that loss rates might be particularly suitable for smaller loans for which flow models are used and might be an alternative way of deriving cash

⁶ For regulatory capital purposes under Basel II some banks uses specified risk weightings based on external ratings. These are called standardised banks. These banks would typically have less developed systems internally to assess credit loss expectations. Banks that do not apply Basel II for regulatory capital are also likely to have less developed systems.

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flow estimates more generally. We learnt that loss rate methodologies can be a flexible tool that can be used as a means to implement different impairment models (ie loss rates as such are not an ‘impairment model’ by themselves).

- A63. A loss rate is a measure that reflects management’s estimated credit loss on a pool of assets and is based on historical experience with actual losses and adjusted to reflect current conditions that differ from those reflected in historical actual loss data.
- A64. Loss rates may be determined in a number of ways. For example, loss rates can be calibrated to apply for different outlook periods, as annualised rates or as cumulative rates to address the timing of losses. The use of an average loss rate does not directly contemplate the timing of expected cash flows over the life of the asset as currently proposed in the IASB ED. However, under certain scenarios the application of an average loss rate yields similar results to the use of net present value techniques.
- A65. We learnt that one limitation of the loss rate is that it does not contemplate the timing of losses over the life of the asset as currently proposed in the IASB ED, but it does approximate well to loss experience patterns.
- A66. We learnt that loss rates can be applied to the three ‘good’ book / ‘bad’ book alternatives outlined in paragraphs A35 to A37. Loss rates can be applied to the ‘good’ book using the following three inputs:
- estimate of EL rates over the life of the portfolio;
 - current WAL; and
 - WAL to-date.
- A67. We learnt that it may be difficult to obtain WAL to-date for open portfolio for smaller financial institutions. The EAP discussed that as a practical expedient, an allowance based on 50% of WAL could be applied to the ‘good’ book of assets for portfolios in a steady state environment with negative (positive) adjustments to the WAL percentage for a growing (diminishing) portfolio.

Links to further information

A68. For further information on the Amortised Cost and Impairment phase of the IAS 39 replacement project please refer to the following links:

Main project page

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+Impairment+of+Financial+Assetseplacement+of+IAS+39+Financial+Instruments+Recog/Financial+Instruments+Impairment+of+Financial+Assets.htm>

Exposure draft

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+Impairment+of+Financial+Assetseplacement+of+IAS+39+Financial+Instruments+Recog/Exposure+Draft+and+Comment+Letters/Exposure+Draft+and+Comment+Letters.htm>

Expert Advisory Panel (meeting summaries and recordings)

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+Impairment+of+Financial+Assetseplacement+of+IAS+39+Financial+Instruments+Recog/Expert+Advisory+Panel/Expert+Advisory+Panel.htm>

'Snapshot' summary of the exposure draft

<http://www.iasb.org/NR/rdonlyres/B01BB410-D2C8-42B3-A873-8675AE919E21/0/SnapshotFIImpairment5November.pdf>

Webcasts and recorded Q&As

IASB/FASB Staff paper

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+A+Replacement+of+IAS+39+Financial+Instruments+Recognitio/Webcast+Recordings/Webcast+Recordings.htm>

IASB staff examples

<http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+Impairment+of+Financial+Assetseplacement+of+IAS+39+Financial+Instruments+Recog/IASB+Staff+Examples/IASB+Staff+Examples.htm>