Expert Advisory Panel Meeting
24-25 March 2010 (London)
Summary of the discussions of the IASB proposals

Note: The following represents a summary prepared by the IASB staff as a convenience for those who are interested in the panel's work. The summary does not constitute minutes of the meetings, and does not capture the views of individual panel members. As noted below, the panel discussions are continuing.

1. Administrative matters

a. Introduction

b. Field testing

The EAP was reminded that once approaches of implementing the proposed impairment model were more fully developed panel members would be expected to participate in some field testing.

2. Discussion of the effective interest method issues (IASB model)

a. Annuity approach to expected loss (EL) measurement

- The EAP continued its discussion on a discounted cash flow (DCF) approach to EL measurement that uses an annuity concept for credit loss allocation.
- The EAP discussed the sensitivity of the result to using different discount rates in calculating the present value of the EL. The particular example discussed used the risk free rate as the discount rate. Different interest rate scenarios were used to demonstrate that the closer the discount rate is to the effective interest rate (EIR) the closer the approximation.
- The main advantage of the annuity approach are that it provides a very generic platform that can accommodate fixed and variable rate instruments, as on- and off-balance sheet credit exposures as well as optionality in the cash flows of an instrument (eg prepayment).
- The EAP will continue to explore the application of this approach to more complex products, and will also consider the implications of prepayments and subsequent changes in expectations.

b. Analysis of a simplified approach to implement the IASB model using an EL approach

- The EAP continued its discussion of the simplified approach of using three building blocks for expected losses (allocation of initial EL, an experience adjustment and adjustment for changes in future expectations).
- When estimating the allocation of initial EL, using an average EL (cumulative EL divided by the number of years of the life of the instrument) for bullet loans and a principal weighted average conditional EL for amortising loans appears to achieve a reasonable approximation of the proposed impairment model, especially within a realistic interest rate range (0-15%).
- The modelling of different assumptions about cash flow estimates demonstrated that when using *constant* predictions the effect on the income statement is similar to the pattern under an incurred loss model.
- The EAP will continue to explore this simplified approach further especially for open portfolios.
- The EAP discussed the interaction between using an open portfolio approach for estimating EL and maintaining data at the individual instrument level. Several approaches can link the data at portfolio and individual instruments level, eg top-down approaches that allocate the portfolio EL to individual instruments, bottom-up approaches that aggregate information related to individual instruments or combinations of dis- and re-aggregation.
- The EAP also discussed how the ECF approach would be applied to an open portfolio and considers it to be a significant operational issue. This is because in revising expectations of losses on an open portfolio, it is hard to assess whether this change relates to the 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 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.
- More generally, the EAP noted 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 included in the portfolio has to be maintained (ie the related EIR). The EAP considered that *decoupling* the EIR calculation from the EL related calculation would be crucial in implementing an impairment model for open portfolios.

- The EAP will explore how the ECF approach could be made operational while remaining consistent with the objectives of the IASB exposure draft (ED).

c. Variable rate instruments

- The EAP discussed the practical implications of applying the ED to variable rate instruments.
- The EAP learned that alternatively to resetting interest on variable rate loans US GAAP (former SFAS 114) allows applying a fixed rate once a loan is impaired. However, using forward rates in determining expected cash flows was not allowed under that guidance. The EAP discussion revealed that this could cause problems for prepayable floating rate instruments.
- The EAP will explore this issue further noting that *decoupling* was also instrumental for making the impairment approach operational for variable rate instruments.

d. Applying the ECF approach to specific types of instruments (eg instalment loans or revolving facilities)

- As a starting point, the EAP discussed how the EIR is approximated in current practice. This is particularly difficult for variable rate revolving facilities. Many financial institutions today treat the current draw down as a short-term fixed loan and the annual fee on the undrawn portion of the facility is taken into income linearly.
- The EAP discussed some of the challenges of calculating EIR under the ECF approach for revolving facilities, which include:
    - estimating the customer's lifetime usage behaviour at origination;

