

ACCOUNTING STANDARDS BOARD

IASB Exposure Draft Financial Instruments: Amortised Cost and Impairment

Note of Discussions at ASB Constituent Round Table
held on 6 May 2010 at Aldwych House, 71-91 Aldwych, London, WC2

Current IASB position

The following key points were made in relation to the IASB proposals:

- The suggestion that there was an inconsistency in the model's treatment of initial and subsequent credit losses was misplaced. The IASB Board had deliberately chosen to propose different accounting for initial credit losses and for subsequent changes. Amortising the initial credit losses over the life of the instrument was not dissimilar to accounting applied elsewhere to the measurement of effective yield on an instrument. The initial expectation of losses was reflected, either explicitly or implicitly, in the pricing of the instrument but the catch-up adjustments related to subsequent changes in expectations and the accounting being proposed (immediate recognition) was similar to that used for other changes in estimates, for example in pensions accounting.
- Under the model, the carrying value of a loan was always the current value of the expected future cash flows discounted at the original expected yield. The view that there could be 'negative' impairment/provision was a misconception. The losses would always be covered by the provision but the model allowed the carrying value to be adjusted for an improvement in credit worthiness.
- The volatility resulting from the catch-up adjustments was a reflection of real economic changes in the underlying credit-worthiness, which deserved to be reflected in financial statements as failure to do so would defer the provision of information on changes in credit.
- The Expert Advisory Panel (EAP) was making better progress than some had imagined would be possible. There was clear recognition of the challenges presented by the need for estimation of cash flows and recognition that a degree of subjectivity in the estimation of cash flows was unavoidable. The EAP was also looking at ways of reducing the complexity of integrated Expected Interest Rate (EIR) calculations by decoupling the two sides of the EIR calculation, for example by retaining the existing system for recording a loan and the accrual of contractual interest and looking to a separate system (that was currently in risk) for arriving at the expected losses over the period of the loan and then converting that information into a yield adjustment. Consideration was also being given to a number of possible simplifications in the way estimates might be arrived at.

- The EAP had yet to turn its attention to the operational issues arising in relation to open portfolios, loan commitments with revolving facilities and variable rate instruments.
- Effort was being applied to the identification of investor views, including a user survey seeking input and feedback on whether the balance of judgement v disclosure would work and on catch-up adjustments as an alternative to spreading.

In discussion, the following points were made:

- The IASB had done quite a lot of work on operational issues and had reflected some of it in the development of the ED but had decided not to do more extensive work before publishing the ED because of the intention to set up an EAP. The decision not to do more work on operational issues before publishing the ED and to ask the EAP for advice had also been influenced by the results of a feasibility study which had identified two distinct sets of views, from preparers who wanted very little detailed guidance and from preparers who wanted very prescriptive guidance.
- The EAP would be deciding the form of its output. The IASB would then consider what should be done with that output as part of its re-deliberations.
- The ED proposals were not for a through the cycle model but for cash flows through the life of the loan. However, historical loss data would inform the estimate because losses were expected to be similar to those occurring during similar past conditions.
- While the IASB had targeted investors through its user survey to find out whether catch-up adjustments were going to help users' understanding of financial statements, inputs from non-users, in any form, were also welcome.
- The effect of allowing catch-up adjustments could be that eventually the figures would be the same as from an incurred loss model. However, the adjustments all had to be in the context of the expected loss (the present value of expected cash-flows discounted at the original effective rate, which was not necessarily the same as the incurred loss provision). The maximum carrying value of the asset (if no credit losses were expected) could never be more than the original contractual cash flows discounted at the initial effective yield.
- No limit was being placed on the information that should be taken into account in determining expected cash flows but the model was using an amortised cost measure and not a fair value measure. A measure of judgement could be needed in arriving at the best estimate of future cash flows.
- Although the IASB had not ruled out practical expedients and other approaches fitting into the conceptual basis of the model it had not yet reached any conclusions about the alternative ways in which it might be applied to an open portfolio.

