Expert Advisory Panel Meeting
25-26 February 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 are not minutes of the meetings, and do not capture the views of individual panel members. As noted below, the panel discussions are continuing.

1. Administrative matters

a. Future meeting venues are confirmed as follows:

24/25 March – London

26/27 April – London

24/25 May – Norwalk

21/22 June – Beijing

b. Objective of the panel:

The chairman reconfirmed the objective of the expert advisory panel (EAP) is to make recommendations to the IASB and FASB on how the operational challenges of implementing their respective models may be resolved.

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

a./b. Implementation of the IASB model as in the Exposure Draft (ED) using an EL (EL) approach

- The EAP discussed how the IASB model could be implemented using an approach that combines the information in accounting systems (interest revenue based on contractual terms and conditions) and the information in risk systems (EL).
- In practice, many financial institutions store contractual interest rate data and EL data information in separate systems while the use of one integrated system is rare.
- The discussed proposal (simplified approach) would adjust the interest revenue calculated on the basis of contractual data in the accounting system using an allocation profile for expected credit losses derived from EL data in

the risk system. The allocation profile could be derived for both bullet and instalment (amortising) loans.

- This simplified approach would not capture differences in the level of contractual interest or timing of credit losses. Some data modelling was used to demonstrate that in these two factors do not have a significant impact on the allocation profile in the scenarios used.
- Some EAP members observed that this simplified approach appeared to focus on losses of principal amounts in determining the EL while the ED requires to consider both losses of principal and interest. Therefore, this simplified approach may be less accurate for certain asset classes eg loans with high interest income such as leveraged loans.
- Some EAP members emphasised that the appropriateness of simplifications and approximations would depend on the circumstances. Any related guidance the IASB might provide should allow flexibility to accommodate different circumstances including different system environments of different banks.
- The EAP considered that in determining EL a Basel II EL can be one input in determining the life time EL under the IASB's proposals ie entities may leverage off the data used for determining BASEL II EL. However adjustments would be needed because the time horizon for the BASEL II EL is 1 year whereas the IASB ED requires entities to take into account the EL for the lifetime of the loan. EAP members also observed that using the BASEL II parameters under internal rating based (IRB) approaches is only one possible starting point. Other banks (especially standardised banks) and non-banks may have other ways of estimating EL.
- The EAP also discussed another adjustment that would be required when using a Basel II EL, which relates to converting the basis of determining parameters from a through-the-cycle basis into a point-in-time basis. The EAP observed that determining what the cycle is was difficult. Since the objective of the IASB ED was to determine the EL for the life of the instrument the estimate might include elements of both through-the-cycle and point-in-time aspects depending on the circumstances. The EAP

discussed relevant circumstances such as the term of the instrument (how long versus the length of a cycle), how susceptible a parameter is to change (eg prepayment and loss estimates) or whether changes are reflecting a change in long term trends.

- EAP members recommended that in determining the EL entities should be required to consider and use the best available information. The information available could differ both between entities and different segments within an entity. Many members stressed the need to take a principle-based approach in any final requirements to reflect the different information and systems that entities have.
- The EAP was interested in modelling additional scenarios using this simplified approach.

c. Implications of 'actual' losses

- The EAP discussed the implications that 'actual' credit losses might have for the impairment model. EAP members noted that the definition of actual losses should be flexible as circumstances vary in different jurisdictions with different legal systems.
- One thought on the definition in the IASB ED was to perhaps consider revising the definition of write-off by removing the reference to ceasing any further enforcement activities.
- The discussion raised the question whether the issue of what 'actual' loss and its relevance is resulted from the lack of clarity about the timing of loss recognition in the incurred loss model.
- EAP members noted that the definition has an impact on how a loan and the associated loss allowance is presented ie on a gross versus net basis (but that it would not affect the measurement of the asset in the balance sheet – ie amortised cost as the net carrying amount – or profit or loss).

d. Simplifications for standardised banks

- The EAP discussed what practical expedients might help implementing the IASB proposals in standardised banks (ie banks that use a standardised approach under Basel II), such as a loss rate method.
- The EAP agreed that the issue not only one of standardised versus other banks but also related to portfolios in general (ie there can be a need for a standardised or simplified approach for some portfolios within a bank that otherwise uses IRB approaches).

e. Macroeconomic outlook and management judgement

- The EAP discussed what guidance might be useful in helping entities including a macroeconomic outlook in their cash flow or EL forecasts and how to apply the management judgement involved. The discussion used experience from the United States of America (US) where regulators have issued guidance on how environmental and qualitative factors should be considered in estimating credit losses.
- The EAP learned that the US guidance emphasised 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. There should also be a linkage between observed changes and the loss expectations.
- In addition, the EAP was informed that there should also be a relationship between the analysis of the portfolio, the amount of loss allowance and the provision and that this relationship should be documented.

