

Impairment: Expected Loss over the Life of the Portfolio**Basic features of an alternative model to IASB expected cash flow model**

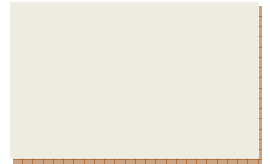
The European Banking Federation (EBF) is evaluating the IASB's Exposure Draft ("ED") "*Financial Instruments: Amortised Cost and Impairment*". The Federation believes that the ED is an important step in the right direction as the industry conceptually supports the development of an impairment model that is based on "expected loss", rather than the current "incurred loss" model in IAS 39. However, the EBF believes that the "expected cash flow" model in the ED has a number of significant and important drawbacks, including:

- Conceptual issues: for example, as proposed in the ED, the initial expected cash flow estimate is recognised over the life of the related assets, whereas the present value of (positive and negative) changes in the expected cash flow estimate must be recognised immediately. This results in significant additional subjectivity, volatility and procyclicality.
- Practical issues, as the proposals in the ED are extremely complex, making the proposals difficult to be:
 - understood by users, e.g. due to the proposed combination of credit losses with interest margins;
 - implemented by preparers, e.g. due to the need to completely revise the methodology for effective interest rates and the need to define expected cash flows by time period whereas entities manage expected losses and
 - made reliable and relevant enough in practice given insufficient modelling capabilities.

For these reasons, the industry has been working to identify a number of sources of complexity as well as the conceptual issues. To address these shortcomings, the EBF has developed an alternative application of the concept of expected loss for impairment that it believes is conceptually superior, in line with the general objective of financial statements and consistent with the lending activity and credit risk management of financial institutions.

The model proposed by the industry is "*Expected Loss over the Life of the Portfolio*" ("**ELLP**") model and is built around the following key principles:

- 1) The new impairment model should not change the current definition of amortised cost or the EIR calculation
- 2) Expected losses in the context of the new impairment model should be determined on a portfolio level
- 3) The methodology is based on the "expected loss over the life of each portfolio"
- 4) Impairment allowances are built up to be used, and therefore they are not just buffers.
- 5) Impaired loans are treated as in the current IAS 39.
- 6) Impairment allowances must be properly considered in the capital framework



1) The new impairment model should not change the current definition of amortised cost or the EIR calculation

Banks manage interest rate risk and credit risk on a different basis. For this reason these risks should not be co-mingled in the calculation of the EIR. This would not only be complex to implement, but also difficult to understand by the users of financial information.

The EBF proposal is to keep the current definition of the effective interest method under IAS 39 and exclude the expected loss from the EIR calculation. It is proposed to present the expected loss in a separate line in the income statement which would allow users of financial statements to distinguish the interest from the credit component. The EBF believes that the current effective interest method under IAS 39 is well understood by users. A change to this model raises operational risks and increases the complexity of implementation, while reducing the transparency of financial information.

2) Expected losses in the context of the new impairment model should be determined on a portfolio level

An impairment methodology based on estimated expected losses is only meaningful if it is applied on a portfolio basis. Therefore, an expected loss impairment model should be built around the following features:

- Expected losses are determined at a portfolio level. The definition of portfolios for determining expected losses under IFRS should be aligned with the credit risk management practices of the reporting entity. Therefore, the definition of portfolios for the purpose of determining expected loss should consider at what level credit risk is managed and how the entity's business model is organised. Such an approach is consistent with IFRS 7 ("disclosure through the eyes of management") and IFRS 9 (classification partly based on the business model).
- Inherent in this approach is that the size and nature of portfolios may vary within and between different entities. One entity may manage on the basis of a limited number of portfolios where another entity may manage on the basis of many small portfolios. Furthermore, consumer retail business is commonly managed on the basis of large homogeneous portfolios whilst certain large/unique wholesale exposures may be managed on an individual basis. It is important that the portfolio definition for expected loss reflects these different levels of (credit risk) management.
- Financial institutions manage their business and credit risk on an "open portfolio" basis. This means that portfolios may be open to new loans¹ with similar credit risk characteristics as existing loans, i.e. portfolios are dynamic in the sense that existing loans mature and new loans may be added. An open portfolio approach must be allowed as the basis for the determination of expected loss in an IFRS impairment model to align internal risk management practices with the proposed impairment model. It would not be appropriate for an IFRS impairment model to require closed portfolios (i.e. portfolios only containing assets of a specific 'inception date' and/or 'maturity date' that subsequently "run-off" over time), because this would result in a very large number of "run-off" portfolios and, in most cases, a disconnection with internal credit risk management.