- Respondents to the ED would not be in a position to come to a view on possible alternatives (such as the FASB proposals) before the IASB deadline for responses. The IASB did not want respondents to defer responding but would maintain a dialogue beyond the closing date.

Is 'Expected Loss' better conceptually?

In a short presentation and subsequent discussion around the conceptual superiority or otherwise of the expected loss approach, the following points were made:

- The IASB had done a good job in identifying the bias in the incurred loss approach (not recognising credit loss as early as it should be). For that reason, any expected loss model would be better than incurred loss and people should not be overly concerned about getting the expected loss model absolutely (as opposed to approximately) right.
- It would have been helpful if the IASB had articulated more clearly the reasons why the incurred loss model had been chosen originally, for example that it had been regarded as more objective. It may be that the real problem with the incurred loss model was that people were not actuating the triggers consistently or early enough.
- During the 1990s banks had specific provisions (similar to incurred loss) and general provisions (similar to expected loss) reflected in the balance sheet and in movements in the profit and loss account, and regulatory advantage had been given to general provisions. Some banks had indulged in profit smoothing through the general provision, particularly in America, and IASB members from America appeared to have seen this as a loophole in the expected loss approach that needed to be closed.
- One reason why expected loss was conceptually better was seen in the example of a financial product involving repayments over a 5 year period, the correct price for which (on the basis of experience) was 15% and on which 3% losses would be incurred. If there was always a low incidence of loss in years 1 and 2 with the losses bunched in years 3, 4 and 5, then allowing the 15% to flow straight through into the profit and loss account would overstate the income in years 1 and 2. This would not matter in a balanced portfolio having assets of the same value year after year. However, for institutions growing their portfolios (which, historically, had been by as much as 15% per annum) profits at the beginning of the cycle would be grossly overstated. Looking at the profit over the period of the loan was therefore of paramount importance. It was what used to be called matching, the failure of which gave investors misleading information.
- The IASB had looked at the use of the expected loss model in its annual improvements for 2004 but the example given had only related to portfolios and not to single items.
- The expected loss model was a way of presenting the opportunity cost of lending at a particular rate, which could change the view someone might take

at the inception of a loan of the appropriate rate or credit spread. In this sense it offered a completely different view of lending activities.

- The debate on IAS 37 was generating potentially differing views (often from the same people) in relation to provisions and loans. The incurred loss model had become the 'more likely than not' event with probability applied to cash flows. The debate had now shifted to probability weighted events and probability weighted cash flows.
- The incurred loss model was 'telling it how it is' but it had had the effect of destroying the sensible provisioning process. The expected loss approach was retrofitting a provisioning process (that was not 'telling it how it is') for governance purposes because boards had not been building up the capital they should have done in the good times. It would have the effect of allowing some board conservatism and an element of prudence. While, given current times, any expected loss model was better than an incurred loss model, the departure from 'telling it as it is' was a matter for regret.
- The expected loss model more clearly reflected economic reality and should improve comparability between the profit and loss accounts of banks with different riskiness of loans, on the basis that a bank lending at a higher rate to riskier customers should take into account the higher risk of loss on those loans. It could also be argued that expected loss did 'tell it how it is' in the sense that there was plenty of estimating in accounting that took account of future expectations.
- Most banks in the European Banking Federation would support the expected loss approach but not the ED version of it.
- Incurred loss information (including the loss events information) was of value to users. As the expected loss methodology would be sensitive to the views being used there would be a need for a benchmark. Incurred loss may therefore need to be retained as part of the methodology or as part of the disclosures required.
- It would be wrong to regard the incurred loss approach as wholly objective because the degree of objectivity achieved had always been dependent on the way in which it was applied.
- One of the problems with the incurred loss model was the lack of clarity over the triggers and the consequent inconsistency between banks in different parts of the world in their interpretation of what an incurred loss was. If anything like an incurred loss model was to be retained this lack of clarity would need to be addressed. Banks would be likely to continue using incurred loss information for internal management purposes and/or to meet stakeholders' information needs so there would again be a need for better definitions.

