

# **Expert Advisory Panel Meeting**

## **24-25 May 2010 (Norwalk)**

### **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. Application of loss rate methodology**

- The EAP received a presentation on the loss rate methodology.
- 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. Hence, they involve expert credit judgement (ie qualitative factors). Loss rates can be determined in a multiple number of ways eg based on historical charge-off data, probability of default (PD) and loss given default (LGD) data migration matrix or roll rate analysis.
- The EAP discussed that loss rate methodologies are not an 'impairment model' by themselves but rather a flexible tool that can be used as a means to implement different impairment models. The particular impairment model would dictate how appropriate loss rates for that purpose would be determined. For example, loss rates can be calibrated to apply for different outlook periods, as annualised rates or as cumulative rates. Under certain scenarios the application of an average loss rate yields similar results to the use of net present value techniques.
- Loss rates could be applied to pools of homogenous loans with similar risk characteristics that are not individually evaluated and impaired. Loss rates have a good compatibility with banks' credit functions and systems, including that they can be applied to open portfolios.
- The EAP discussed that loss rates might be particularly suitable for smaller loans for which flow models are used. Also, loss rates might be a simple way of deriving cash flow estimates more generally.
- The EAP will continue to explore circumstances under which the use of loss rates would be a close approximation to the IASB's exposure draft (ED).

## 2. Dealing with open/closed portfolios

- The EAP discussed three ways (*loan level tracking*, *closed pool tracking* and *open pool tracking*) of implementing the IASB's ED to pools of loans. The discussion addressed the operational complexity of implementing the ED for pools of loans.
- Given that the IASB's proposals involve the use of the original EIR this information would have to be maintained over the life of the financial asset. Today, EIR information is usually not stored in systems in a way that would allow using it directly in conjunction with credit risk data. Risk management generally determines EL on an open portfolio basis.
- The EIR calculation as proposed in the ED can be implemented at an individual loan level, but when implemented in a pool approach, it 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.
- *Loan level tracking*: Expected loss (EL) is estimated at the cohort level and is pushed back down to the individual loan level. EL and EIR data is stored at loan level. This means that at each measurement date cohorts are formed based on the then current credit characteristics and then information is pushed down again to the loan level. While operationally the simplest of the three approaches, loan level tracking requires storing and tracking of large amounts of data.
- *Closed pool tracking*: At inception closed pools are created based on key EL drivers and EL is estimated on the basis of the average pool characteristics. Both EL and EIR are stored at pool level. At each measurement date loans *within* the closed pools are cohorted and EL is estimated for each cohort. The updated EL is then aggregated and stored at the pool level. Changes in estimates are calculated at the pool level. New loans are treated as new closed pools. Compared to *loan level tracking*, *closed pool tracking* requires less data to be stored and tracked, however there are significant inefficiencies in processing capabilities by having to cohort within closed pools at each reporting date.
- *Open pool tracking*: EL for new loans entering into the pool are estimated and stored either at loan level or at cohort level. An updated 'inception' EL and

- All of the above three ways of implementing the IASB's proposals to pools of loans represent significant changes and require significant investments in time, data storage and system capabilities. The EAP also discussed that the transition to the new impairment model would be challenging.

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

#### **a. Estimates for nonrated instruments**

- The EAP discussed a framework for implied ratings of non-rated instruments.
- The framework is based on a matrix that considers the following factors:
  - o financial (free cash flows);
  - o business (scale of operation, market share, barriers of entry, volatility of earnings); and
  - o corporate governance, management (transparency and management track records).
- Based on the above factors the matrix suggests an equivalent implied credit rating.
- The EAP discussed that such internal ratings were typically easier to adjust and cheaper than external ratings. This approach would also be suitable for smaller banks.

### **4. Summary of operational issues identified and discussion of converged approach**

- The EAP discussed the following operational issues identified in the discussions at the April EAP meeting:

#### **a. Recognition of interest revenue**

- The EAP considered de-coupling<sup>1</sup> the calculation of interest revenue and EL as the best solution to address the complexity of an EIR calculation in the context of separate accounting and credit risk systems.

