16 Mar 2011

International Financial Reporting Standards

# Estimating expected losses

IASB Meeting: Week beginning 14 March 2011

Slides to accompany Agenda paper 4B

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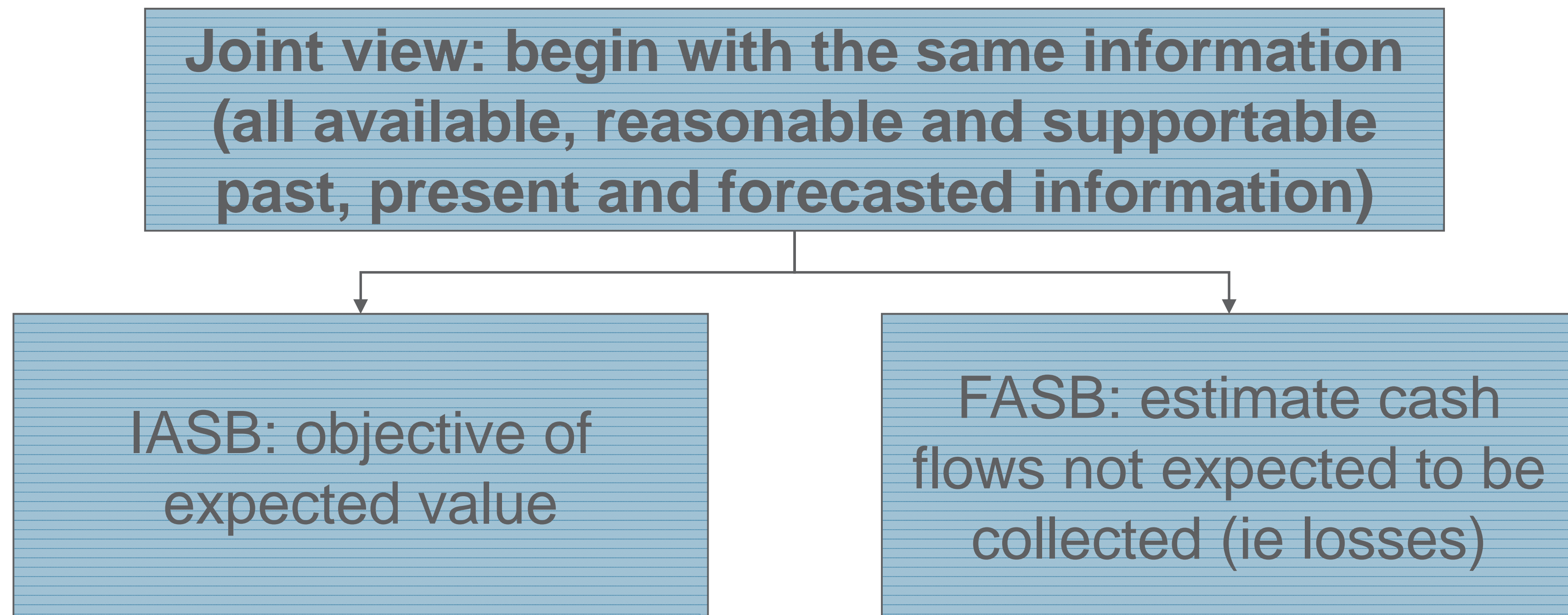
# Main Question



- **What measurement method should be used for estimating expected losses?**

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# Original proposals



| | IASB model | FASB model |
|---|---|---|
| Original ED | Probability-weighted possible outcomes | Estimate amount of losses expected; no specific guidance |
| Feedback to original ED | Practically difficult and may not be relevant for single instruments | No specific feedback |

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# Alternatives



- IASB staff: objective of expected value
  - Pure form: probability-weighted possible outcomes
  - Proxy techniques are acceptable
- FASB staff: objective to estimate amount of losses expected to occur
  - Similar to most likely outcome
  - Historical loss rates

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# IASB staff recommendation



- Expected value as an objective
  - Inherent in expected loss model
  - Pricing of loans includes expected losses
  - No differentiation between portfolio and single instrument
  - Most likely outcome would revert to incurred loss model

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# Practical considerations

- Probability-weighted possible outcomes purest form of expected value
- Many entities already perform calculations for internal purposes that would provide an appropriate estimate of expected value
- Consider a representative sample of possible outcomes