The advantages and disadvantages of 'Expected Loss'

In a short presentation, the merits and demerits of the IASB's model were said to be:

Merits

- Meets the G20 expectations
- Prevents artificially high profits being booked upfront and delayed loss reporting
- No trigger events
- Reflects credit losses expected across a portfolio

Demerits

- Inherent complexity and volatility
- Increased use of management expectations
- Implementation and unit of account challenges
- Catch-up adjustments reflect only changes in expectations not actual experience

In the discussion that followed, the following points were made:

- The decoupling needed was likely to give rise to problems (with banks having different systems for contractual interest and risk) but once decoupling had been achieved then it would be possible to focus on the usefulness of incurred loss information, because the building up of the provision would be separate from the incurred loss.
- Any model that retained incurred loss within it would also retain the trigger event problems that were seen as one of the weaknesses of the present model. Trying to distinguish losses due to general changes in economic conditions from those specific to a particular loan was likely to be challenging. The IASB model did not have this problem. Trigger events would not be an issue because in using probability weighted events and probability weighted cash flows there was no need to look for the magic event that said someone now had an incurred loss and there was never the issue of a particular event being so probable that it flipped from being an expected event to an incurred event. Retention of incurred loss would necessitate retention of that distinction.
- An additional challenge of the expected loss model would be the disaggregation and the related profit and loss account implications.
- The ED model required the maintenance of a separate loan loss allowance account, the changes in the balance of which should be shown during the period and, to the extent that a loan had gone bad, there would be actual write-offs to that account. There was also a requirement to disclose non-performing loans. However, bad loans did not necessarily automatically result in an adjustment. If loans went bad in line with expectations then there would be no catch-up adjustments.
- Some banks remained to be convinced about the conceptual basis for dealing with expected losses through the effective interest rate and for spreading the initial expectation while creating a volatile capture of subsequent changes. While it was true that the credit risk was an implicit consideration in pricing there were many other factors affecting pricing, which was often competitive, and banks could sometimes take the opportunity to widen margins if credit risk was deteriorating. The preference of the EBF would be to see this separated from the EIR. The initial expectation, in including expectations about the future, was often going to be wrong and the catch-up changes

would in part be a reflection of the institution's ability to forecast accurately. While giving information about expected losses was a good thing, expected losses should be treated as being crystallised by incurred losses. Only if incurred losses accelerated and the provision had been exhausted should there be a further charge to the profit and loss account.

- The expected loss approach might be more pro-cyclical than the incurred loss approach and, in this sense, would not meet the G20 expectations. In the lead up to a recession, institutions would be making very big provisions (as loss expectations increased) with resultant huge losses which risked sending signals to the market that a bank was in trouble. Conversely, as the economy moved out of recession banks would be showing huge profits. The role of management judgement in the catch-up adjustments would also become more significant because changes in estimates would have an immediate impact on the bottom line (rather than being spread, as with the initial expectations).
- This view of the extent to which the expected loss approach would be more pro-cyclical than the incurred loss approach was not consistent with simulations conducted by an EAP member using available data over the past 20 years which had shown the expected loss model to be less pro-cyclical than the incurred loss model.
- From a user perspective, with the expected loss model things did not start off in such a bad place because some losses were being provided for at the outset. Also, in relation to 'saying it as it is', recessions did occur and bank business was cyclical and users did not want banks to be covering things up but to see that banks had sufficient reserves to weather the next downturn.
- The expected loss approach might be like taking the punchbowl away from the party before it got out of hand (which regulators might welcome) and which could therefore be a double plus for G20.
- It might be interesting to model the circumstances in which the expected loss approach would be more pro-cyclical or less pro-cyclical. While this could be a useful debate it was tied to the issue of whose role it was to address pro-cyclicality. It was, arguably, not part of the standard-setter's role.
- Complexity was generally acknowledged to be a problem. Credit losses tended not to be distributed normally across the cycle, and some banks were questioning the practicability of the methodology of probability-weighted outcomes, which was not how credit risk in banks was managed. The implication was that data would be available about how different economic factors affected credit losses and the models for this, if they existed, would be very complicated and challenging to audit. The EBF preference was for 'best estimate' which was close to what banks used currently.
- There were doubts in some people's minds about how useful economic data was for predicting outcomes.