**b. Estimation of expected cash flow and EL**

- The EAP discussed the use of loss rates as a proxy for the reduction in future cash flows due to credit losses. The EAP also discussed how for open portfolios in a steady-state average loss data could be used to simplify EL estimates (with management judgement applied to reflect other information not captured in the models).

**c. Unit of account closed portfolio vs open portfolios**

- Refer to item 2 'Dealing with open/closed portfolios'.

**d. Changes in expectation (catch-up)**

- The EAP discussed 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, maintained by historic time periods. It would be operationally easier to use a 'good book/bad book' approach with changes in expectations in the 'good' book recognised over the remaining life of the instrument, whereas changes in estimates for the 'bad' book are recognised immediately in profit or loss. However, that would be a different impairment model rather than addressing operational aspects of the IASB ED.

**e. Performing and non performing loans (good book/ bad book)**

- Most banks today manage credit risk by differentiating between a performing ('good') book and a non-performing ('bad') book. Hence, applying an ECF approach is operationally challenging in this context (see item d above), particularly for small loans in a flow business (ie for many retail products).
- Operational complexity could be reduced if a statistical approach such as a loss rate could be applied for the 'good' book assets.
- The EAP discussed the amount of provision that should be transferred when a loan moves from the 'good' book to the 'bad' book. The alternatives discussed were a 'rucksack' approach that would result in a transfer of the proportional loss allowance attributable to the loan that is moved to the 'bad'

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<sup>1</sup> This issue have been discussed in previous EAP meetings. For more information refer to previous EAP meeting summaries.

book and a ‘full allowance’ approach that would take the entire loss allowance needed in the ‘bad’ book for that loan from the ‘good’ book loss allowance.

## **5. Operational issues on variable interest rates (forward yield curve versus spot rate assumptions)**

- The EAP discussed the issue of discounting variable rate loans using a flat rate (ie assuming the current variable rate remains constant for the remaining life of the financial asset) vs the term structure of interest curve. Conceptually, using the term structure of interest curve for discounting is required. Only using that discount rate ensures that each cash flow is discounted at the appropriate rate so that the carrying amount represents a present value.
- For variable rate assets, the variability of the interest rate has two offsetting effects on the measurement resulting from the change in future variable interest payments and the related change in the discount rate (ie higher discount rates result in higher forward interest cash flows). If a variable rate loan is issued at par these two effects are exactly offsetting regarding the benchmark risk element. Consequently, using a flat interest curve instead of the term structure of interest curve does not make a difference in such a particular scenario.
- However, in any scenario in which the carrying amount does not equal the nominal amount using a flat interest curve instead of the term structure of interest curve does make a difference.

## **6. Examples**

- The EAP discussed various examples and compared the outcomes under the current IAS 39 and US GAAP requirements, the IASB’s ED and the US GAAP draft proposals to verify the understanding of the respective requirements.

## **7. Lessons learned on impairment models**

- The IASB board and staff members participating in the EAP have summarised<sup>2</sup> what from their perspective are the main issues discussed at previous EAP meetings to date, their implications and possible solutions. The Chairman asked EAP members to provide any feedback on the summary.

## **8. Discussion of the proposed revision to the IASB’s working issues list**

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<sup>2</sup> The summary is available on the IASB website (<http://www.iasb.org/NR/rdonlyres/A40E4FED-61F6-4FDF-93F1-C87709265508/0/EAPupdate.pdf>).

- The EAP confirmed the latest revision to the IASB's working issues list:
  - the issues 'estimates for individual financial instruments', 'estimates on a portfolio and individual level' and 'migration of instruments over time' have been included in the discussion of 'open/closed' portfolios'; and
  - the issues 'lack of historical data', 'correlation in portfolios', 'estimates using data from secondary sources', 'updating estimates', 'loan restructures and loan commitments' and 'applying the ECF approach to specific types of instruments (eg instalment loans or revolving facilities)' have been thoroughly discussed by the EAP and tentatively closed.