    - adjusting the EIR whenever the customer's usage deviates what was initial expected; and
    - contractual spreads and fees that vary with the customer's financial ratios, indicators of credit quality and usage levels.
- The EAP noted that today's IFRS requirements use two different standards for the commitment phase (IAS 37) and the phase after draw down (IAS 39). This can result in purely accounting driven effects on profit or loss from changing between the standards. The EAP discussed whether the accounting treatment could be aligned by using one consistent EL-based approach for both on- and off-balance sheet credit exposures.
- The EAP will further explore whether *decoupling* could reduce the complexity of calculations in relation to revolving facilities.

e. Carrying amounts exceeding the initial measurement ('negative provisions')

- The EAP continued its discussion on the outcome of the impairment model for early loss patterns (ie instruments for which the defaults peak in the early part of their term).
- Some EAP members thought the ECF approach would give rise to a 'negative' credit loss allowance when losses occur in the early phases of a loan. The EAP discussion revealed that the impression of a 'negative provision' results from a portfolio effect under a symmetrical measurement model (as used in the ED). This is because on a portfolio level the combined (net) effect of the credit losses on defaulted loans and the gains from the improvement of credit quality on other loans in the portfolio result in a carrying amount that appears to not include a full credit loss provision for the defaulted loans.
- An example was used to demonstrate that the incurred loss on an individual loan is not deferred but fully provided for. If the overall original credit loss estimate for the portfolio is still accurate (ie no revision) then the credit loss on the defaulted loans of the portfolio is compensated by a gain under a symmetrical model on the loans that have made it past the default peak and for which loss expectations have decreased.

- The EAP discussed examples of early loss patterns such as construction loans for which the migration pattern shows upward movements for loans that have passed the loss peak without defaulting whereas some loans move down to default status.

3. Discussion of the cash flow estimate issues (IASB model)

a. Implementation of the IASB model as in the ED using an EL approach

- The EAP discussed the results of various simulations based on the simplified model using the following different assumptions of how EL would be estimated:
    - through the cycle (TTC) EL is considered to be the best estimate;
    - TTC EL is considered to be the best estimate except for the next year which is perfectly predicted;
    - the observed incurred loss is considered to be the best estimate;
    - TTC EL is considered to be the best estimate except for the next year the EL of which is based on the previous year's incurred loss; and
    - using 10 year historical loss data taking into account rating migrations.

  These simulations were performed for rolling portfolios of 3 and 5 year bullet loans. The outcomes were presented and compared with the incurred loss model, the IASB's ECF model and the average annualised EL (see item 2.b above). The question was raised to what degree the outcomes resulted from the effect of 'phase shift' because of the assumptions how expectations are formed.
- The EAP also examined the results of an approach where subsequent catch-up adjustments (ie revisions of expectations) are deferred over the remaining life of the instrument.
- The EAP will continue to explore this simplified approach further.

b. Lack of historical data

- The EAP discussed what type of information entities could take into account as 'best practice' when there is a lack of historical data for estimating cash flows.
- The EAP considered the following:
    - 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;
    - utilise 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 PD and 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; and
    - use existing Basel II data or use statistical techniques to infer losses.
- The EAP thought that these aspects had no particular order but that the most appropriate approach depends on the individual circumstances. In some circumstances a higher level approach might be appropriate (eg if items are cross-collateralised).

c. Correlation in portfolios

- The EAP discussed the impact of correlation in portfolios on EL estimates.
- Under 'stable' market conditions correlation could reduce the expected loss. However, in 'stressed' market conditions asset performance becomes highly correlated. Correlations can also become unstable and change significantly.
- The EAP considered that the correlation does not affect the EL, but can change the variability around that EL (ie it could change the shape of the distribution curve of possible outcomes). This is important for a thorough understanding

of a credit loss allowance. Therefore, some EAP members considered the effect of correlation more as a matter related to stress testing and hence a regulatory capital issue.