f. Experiences with SOP 03-3: dealing with operational challenges

- The EAP learned about the operational challenges in applying SOP 03-3. This is a US pronouncement that applies to accounting for loans that are acquired when they already have credit impairments and requires estimates of expected cash flows that include the effect of credit losses.
- One approach of implementing SOP 03-3 presented to the panel used Monte Carlo simulation. This process works on a loan-by-loan basis and includes probabilistic estimates of both the amount and timing of credit losses. The

approach accommodates long term estimates (time horizons of up to 30 years). The process involves frequent recalibration using actual data.

- The EAP discussion revealed that Monte Carlo simulation is also used for investment decisions in asset backed securities.
- One of the difficulties encountered in applying SOP 03-3 in a scenario in which there was no purchase of a non-performing loan portfolio at market price was to determine the initial fair value as the starting point. Then the effective interest rate (EIR) is determined as the internal rate of return that equates the expected cash flows with that initial fair value.
- The EAP also learned that many banks applying SOP 03-3 use spreadsheets rather than integrated system solutions, which reflects operational difficulties of embedding the process in their IT systems.
- The EAP discussion also highlighted the consequences of the asymmetry of SOP 03-3 regarding upward and downward revisions of cash flow estimates. That has had business implications because the asymmetric accounting can create an incentive to sell securities and also adds significant application complexity. The asymmetry of SOP 03-3 results from the effect of downward revisions of expected cash flows being recognised as an expense immediately whereas upward revisions are spread over the remaining maturity as an adjustment to accretable yield, which reflects a conservative bias.
- One implementation issue resulting from scenarios where the initial fair value includes a significant liquidity premium is that the internal rate of return can be very high.

g. Interaction with Basel II requirements

- The EAP discussed the interaction between Basel II requirements and the IASB's proposals. The EAP received a summary of key aspects of the Basel II Framework on credit risk, including the differentiation between the standardised approach and the IRB approaches.
- The EAP also learned about the interaction between Basel II requirements and accounting systems in practice. The internal ratings and statistical

parameters used by IRB banks are also often used for the banks' internal risk management purposes.

- The EAP also discussed a comparison of the Basel II Framework and the IASB ED. Key observations were that the determination of probability-weighted outcomes under the ED might be complex, that the interaction between a point-in-time perspective and the forward looking cash flow estimate should be clarified, and that ways of reducing the degree of management judgement in estimating cash flows should be explored.

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

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

- The EAP discussed a simplified approach that disaggregates the calculation of amortised cost into three building blocks:
  - The initial expected loss is allocated by building a provision fund using the average expected loss (which is determined as the cumulative expected loss at inception divided by the number of periods in the life of the instrument).
  - An experience adjustment, which is the difference between the actual loss in a period and the previous loss estimate for that period.
  - An adjustment for changes in expectations for the remaining life of the instrument.
- The EAP discussed whether the simplified solution would work only for static portfolios or also for dynamic portfolios. Some EAP members noted that the simplified model would still require carrying forward information from the date of initial recognition (the initial EL), which is difficult for many systems. The question was raised whether EL-based approaches could be considered an interim step towards an expected cash flow model.
- A quantitative model was used to illustrate different scenarios (ranging from perfect prediction to constant expectations) and the resulting different loss patterns.

- The EAP also discussed the outcome of the impairment model for early loss patterns where the peak of defaults is in the early years of the instrument's life (eg auto loans). This would result in 'negative' loss provisions that are attributable to the difference between the discount rate used (the credit cost adjusted EIR) and the contractual interest rate.
- The EAP was interested in exploring the simplified approach further.

b. Discounted cash flow approach to EL measurement

- The EAP discussed a discounted cash flow (DCF) approach to EL measurement that would avoid the complexity of an integrated EIR calculation. This approach uses a separate DCF calculation for the initial EL that is allocated over the life of the instrument by converting the present value of the EL into an annuity, which is recognised in profit or loss. The discount rate for the DCF calculation would be the risk free or a benchmark rate (rather than the EIR).
- The advantage of this approach is that it avoids the drawbacks of internal rate of return calculations (in particular it avoids an iterative calculation). Using the risk free rate for discounting the EL also excludes changes in the risk aversion or premiums.
- This approach would accommodate calculations both on a pool and an individual instrument basis. It would also allow including other complexities such as prepayment estimates.
- The EAP was also interested in exploring this approach further.