Expert Advisory Panel Meeting
26-27 April 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**

- The chairman informed the panel members that the IASB has published a user questionnaire on impairment of financial assets to solicit user feedback on the board's proposals.

2. **[FASB update and discussions]**

3. **The use of practical expedients**

- The EAP discussed the needs for practical expedients in estimating future cash flows. Smaller financial institutions have the greatest need for practical expedients. These smaller financial institutions typically have the following common characteristics:
    - credit risk management processes are less granular;
    - there is less internal data for statistical estimates as well as limited knowledge of and access to market-based cash flow data;
    - there is limited experience with sophisticated models; and
    - there are insufficient resources within smaller financial institutions with the appropriate knowledge of expected value concepts. Experience in estimating losses is typically based on applying historical charge-off information.
- A suggested practical expedient is using a 'loss rate' methodology.
- Panel members discussed whether implementing the IASB's proposals would necessarily involve complex models or might be achieved using simpler means. Smaller banks could eg pool and share data and credit loss statistics.
- The EAP will explore this methodology further and then assess whether it is consistent with the underlying principles of the IASB's proposals.

4. Proposed 'converged' impairment model

- The EAP discussed an outline of a possible 'converged' approach. The converged approach contains elements from the IASB, FASB, European Banking Federation (EBF) and Basel Committee proposals.
- The key aspect of the proposed converged model is differentiating between a 'good book' and a 'bad book'. Loans that go bad are transferred from the 'good book' to the 'bad book'. This recognises the way in which firms manage risk.
- For the 'good book', the provision for building the allowance is based on the lifetime expected loss divided by the weighted average life of the 'good book'. The allowance for the 'good book' is to be no less than the 1 year expected loss of the portfolio. The calculation for the 'good book' is always a prospective forward looking calculation. There is no need to track individual asset maturity or any parameters from the date of initial recognition of an asset. Subsequent reassessment of the expected loss on the 'good book' would be made periodically with subsequent changes amortised on a prospective basis over the weighted average life of the portfolio.
- For the 'bad book', impairment is measured based on the lifetime expected loss. The *proportionate* amount of the 'good book' allowance that relates to the loan transferred to the 'bad book' is transferred to the 'bad book' allowance. The remaining difference to the lifetime expected loss is recognised as an immediate additional provision. Subsequent changes in expected loss would be booked in the current period.
- The EAP discussed the model results under the converged approach using through the cycle estimates and point in time estimates. Under the assumptions of the example point in time estimates resulted in more volatile results.
- A number of operational issues were considered, including how to define portfolios and transferability between them.
- The EAP discussed whether amortising subsequent changes on a prospective basis over the weighted average life of the portfolio could be supported by an analogy to changes in estimates of the useful life of property, plant and equipment. The EAP learned that the analogy is inappropriate because IFRSs

treat changes in estimates related to bad debts as the type of change in estimate requires the effect of the change to be recognised immediately in the current period instead of the current and future periods (like the effect of changes in estimates of the useful life of property, plant and equipment).

- The EAP will continue to work on this converged approach, focusing on operational issues as a priority.

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

a. Annuity approach to expected loss (EL) measurement

- The EAP continued its discussion of a discounted cash flow (DCF) approach to EL measurement that uses an annuity concept for credit loss allocation.
- The EAP discussed the modelling results that demonstrated the flexibility of this approach by applying it to the following different scenarios:
    - fixed rate loan with subsequent changes in expectations;
    - amortising fixed rate loan;
    - fixed rate credit commitment with a single drawdown in event of default;
    - floating rate loan with no changes in expectations;
    - floating rate loan with subsequent changes in expectations; and
    - fixed rate bond.
- The EAP noted as per last meeting that the closer the discount rate is to the effective interest rate (EIR) the closer the approximation. The approach appears to be less accurate for riskier products with higher coupon rates.
- The EAP also noted that this approach avoids the complex internal rate of return (IRR) calculation because it is a closed form calculation. It also works for loan commitments, where an iterative calculation does not work as there is no initial cash flow, as well as for floating rate loans.
- The EAP however noted that the annuity approach would still require forecasting of expected cash flows over the life of the instrument. However, the EAP noted that this approach can be further simplified for example by using annualised cumulative default rates as an approximate for EL.