¹ In this paper we always refer to "loans", but the model is intended to be applied to all assets that are classified at amortized cost under the future IFRS 9.

- Estimating expected losses is based on statistical parameters (including for example “probability of default” and “loss given default”) that are calibrated by means of various models (e.g. rating methods in accordance with Basel II). A variety of risk models may be used within a reporting entity as long as the selection of risk models is consistent with the objective of providing the best estimate of the expected loss over the life of each portfolio. In this regard, banks with highly sophisticated risk modelling approaches will often apply different models within each portfolio under IFRS.

3) The methodology is based on the “expected loss over the life of each portfolio”

Defining Expected Losses

ELLP is a unique parameter that aggregates the future expected losses of each specified portfolio. The expected losses would reflect the characteristics of the financial assets which exist in the portfolio at the reporting date and the expected lives of the financial assets in the portfolio at that date.

To estimate expected losses and provide discipline to the process, historical loss experience should provide the basis for estimating expected losses. Historical loss experience should be adjusted to reflect the effects of conditions that did not affect the period on which the historical loss experience is based and to remove the effects of conditions in the historical period that do not exist at the reporting date.

Entities that have no entity-specific credit loss experience or insufficient experience may use peer group experience for comparable portfolios.

Measurement and reporting of ELLP

For the purposes of this methodology, the life of the portfolio is defined as the average maturity of the loans in the portfolio weighted by the outstanding balance.

The expected loss for each portfolio should be reviewed and recalculated periodically, at each reporting period.

The ELLP should be spread in the Income Statement over the average life of the portfolio (linearly or any better allocation).

Adjustments to expectations

Changes in expectations about the ELLP must also be spread over the remaining life of the portfolio, consistently with the treatment of original estimate. There is no conceptual difference between the calculation of initial or subsequent loss expectation, both being the entity’s best estimate of incurred loss. Changes in ELLP may result from changes in current or expected credit risk conditions and changes in the composition of the loan portfolios since the last reporting period end. Therefore any adjustments to the initial estimation of the ELLP should be accounted prospectively. In addition, taking into account that the calculation of the ELLP requires a high degree of judgement, the EBF considers that applying a different treatment for subsequent changes could lead to Income Statement manipulation by entities through different reporting periods.

4) Impairment allowances are built up to be used, and therefore they are not just buffers

The principle is that incurred losses (i.e. loan losses recognised on defaulted loans) are booked against the existing impairment allowances (“allowance account”). It is consistent with the principle of this approach that impairment allowances are built up to cover future expected losses. Under this approach, impairment allowances are not prudential ‘buffers’ or reserves.

This is done by using the following criteria:

- Incurred losses are booked against existing impairment allowances
- To the extent that impairment allowances are not sufficient to absorb losses, incurred losses are booked directly to the income statement. It is not possible to have a negative expected loss impairment allowance account.
- Any subsequent increases or decreases in incurred losses are booked against the expected loss impairment allowance account accordingly.
- As a result, the overall impairment allowance (for incurred losses and expected loss together) is:
 - as a minimum at least equal to or higher than the incurred loss impairment allowances under the current IAS 39 model (as all incurred losses are provided for and the portfolio expected loss cannot be negative)
 - never greater than the total expected loss in the portfolio (in case the level of total expected loss is reached, the building up of expected loss would cease) plus the incurred loss impairment allowances under the current IAS 39 model.

Under the proposed model, loans on which incurred losses are identified (herein described as ‘non-performing’ loans) are separated from the performing loans. Consequently no further expected loss is calculated and the expected loss previously created will be allocated to the non-performing loan. For non-performing loans an incurred loss impairment allowance will be calculated and adjusted against the expected loss impairment allowance account. This reflects the fact that non-performing loans are the crystallization of the expected loss.