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# Some appropriate estimates of expected value



- Historical loss rates adjusted for future expectations
- PDs, LGDs, EADs
- Migration matrix
- Roll rate analysis

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# FASB staff recommendation



- Estimate cash flows expected to be uncollectible
  - Estimated losses should predict actual losses
  - Expected value is more complex
  - Emphasis on qualitative factors
  - Pool overlay – treat single asset as if it were part of a portfolio

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# Impairment of purchased financial debt instruments

Agenda paper 4A

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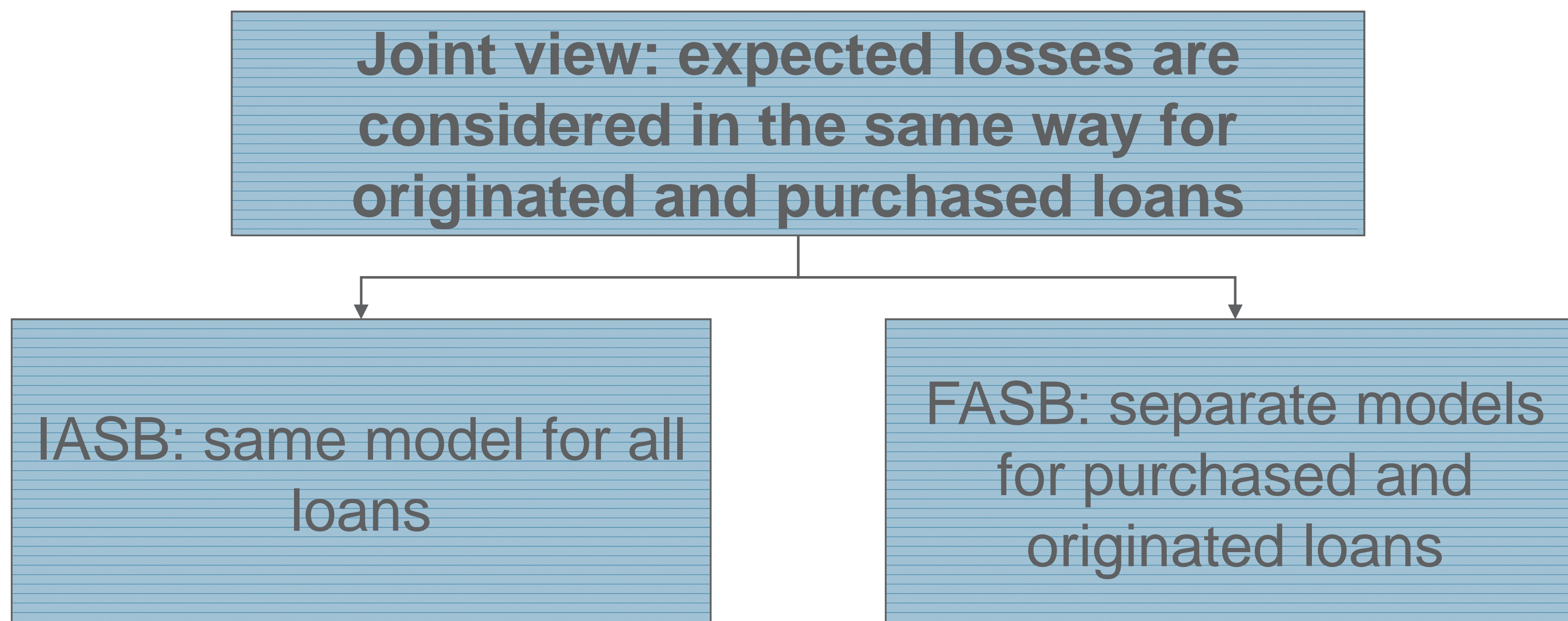
# Main Question



- **Should purchased loans have separate interest revenue and impairment models?**

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# Issues addressed



- Issue 1: Presentation of purchased loans upon initial recognition
- Issue 2: Effective interest rate and accretion of discount on purchased loans
- Issue 3: Changes in initial expectations of cash flows expected to be collected