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).
- The modelling used considers only loss of capital (ie principal). Modelling demonstrates that this simplified EL approach provides a good approximation for changes in credit loss expectations (ie catch-up adjustments) under different interest rate scenarios for bullet loans.
- Modelling also demonstrates that this simplified EL approach is also a good approximation for floating rate instruments. Changes in forward rates produce very small catch up adjustments in low interest rate scenarios. For high interest rates environments the approximation would be less precise but might still be reasonable.
- The EAP also compared the modelling results from the IASB's and the EBF's proposed approaches. Under perfect prediction, the IASB closed portfolio and the EBF open portfolio approach provide similar results.
- The EAP will continue to explore how to apply the IASB model to open portfolios and whether the EBF model could fit in to the IASB's principles.
- The EAP noted that to best operationalise any final requirements, those should have flexibility to fit into the way entities manage the business. For example, some entities assess risk on an entity level where as some entities would assess risk on an instrument by instrument level.

c. Open/closed portfolios

- The EAP discussed the operational difficulties in dealing with closed portfolios**.** The IASB's proposal is easier applied in closed portfolio scenarios. However, to set up closed portfolios, a high number of closed portfolios would be required based on credit risk characteristics for a sophisticated financial institution. Portfolios may over time become heterogeneous depending on rating migrations, and therefore entities would need to track the migration patterns for closed portfolios.
- 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

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on probability of default (PD) and loss given default (LGD)) independently from the portfolio they belonged to previously and therefore loans are not tracked for their migration patterns.

- The EAP also discussed the relevance of vintage in determining the Basel II parameters, ie PD, LGD and exposure at default (EAD). Currently, the vintage of a loan is usually not relevant to assess its PD as the PD is attributed to a counterparty and rather than a loan. The LGD is usually independent from the vintage of loans, but under some scenarios, vintage information maybe useful. The EAD is specific to each loan and has to be determined on a loan by loan basis.
- In order to estimate statistical parameters portfolios typically need to included different vintages so as to achieve a sufficient sample size. However, the EAP learned that 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 (eg the original EIR or an initial EL estimate). The different purposes can suggest different portfolio sizes for each purpose.
- The EAP discussed the allocation of the allowance in an open portfolio without the use of vintage information. It is suggested that short cut methods could be used to estimate the allocation (eg based on the weighted average age and weighted average residual maturity of the portfolio). The allowance can then be allocated based on the weighted average age/residual maturity of the portfolio and hence vintage information may not be necessary.

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

a. Updating estimates (operationalise frequency of re-estimates)

- The EAP discussed the operational aspects relating to updating estimates.
- Estimates should be updated at each balance sheet date. The frequency of updates depends on how frequently circumstances change and the difficulties involved in obtaining data.
- Estimates should be updated to reflect material changes and it should be considered whether this creates separate (additional) disclosure requirements to the market or other stakeholders. Estimates should remain current utilising all best available information. Frequency of updates should be subject to

formal internal policy and may be amended in line with market and other eternal events as required.

- Management judgement should be applied and updated in a consistent way. Frequency of updates should be verified with external auditors based upon agreed materiality criteria and reporting thresholds**.**
- The EAP also raised the issue of updating estimates with subsequent events after the balance sheet date. In arriving at or when updating the best estimate, a question was how an entity should consider information obtained post balance sheet date which relates to and provides additional information on the economic conditions or circumstances at the balance sheet date. The EAP suggested that guidance clarifying the treatment of subsequent events would be useful.

b. Uncertainty of estimates

- The EAP discussed the issue of dealing with the uncertainty in cash flow estimates. Estimating future cash flows, especially when there is a lack of historical data, may be a challenging task for entities and may be subject to a high degree of uncertainty.
- The EAP observed that the measurement objective is to arrive at the entity's best estimate and the entity should consider uncertainty in arriving at its best estimate by determining EL as the expected value of the possible outcomes (ie the 'mean'). Once an entity arrives at its best estimate the entity should not make any further adjustments for uncertainty. The EAP noted that because the measurement of the financial instrument is at amortised cost the changes in the risk premium over time would not result in an adjustment to that measurement.

7. Sharing of ideas from the Brazilian Model

- The EAP received a presentation on the Brazilian regulatory loan loss provisioning model. Under the Brazilian regulatory loan loss provisioning model, a provision for the expected loss of the loan is made at inception and is used when there is an event of default.
- The EAP discussed and compared the results of the annuity approach, the IASB's ECF approach and the Brazilian model.