

**Summarised key points from Roundtable discussions on
IASB ED/2013/3 *Financial Instruments: Expected Credit Losses***

21 May 2013 (Melbourne) and 24 May 2013 (Sydney)

Overall impacts of the ED model

Generally, participants are concerned that the 12-month expected loss stage lacks any principle for recognising and measuring losses.

Participants, including banks, generally cannot comprehend recognising day one expected credit losses on financial assets that are already fair valued. Day two losses makes more sense as that indicates the bank had written a bad loan.

One bank noted that generally if its customers' investment ratings are downgraded, banks will re-rate or re-negotiate the existing loans with the customer. If the bank thinks the loans are no longer 'good', the banks will assess whether it wants to continue the relationship with the customer. This applies to loans that are managed individually (e.g. corporate loans), and loans managed in a portfolio (e.g. mortgage loans) and that are in a watchlist.

One participant noted that it will be more so challenging for smaller financial institutions to implement the proposals as these banks currently do not have the level of risk grading systems that the larger banks employ.

The model in the ED will involve collecting and enabling the use of more information to track (the credit quality information of) loans from origination/purchase date to the 12-month bucket to the lifetime bucket and potentially back into the 12-month bucket (where loans deteriorate and subsequently improve).

Currently banks track loans from one internal incremental grading to another and banks generally have many gradings – the model introduces an unwelcome 'cliff' effect.

A change in the remaining term of a loan would change the probability of default (PD) so current systems will need to change to continuously monitor and track such changes.

Credit quality classifications tend to be driven by loan-to-value of collateral ratios.

The model in the ED is 'pro-cyclical' and could tend to exaggerate the impact of deteriorating and improving credit conditions.

Participants commented that they might be more prudent in managing the triggers on the way into the lifetime bucket compared to back the other way. The ED is not clear whether a similar 'significant improvement' in credit quality would be required.

The impact of the ED would vary from bank to bank, but for some it would depend on:

- (i) how much is in the 12-month bucket versus lifetime bucket – today some would probably provide more (than the ED model) on the types of loans that would be in the 12-month bucket, but less (than the ED model) for loans that would be in the lifetime bucket. One bank noted that its current systems are the least robust among other banks. Two banks noted that their current system requirements for investment grade loans require more than 12 months expected loss.

- (ii) current composition of retail versus commercial loans. Banks look at loss emergence period for retail loans (>12 months). Banks manage commercial loans individually so there's more scrutiny over the expected losses.

One bank noted that in this economic cycle, because of the way in which IBNR has been applied, the loss allowance would not increase significantly if they transition to the IASB proposed model. In fact, the loss allowance might decrease because of the requirement to look at expecting losses possible only in respect of the next 12 months.

Banks already 'double-count' impairments under existing requirements as a result of managing loans on an open portfolio basis – so they are less concerned about the double-count issue as expressed in the alternative view of the ED and are not expecting a material change on that front.

Practical issues

The ED is written for impairment assessment on an instrument by instrument basis. The ED is not clear whether impairment assessments should be performed by customer, for example, one customer has two loans (each originated at different periods) and the second loan qualifies for the lifetime expected credit losses bucket but not the first loan. Would the first loan go into the lifetime bucket as well? One bank noted that it currently performs several credit checks on existing customers: (i) typically every six months as customers seek new funding or renegotiate current loan; and (ii) quarterly or annual assessment of valuation on collateral

Banks would need to create 'triggers' for loans without maturities, such as credit card debt.

The unwinding of discount rate would be challenging for variable-rate loans. Banks would need to make simplifying assumptions.

Guidance

Banks are not seeking too much guidance because they don't want to be too constrained in their methodologies.

The proposed reference to 'investment grade' to assess the level of significant credit deterioration (for the recognition of lifetime loss allowance) is not helpful because:

- (i) that information is not available about many customers
- (ii) banks have own gradings that they use to track loans
- (iii) banks could still do business with non-investment grade customers, but lend less and/or have more collateral.

Banks can rebut the 30-day past-due rule with data where relevant. One bank noted that loans that are 30 days past due will typically come good in 90 days.

Delinquency is a key factor for banks' loan loss provisioning.

There was no concern on the application of the IASB proposed model to modified debt instruments, loan commitments and financial guarantee contracts.

Other

The model in ED seems at odds with financial assets measured at fair value through other comprehensive income (FVOCI) and how those assets are currently managed. As mentioned earlier, banks generally cannot comprehend recognising day one expected credit losses on financial assets that are already fair valued and have very high credit quality (which are mostly assets measured at FVOCI) – some banks currently do not have systems to monitor these assets. Insurers face the same issue. One insurer commented that a study was done on corporate and government bonds that are held for regulatory and/or liquidity management purposes, and those assets are of very high credit quality. The study found that the chance of a default on these assets is <1%. It would be impractical for entities to recognise losses on such assets. Participants expressed preference for a practical expedient like the FASB's for FVOCI assets.

Lenders mortgage insurance – would be treated in the same way as collateral. However, one bank noted that LMI is done mainly with an internal insurer, and only the externally re-insured elements would be able to be treated as collateral.

For purchased portfolios, one bank noted it would pay the face value less expected losses (which is assessed against the collateral and potential recovery of incurred losses).

Expected lead time depends on whether the ED as is proceeds to standard (in which case, at least two years lead time required). If tracking of credit quality is not required banks expect < two years lead time.

One bank particularly noted that the IASB proposed model would be costly to implement because of the systems required to track the losses between 12 months and lifetime. Insurers, which currently use fair value through profit or loss for their loan assets would also need to introduce new systems to identify the expected losses on loan assets that would be classified as FVOCI under the classification and measurement proposals.