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# Accounting for purchased loans



| | IASB model | FASB model |
|---|---|---|
| Applies to | All loans | Purchased loans (separate model for originated loans) |
| Presentation on initial recognition | Recognise initially at fair value and then apply supplemental document (SD) | Gross presentation of principal, allowance, and premium/discount |
| Effective interest rate (EIR) | Decoupled approach, except for problem loans | Include expected losses in EIR calculation (consistent with IASB original ED) |
| Changes in initial expectations | Always use same discount rate | Reverse allowance to zero, then record impairment expense |

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# Example: IASB View

Originated loan

- Entity originates a new 5 year loan for £100 (par)
- Expected credit losses over the life of the loan are £5, with floor meeting the higher of test (£3)

Purchased loan

- Entity purchases a one-year-old loan at £100 (par) with 5 years remaining to maturity
- Expected credit losses over the remaining life of the loan are £5, with floor meeting the higher of test (£3)

Comparison
- Both loans have identical terms
- Both loans result in same economic position

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# Example: IASB View



Originated loan

| Loan (transaction price/fair value) | 100 |
| --- | --- |
| Allowance (SD model) | (3) |
| Loan (carrying value) | 97 |

Purchased loan

| Loan (transaction price/fair value) | 100 |
| --- | --- |
| Allowance (SD model) | (3) |
| Loan (carrying value) | 97 |

Comparison

- Original loss expectations the same for both loans
- Both loans should receive the same accounting treatment

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# Issue 1: Presentation of purchased loans



- Alternative 1: gross presentation
  - Separate presentation of principal, SD allowance and a premium/discount
- Alternative 2: net presentation
  - Net presentation of principal and SD allowance
  - Separate presentation of premium/discount
- Alternative 3: present loan at fair value less SD effect

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# Issue 1: Example



| Alternative 1 | | Alternative 2 | | Alternative 3 | |
|---|---|---|---|---|---|
| Loans (principal amount) | 1,000 | Loans | 980 | | |
| Allowance (Discount related to credit losses) | (20) | Allowance (Discount related to credit losses) | (20) | | |
| Purchase price difference | (20) | | | | |
| Loans (transaction price/fair value) | 960 | Loans (transaction price/fair value) | 960 | Loans (transaction price/fair value) | 960 |
| | | | | Allowance (SD model) | (20) |
| | | | | Loans (carrying value) | 940 |

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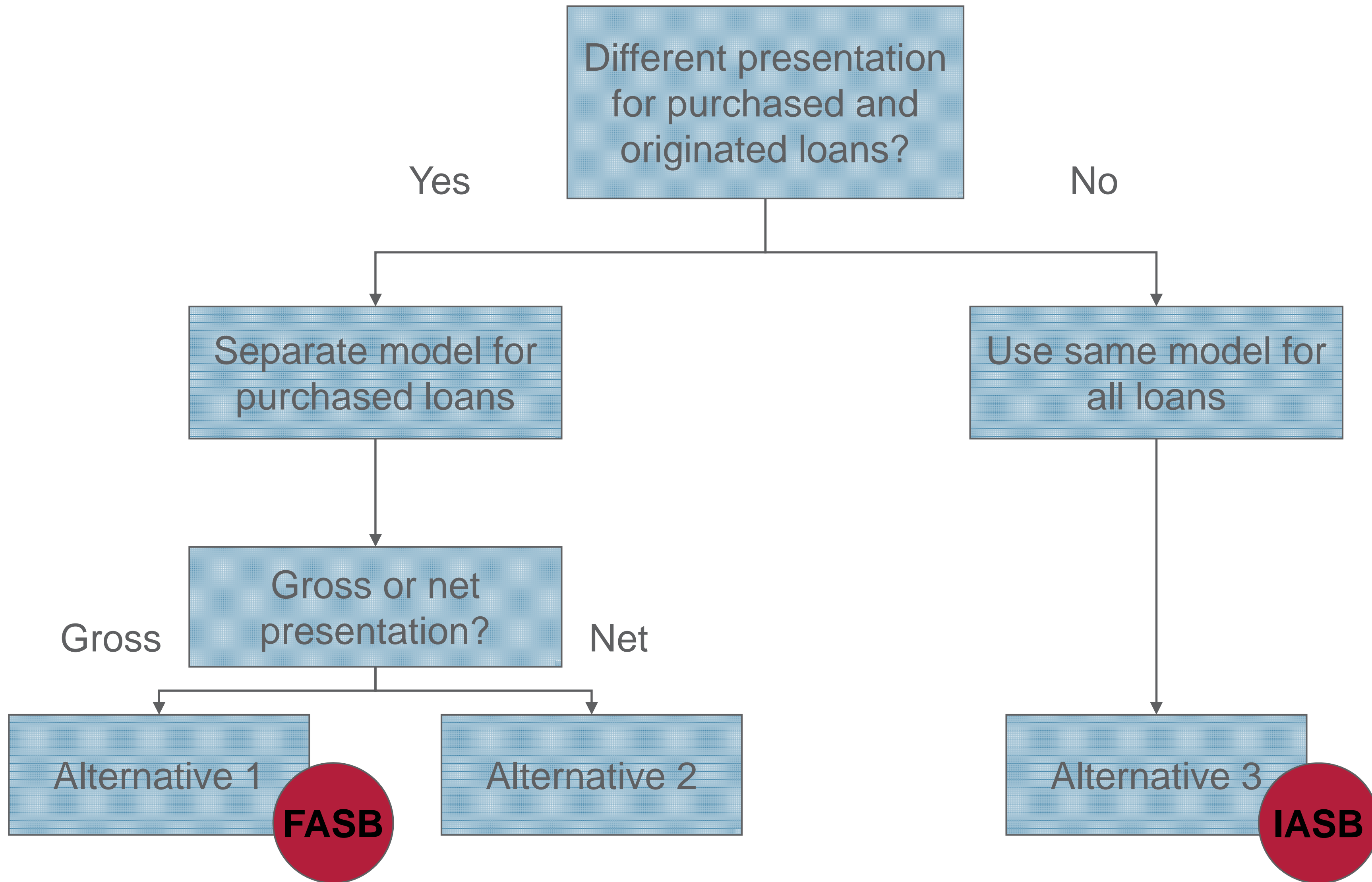
# Issue 1: Presentation of purchased loans