- There could be practical difficulties under the proposed model trying to spread expected losses over a 30 year loan period and it could lead to spurious accounting. However, this problem might not be as great as would at first appear because the requirement of the model was to spread over the expected life rather than the contractual life of the loan.

Alternative models

- The EBF model

The key principles in the EBF model were described as:

- Retention of amortised cost, as in IAS 39
- Retention of the incurred loss model, because it was thought to provide useful information, but with simplifications and improved consistency of application
- Use of expected losses as a way of building up provisions earlier, with the provisions being used as expected losses crystallised and became incurred losses (by charging expected losses across the life of the loans and moving the expected loss provision to the incurred loss provision as losses were incurred) and continuing to build up provision for expected losses at each review (possibly by adjusting historic data for events that had not happened and for events not in the historic data that were expected to happen and possibly by using some Basel II inputs, adjusted as appropriate for the differences in objectives)
- There was an important caveat that while incurred losses should be taken from the expected loss provision, if this provision ran out it could not 'go negative' - the excess of incurred loss would have to be charged to the profit and loss account - and there was an effective ceiling of never building up more provision than the expected lifetime loss on the portfolio.

The key differences in the EBF model (compared with the IASB model) were considered to be:

- not using the EIR mechanism for building up expected loss provisions and building up expected loss provisions one year at a time
- not having different accounting for initial spreading and subsequent catch-up changes in expectations - catch up changes would be allocated across the life of the portfolio
- while it would build provisions up earlier, as with the IASB model, incurred loss information would be retained and displayed in the financial statements along with other financial information (not just in disclosures)
- not imposing a closed portfolio approach.

Further points made during discussion included:

- Under the EBF model, in the same way that an incurred loss was a crystallisation of an expected loss, a reduction (or improvement) in an incurred loss would go back the other way. If the incurred losses had reached

the position where they were being charged to the profit and loss account the reduction would go back to the profit and loss account.

- The model would operate on a portfolio basis, so there could be issues around how the portfolio was defined. Different ways of defining the portfolio could give rise to different answers so a standard using the EBF model would need a definition of a portfolio and a mechanism for applying it consistently. It was suggested that a portfolio should be a matter of fact because, in general, a portfolio was managed and, although there were differences in the way portfolios were managed (because businesses were different), comparability should still be possible by including in the disclosures a description of how the business was managed. The standard could set out some broad principles that might include reference to tests of what information went to credit risk management personnel.
- The IASB model would not depend on how the portfolio was defined. Precisely the same answer would result whether done on a single asset, a small portfolio, a larger portfolio or on the whole entity.
- Clarification in relation to the EBF model was sought on the circumstances where incurred losses arose ahead of time and all the expected loss provision had been transferred into the incurred loss provision because it would appear that the G20 expectation in relation to earlier recognition of further expected losses would then not be satisfied. The explanation was that the model set the incurred loss provision on the balance sheet as the absolute floor. While the model recognised losses earlier, incurred losses were just a crystallisation of expected losses. If the expected loss provision went down to zero there would then be a double charge to the profit and loss account. The provisions would never be less than under the present model and any losses in excess of the provisions would be charged straight to the profit and loss account. Expectations going forward would be continually revised but as they related to future events they would be charged to future periods.
- The EBF model would reduce bank profitability in the good times, as they started to build up provisions earlier, but it would not ensure that banks had bigger provisions than currently in the bad times.