Although the default of a loan can be analogised to the crystallization of the expected loss from a statistical point of view, expectations about losses for the remaining portfolio do not change (entities do not reduce the default probability of the remaining instruments). As a consequence, after the removal of an instrument from its previous portfolio, the remaining contracts of the portfolio will continue to build up an impairment allowance based on the ELLP over the residual life of the portfolio.

5) Impaired loans are treated as in the current IAS 39.

Instruments on which incurred losses have been identified should be measured as in the current IAS 39 with an exception related to the time value of non-performing assets which should not be recorded in the income statement but, in line with the accounting treatment as follows, directly against the existing impairment allowance (increasing the allowance account). The reason for this is that when a loss has been incurred on a loan and the entity

considers it as non-performing the only meaningful information is the amount of that incurred loss.

Therefore the Federation proposes to keep the actual definition of impairment and the methodology to calculate the incurred loss impairment allowance for those non-performing loans.

If a non-performing loan returns to performing status, the loan and its corresponding impairment allowance should be incorporated into the performing portfolio. Conversely, if the impairment allowances on the non-performing loan need to be increased, additional impairment allowances should be taken from the outstanding portfolio expected loss impairment allowance. This is necessary to ensure that the model is applied consistently.

6) Impairment allowances must be properly considered in the capital framework

Globally, many interested parties are addressing the problem of procyclicality. Close coordination between regulators and standard setters is very important to ensure that the combined effects of proposed changes do not impose excessive capital requirements on banks. Certain prudential aspects, for example the implementation of worst-case stress scenarios, should be considered outside the accounting framework, by banking regulators within an appropriate regulatory framework.

For these reasons, the following issues must be considered in any definitive solution to address procyclicality:

- Coordination between accounting standard setters (IASB) and regulators is essential. The coordination among regulators and Standard Setters is also desirable to simplify implementation of the impairment model as risk parameters from regulatory requirements can, where appropriate, be used as inputs to the provision model.
- Duplication of requirements must be avoided, as could result in overlapping provisions and capital buffers.

7) Comparisons to IASB Model

In summary, the alternative proposal is consistent with the objective of the IASB's Exposure Draft as it is based on expected losses. However, it has some key differences to the IASB proposal which the EBF believes makes it easier to apply, easier to understand by users of financial statements and consistent with the methods financial entities use manage their credit risk. The main differences to the IASB proposal are the following:

- The IASB proposes to include impairment in the definition and calculation of amortised cost and Effective Interest Rate. In the alternative proposal, the definition of amortised cost remains as in current IAS 39 and impairment is an independent estimate separate from the EIR calculation.
- The approach included in the ED implies a loan-by-loan or closed portfolio basis for measuring impairment. The alternative proposal follows the business model of each entity as the primary driver. The approach allows application on a loan-by-loan, closed portfolios or open portfolios, depending on how the business and risks are effectively managed.

- The proposed IASB’s expected cash flow approach requires an entity to reassess the expected cash flows each period and to recognise the effects of any changes in credit loss expectations immediately in the Income Statement. In the alternative proposal, subsequent changes in expectations would be spread over the life of the portfolio, consistently with the treatment of initial expectations, subject to the condition that total impairment allowances (for incurred losses and expected losses together) are always at least equal to or higher than the incurred loss impairment allowances under the current IAS 39 model.

8) *Summary*

The EBF believes that the ELLP model set out in this paper is easier for users of financial information to understand and for preparers to implement at a reasonable cost. The proposed model captures the economic reality of the lending activities of financial institutions and is in line with the philosophy of the six point plan of the BIS to achieve a sound “expected loss provisioning approach” established in their paper “Guiding Principles for Replacement of IAS 39”:

- 1) address the deficiencies of the incurred loss approach without introducing an expansion of fair value accounting;
- 2) promote adequate and more forward looking provisioning through early identification and recognition of credit losses in a consistent and robust manner;
- 3) address concerns about procyclicality under the current incurred loss provisioning model;
- 4) incorporate a broader range of credit information, both quantitative and qualitative;
- 5) draw from banks' risk management and capital adequacy systems; and
- 6) be transparent and subject to appropriate internal and external validation by auditors, supervisors and other constituents.

Additionally, the important issues of disclosure and transition have not been addressed in this paper. We believe that these are key issues for the implementation of the model and must be addressed once the primary principles of the model are agreed.

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