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# Issue 1: Staff recommendation



- IASB view : Fair value presentation (Alternative 3)
  - Consistent with application of SD
  - No distinction between EL for originated and purchased loans
  - Contradicts fundamental accounting conventions for other purchased assets
  - Expected loss model does not per se require an allowance balance
  - Can meet user needs through disclosures
  - Economically an acquirer of loans is in a different position to the party who originated that loan

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# Issue 1: Staff recommendation



- FASB view: Gross presentation (Alternative 1)
  - Users: allowance important for evaluating credit assumptions build into loan valuations (so can compare with entities that originated an equivalent loan)
  - Presenting a loan loss allocation upon acquisition is consistent with SD
  - EL is part of the transaction price and should be grossed up to reflect it and the discount

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# Issue 2: Accretion of discount and EIR

- Alternative 1: Contractual cash flows
- Alternative 2: Contractual cash flows, with exception:
  - For problem loans, accrete on reduced cash flows expected not to be collected
- Alternative 3: Cash flows expected to be collected (equivalent to IASB original ED)
- Alternative 4: Accounting policy election in respect to Alternatives 1 and 2

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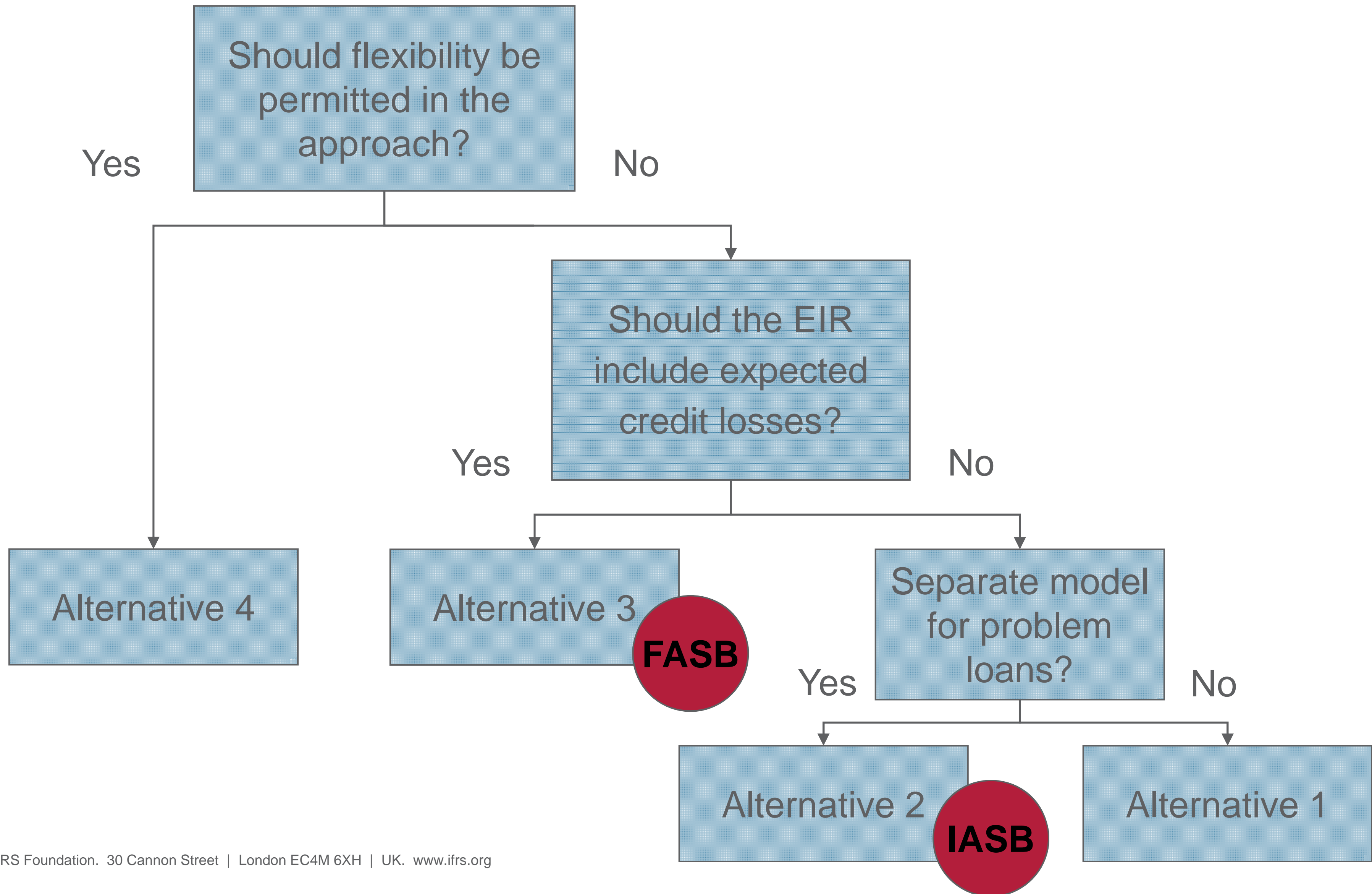