- The Basel model

The Basel model was said to be a work in progress in which the aim had been to stay close to the philosophy underlying the ED. The key differences were:

- Imposing onto the calculation of the EIR the average loss rate for each loan or set of loans rather than trying to pin down the cash flows on each loan on a period by period basis.
- Some were arguing that, rather than calculating the loss using just the part of the economic cycle matching the behavioural maturity of each loan (which was probably largely uncontroversial) the whole of economic cycle would be used (which would in many cases go beyond the horizon of the loan and

could give rise to questions about whether that could be reconciled with proper accounting).

- Addressing concern about the pro-cyclical effects of catch-up adjustments by allowing them to be spread forward in certain circumstances (yet to be defined) through adjustments to the EIR.
- Overlaying the approach with a 'sufficiency of provisions' test requiring provisions to be at least the incurred loss or possibly incurred loss plus additional losses expected in the immediate future, both of which gave rise to definitional challenges and in the latter case looked like adding in a bit of prudence.

In discussion, the following further points were made:

- One of the ways of dealing with concern around the balance sheet provision under the EBF model going down to zero might be to set the floor at incurred loss plus something, as in the Basel 'sufficiency of provisions' test. However, if that was factored in the result might not look very different from the incurred loss model.
- The Basel Committee's proposals were not likely to be published for comment separately from their inclusion in the response to the IASB. This was another aspect of the problem that because all constituents were expected to respond to the IASB by 30 June they would not have the opportunity to consider as part of that response alternatives that other constituents may be working on. However, the expectation would be that if the IASB significantly modified its proposals there would need to be further due process around the revised proposals.
- The Basel Committee's deliberations were solely as part of the input to the IASB process and there was no question of the Basel Committee attempting to set accounting standards itself.
- The IASB model would require separate lines in the financial statements for provisions (including expected losses), for unexpected losses and for interest. It would not be prescriptive as to whether these lines should appear together but there was a good argument for them to appear in consecutive lines.
- Many EBF members had doubts about the informational value of some of the numbers in these lines and about the degree of granularity of disclosures that would be needed to make sense of the numbers for initial expectations and subsequent changes.

- The FASB model

The FASB model was described as being similar to current requirements in assessing credit impairments based on past and current factors impacting the collectability of the financial asset while using NPV techniques to determine credit impairment.

Other points made included:

- Presentations on the FASB model had been made to the IASB and to the EAP but it was not clear at this stage either what the final decisions were likely to be or when they would be published. It was likely to be similar to the present FASB model with trigger events removed and earlier provisions.
- One of the consequences of the expected approach would be that use of NPV techniques would produce day 1 (or rather day 2) losses. However, if the loan was put into a portfolio using the loss rate approach then there would not be a day 1(2) loss and the result would be similar to an expected loss model.
- The model would operate in the context of all the loans being at fair value through the OCI. Therefore, it was an impairment model built on a different underlying classification model and so would be expected to be different from an impairment model under IFRS. This might result in a different split between OCI and profit and loss. If the same model was used it might be possible to produce the same profit figure but could have less informational value overall for users of the accounts.

Conclusions

In a short concluding session, the main points were noted as:

- There had been some useful clarifications of the IASB model.
- Expected loss was considered to be conceptually superior to incurred loss, with some qualifications about the possible need to show incurred loss on the face of the balance sheet as well because it provided useful information.
- There had been a reasonable level of consensus around the merits and demerits of expected loss.
- There had also been a consensus that the model in the ED would be more complex and more subjective, with a number of implementation changes.
- The greatest reservations (addressed in the EBF and Basel models) were in relation to the treatment of catch-up adjustments, which the IASB had justified on the grounds that they should be treated like any other losses.
- The Basel model was looking for more prudence.
- The EBF model had some characteristics that might help to address unit of account problems.
- There were no right answers, given that subjectivity was inherent in any system dealing with expectations, so the disclosure package (and a system for keeping it under constant review) was likely to be critical.

The ASB Chairman noted, in conclusion, that this was a very difficult subject and appealed to constituents to be as positive as they could in their responses to the IASB, emphasising what was good in the proposals and with clear explanations of their reasons where they did differ from the IASB view.