ASB Constituent Roundtable

Financial Instruments: Amortised Cost and Impairment

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ED Financial Instruments: Amortised Cost and Impairment

2010

IASC Foundation

The views expressed in this presentation are those of the presenter,
not necessarily those of the IASC Foundation or the IASB

Clarifications on model

- Catch up adjustments

- 'Negative' impairment

- Volatility tantamount to fair value

Catch-up Adjustments – why?

- Day 1 treatment – allocation of losses adjusting EIR
    - Reflected in initial pricing
    - No day one loss

- Catch-up adjustment
    - Reflects impact of changes in loss estimates *in current period*
    - Provides benchmark to assess original investment decision

- Spreading of adjustments to loss expectations
    - Can result in discount rates below risk free rates or even negative
    - Inconsistent with other IFRS (eg IAS 36 and IAS 8)

'Negative' impairment / provisions

- *Symmetrical* model

  – Reflects all improvements in credit quality – not limited to those that are reversals of previous impairments

  – Hence gains on better-than-expected performing assets have an offsetting effect regarding impairment losses

- 'Negative' impairment / provision is a misconception

  – Result of looking at gains and losses in aggregate

  – Carrying amount is always the present value of the cash flows expected to be received
  => no deferral of incurred losses

'Volatility tantamount to fair value'

- Not all volatility is equal – real v artificial

- Expected credit losses adjusted (numerator) – discount rate (denominator) is not

- For a floating rate instrument – only the base rate is updated but not the credit spread, hence different from fair value

Expert Advisory Panel

- ## What is it for?

  – To consider how to address operational challenges

- ## Who is on it?

  – Credit and risk experts from all major regions

- ## How does it work?

  – Public meetings

  – Two EAP subgroups

    – Cash flow estimates

    – Effective interest method

- ## What will be produced? EAP will decide

Main Operational Challenges

- Estimation of cash flows

  - Data availability

  - Timing estimates

- Complexity of integrated EIR calculation

Possible solutions to challenges of estimating cash flows:

- Lack of historical data
  - Look for other loan types that maybe proxies
  - Use average of a range of defaults if there is high uncertainty
  - Use management judgement of expected losses for pricing
- Estimates using secondary sources
- Interaction with Basel II requirements

Expert Advisory Panel

Possible solutions to challenges of EIM approximations:

- Adjust contractual interest revenue using an allocation profile for expected credit losses derived from expected loss (EL) data in risk systems

- Disaggregating the calculation of amortised cost into three building blocks (the initial expected loss, an experience adjustment and an adjustment for changes in expectations for the remaining life of the instrument) ('decoupling')

- Use separate DCF calculation for the initial EL that is allocated over the life of the instrument by converting the PV of the EL into an annuity

Expert Advisory Panel

Other operational issues to be discussed:

- Open portfolios

- Loan commitments and revolving facilities

- Variable rate instruments

Investor perspective

- IASB conducting a user survey to get input

- Asking whether the balance of judgement v disclosure works

- Seeking feedback on catch-up adjustments v spreading

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.

Is expected loss conceptually superior?

- **Components of a loan**
  - Principal
  - Fees
  - Contractual Interest
  - Expected credit loss

- **Incurred loss method**
  - amortise *interest and fees* over life of loan
  - recognise *actual loss* as it is incurred, indicated by trigger events

- **Expected loss method**
  - amortise *interest, fees and expected credit loss* over life of loan
  - *Catch-up adjustments* are recognised in the period where the credit loss expectations change.

Merits and Demerits of IASB's model

- ♦ **Merits**
  - Meets the G20 expectations
  - No more artificially high profits being booked upfront and delayed loss reporting
  - No need to consider trigger events
  - Reflects the credit losses as expected across a portfolio of loans
  - Other

- ♦ **Demerits**
  - Inherent complexity and potential volatility may make outcomes difficult to understand/ explain
  - Increased used of management expectations
  - Implementation challenges e.g. data availability
  - Unit of account challenges
  - Positive or negative catch-up adjustments only reflect changes in loss expectation not actual experience
  - Other

Alternative Models

EBF	Basel	FASB
♦ Calculate Amortised cost as under IAS 39 ♦ Estimate expected losses over life and recognise over the life ♦ Book incurred credit losses against expected loss allowance, book any excess directly to income statement ♦ Isolate non-performing loans and treat as in IAS 39	♦ Calculate loss rate (based on average loss rate for a complete economic cycle) ♦ Apply loss rate to contractual cash flows over life of loan to determine expected cash flows and EIR. ♦ Revise EIR if material changes to expected cash flows ♦ Catch-up adjustments as for the IASB's model	♦ Assess credit impairments based on past and current factors impacting collectability of financial asset ♦ Use NPV techniques to determine credit impairment • Amortised cost in excess of PV of expected cash flows • By reference to financial assets with similar risk characteristics • Average loss rate for homogenous pool of financial assets