# Issue 2: Accretion of discount



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# Issue 2: Staff recommendation



- IASB View: Alternative 2
  - No basis to distinguish between originated and purchased loans
  - Alt 3 not operational (was the IASB original ED)
  - TPA approximates integrated EIR
  - Separate distinction for ‘problem loans’ as entities already calculate integrated EIRs today and is operational
- FASB View: Alternative 3
  - Eliminates separate models for credit impaired and non-credit impaired loans
  - Alt 2 inflates EIR
  - Avoids complexity of defining problem loans and identifying on an individual basis

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# Issue 3: Change in initial CF expectations



- Alternative 1A: increases beyond reversal of existing reserves as adjustment to yield. Decreases as impairment expense.
- Alternative 1B: increases beyond reversal of existing reserves as adjustment to yield. Decreases, decrease yield to initial EIR, with further decreases as impairment expense.
- Alternative 2: all changes recognised as adjustment to allowance (additional issue applies)

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# Issue 3: Alternatives (for Alt 2)



- How to recognise increase in expected cash flows:
  - Alternative 2A: allowance for credit losses; record a gain (symmetrical model)
  - Alternative 2B: reverse allowance until it reaches zero, then record offsetting impairment expense for gain
  - Alternative 2C: no gain prior to recognising an impairment expense and allowance