- The EAP considered that if the objective of the impairment model is to account for credit losses at the individual instrument level then correlation should not be included in an estimation of credit losses. However, some EAP members wondered whether including correlation in the measurement of EL might still be appropriate.
- Many EAP members view correlation as a market dynamic similar to liquidity and not a factor that drives the performance of an individual loan.

d. Estimates using data from secondary sources

- The EAP discussed estimates using data from secondary sources. This issue would primarily apply to entities that did not originate the asset but acquired it from another entity (rather than directly from the debtor).
- When using data from secondary sources entities should consider the reliability and timeliness of the source data. The difficulty is assessing whether the data suits the intended purpose.
- The EAP thought that when using secondary sourced data management judgement is still required. The EAP considered that any management adjustments should be clearly defined and subject to a well governed committee structure.
- One possible way to estimate initially expected losses is to use publicly available, fundamental ratings that provide long-term views on the creditworthiness of assets while at the same time incorporating market implied ratings to identify short-term default candidates and predict rating changes. An issue that entities should consider is that short term views are also affected by liquidity and swings in the market's risk aversion and not just the credit quality of the asset.
- The EAP also discussed audit aspects of using data from secondary sources. This is similar to using data of external service providers such as pricing services (eg when determining fair values). The EAP considered that auditors

could draw on the procedures that had been developed to address those situations.

e. Loan commitments

- The EAP discussed how risk managers deal with loan commitments and other off balance sheet items.
- 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.
- The key difficulty is to determine the EIR because it depends on several factors:
    - fees charged for the loan commitment;
    - the likelihood of conversion into a loan (drawdown); and
    - the interest (spread) if converted, which may depend on the extent to which a facility is used and the level of benchmark interest rates at that time.
- The current accounting under IFRSs requires an assessment whether a drawdown is probable. If so, the fee is deferred and included in the EIR (or recognised as revenue on expiry of the commitment if no loan is made). Else, the fee is recognised as revenue over the commitment period.
- The EAP considered that the issues are similar to those for revolving facilitates as outlined in item 2.d.
- A possible approach the EAP discussed is to amortise the expected loss from the drawdown over the life of the loan commitment against fee income/interest revenue.
- The EAP will continue to discuss the issues relating to loan commitments and revolving facilities together.

4. Discussion of the proposed revision to the IASB's working issues list

- The EAP confirmed the latest revision to the IASB's working issues list:
    - the issues 'implications of 'actual' losses' and 'macroeconomic outlook and management judgement' had been thoroughly discussed by the EAP and tentatively closed;
    - the issues 'penalty payments', 'recovery costs' and 'cash flows for floating rate notes where benchmark interest rates are not observable' were considered to not warrant separate attention but instead be covered by other discussion items.

5. Basel Committee presentation

- The EAP received a presentation from the Basel Committee on its EL provisioning proposals.
- The proposals are based on a 4 step approach.
    - Step 1: Calculation of a loss rate that is used for estimating the EL over the life of the loan or loan portfolio. This loss rate is based on historical data (factoring in a full economic cycle). Then management judgement is required to make appropriate adjustments to the loss rate for aspects such as the nature of the items, significant changes in economic conditions or structural changes in lending policy. These adjustments should be based on objective factors.
    - Step 2: Determination of the EIR. For this purpose the loss rate in Step 1 would be applied evenly to all contractual cash flows (ie a constant percentage haircut) and the resulting reduced cash flows would be used as input in the iterative EIR calculation.
    - Step 3: The EIR in Step 2 would be used to recognise interest revenue (by multiplying it with the carrying amount) and to build up the credit loss allowance over time (which reduces the carrying amount). The credit loss allowance could not be negative. In case of material changes in estimates the EIR would be revised. To ensure the adequacy of the credit loss allowance at any point in

time there would be a minimum requirement that the allowance covers at least the EL within the upcoming period.

- Step 4: The credit loss allowance is used to absorb realised losses.

- The EAP discussed whether there was a trade-off between ensuring the adequacy of reserves and avoiding pro-cyclicality.

6. Proposal of a single converged model

- The EAP received a presentation of on an alternative model – 'the balance sheet approach'.
- The EAP discussed the main differences between the balance sheet approach and the IASB's proposals:
    - the balance sheet approach would not use the lifetime EL but the EL associated with a shorter outlook period (that is considered more reliable);
    - the initial EL would preferably be recognised immediately (day one loss) rather than over time through an adjusted EIR;
    - the credit losses would be determined by reference solely to principal amounts (ie exclude interest amounts); and
    - cycle parameters would be based on downturn through-the-cycle.
- The EAP considered this model as closer to the FASB's proposed model than the IASB's proposals.
- The EAP agreed to form a working group that will look further into this approach.