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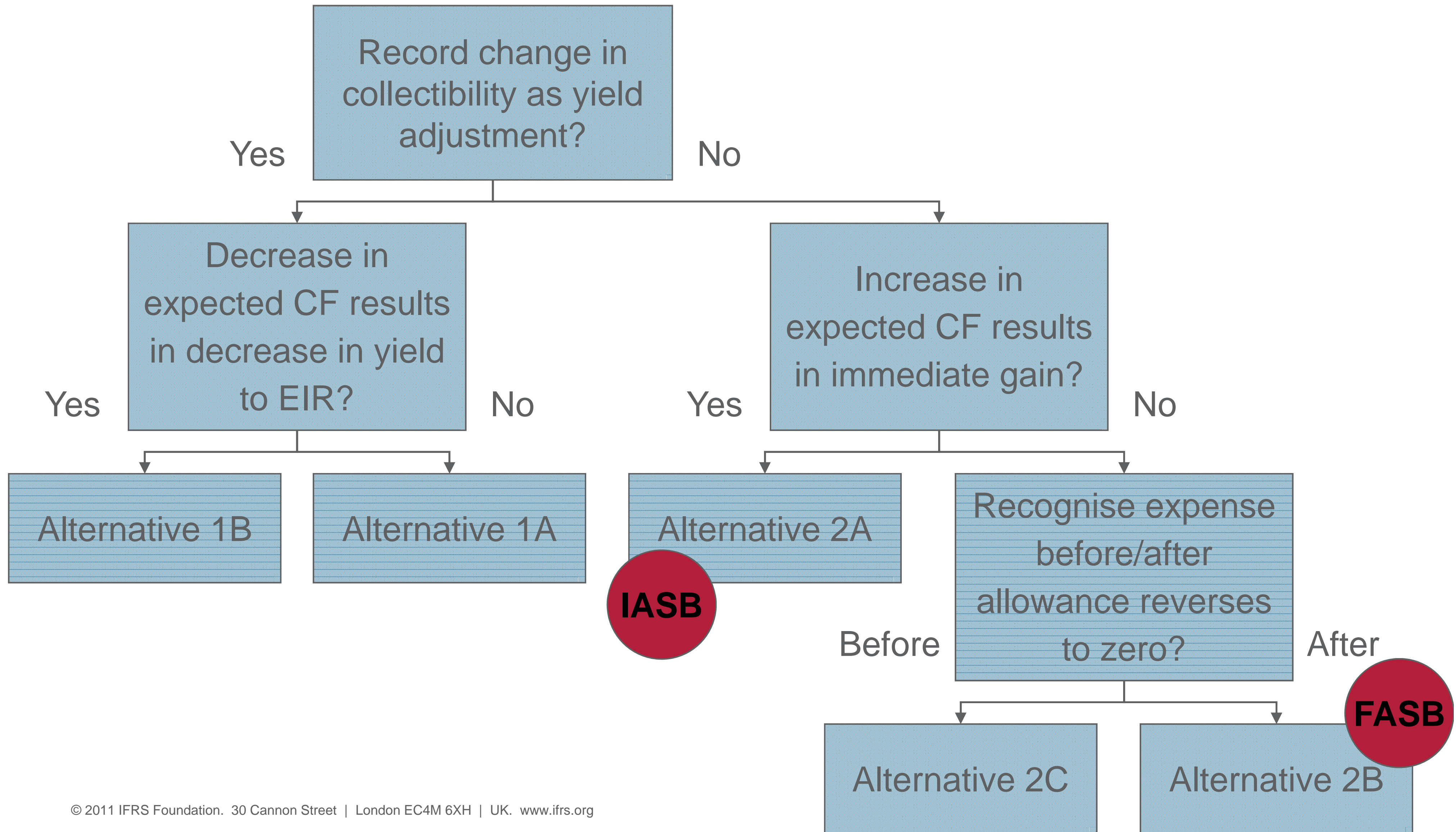
# Issue 3: Change in collectibility



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# Issue 3: Staff recommendation



- IASB View: Alternative 2A
  - Alt 2B creates operational complexity
  - Inappropriate to sacrifice neutral accounting model for anti-abuse provisions
- FASB View: Alternative 2B
  - Does not recognise gains due to favourable change in expectations
  - Allows full reversal of allowance
  - Anti-abuse provision

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# 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.

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