EFRAG

European Financial Reporting Advisory Group

FEE

Impairment of Financial Assets
The Expected Loss Model

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Impairment of Financial Assets: The Expected Loss Model

SUMMARY INTRODUCTION

1   In response to the recent financial crisis, aspects of financial reporting have come under the spotlight and calls for change have been raised. The financial reporting of losses on financial assets held at amortised cost is one such principal area and the International Accounting Standards Board ('IASB') has reacted by proposing a new impairment model. Given the complexity involved in accounting for the impairment of financial assets, both FEE and EFRAG felt that both European constituents and also other interested parties may benefit from having an additional, educational resource to assist them in understanding and analysing the new impairment proposals.

2   This joint FEE-EFRAG paper firstly provides detail on the context of the recent IASB proposals and then goes on to give a general description of the expected loss model (including two worked computations). This high-level analysis is followed by a discussion about what information is generated by the model, including a description of how the results would be presented and disclosed in the financial statements and associated notes. Finally the Paper compares the expected loss model with other kinds of impairment models. Appendix A to the paper sets out a list of terms and definitions used in this Paper in order to ensure "common language" in the forthcoming impairment debates. The aim of the paper is to provide general characteristics of the expected loss model, highlight the potential complexities and challenges and stress the key differences from other models rather than provide the assessment of its suitability, which would be provided in the comment letters to IASB by both FEE and EFRAG next year.

DETAILED PAPER

Purpose

3   On 5 November 2009 the IASB issued its exposure draft: *Financial Instruments: Amortised Cost and Impairment* (the Exposure Draft) with comments invited until 30 June 2010. The proposals in the Exposure Draft will replace the amortised cost measurement requirements (including impairment) for financial instruments in IAS 39 *Financial Instruments: Recognition and Measurement* ('IAS 39'). The IASB plans to develop a final standard from the proposals in the Exposure Draft before the end of 2010 as a 2nd phase of the full replacement of IAS 39 by IFRS 9.

4   The Exposure Draft proposes to provide a more principles-based approach to establishing measurement requirements for amortised cost than the one currently required by IAS 39. It has been drafted in such a way that emphasises these principles along with application guidance without including implementation guidance or illustrative examples.

5   To complement the issuance of the Exposure Draft FEE and EFRAG have drafted a joint paper explaining one key aspect of the Exposure Draft, the expected loss model for impairment of financial assets.

6   The primary purpose of the joint paper is to assist stakeholders in developing responses to the IASB on the Exposure Draft by providing additional information about the impairment model it proposes and by explaining and exploring its pros and cons. It has been drafted with a broad range of stakeholders in mind, including those from non-financial services backgrounds. In this regard, the paper is designed to be accessible and easy to understand.

7   The paper has been drafted with an educational purpose in mind. This paper is not designed to influence stakeholders' views on the impairment model proposed in the Exposure Draft and as a result does not conclude on a preference for a particular impairment model by either FEE or EFRAG.

Context

8   During the current financial crisis, criticisms were raised against the current IFRS impairment model for financial assets (the "incurred loss model"). The issue with the incurred loss model is that impairment losses (and resulting write-downs in the reported value of financial assets) can only be recognised when there is evidence that they exist ("have been incurred"). Reporting entities are not allowed currently to consider the effects of expected losses. There is a view that earlier recognition of loan losses could have potentially reduced the cyclical moves in the recent crisis[1].

9   Responding to the request of the G20[2] leaders to strengthen accounting recognition of loan-loss provisions by incorporating a broader range of credit information, the IASB has reviewed the incurred loss model and examined the expected loss model as a potential alternative. As a result of its deliberations so far, the IASB issued the Exposure Draft.

10   In addition, there has been support from some stakeholders for an impairment model that is counter-cyclical, in particular for a model which includes through-the-cycle reserves or provisions, for example the dynamic provisioning model currently required by the Bank of Spain (its central bank). There has also been some support for the creation of a general reserve which would create a regulatory buffer against unexpected impairment losses in prudential reporting, but not in the general purpose financial statements.[3]

11   The expected loss model is more subjective in nature compared to the incurred loss model, since it relies significantly on the cash flow estimates prepared by the reporting entity which are inherently subjective. Therefore some safeguards need to be built into the process such as disclosures of methods applied and periodical back testing and immediate reflection of the results of the back testing in the models applied for the future.

12   The expected loss model will involve significant operational challenges in Europe, notably it is onerous in data collection since data needs to be collected for the whole portfolio of financial assets measured at amortised cost held by a reporting

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[1] *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System,* 2 April 2009, section IV

[2] G20 Declaration on Strengthening the Financial System - London , 2 April 2009

[3] FEE Policy Statement on Dynamic Provisioning for Financial Instruments, March 2009

entity. That means that data is not only required for impaired financial assets but it also requires having historical loss data for all financial assets held at amortised cost. Financial institutions do not always have historical loss data for financial assets—particularly for some types of financial asset or some types of markets, the historical loss data do not reflect the losses to maturity or the historical data are not relevant due to significant changes in circumstances. Many non-financial institutions are unlikely to currently have sufficient data to calculate expected losses on their portfolios of receivables either.

Purpose and scope of an Impairment Model

13   The general purpose of an impairment test is to ensure that an asset is not carried for financial reporting purposes at an amount that exceeds its recoverable amount.[4] To do so would overstate a reporting entity's financial position and performance.

14   Currently, IFRS requires that all financial assets, except those that are measured at fair value through profit or loss, are assessed for impairment. As reporting entities adopt the IASB's recent standard on financial instruments[5], only financial assets measured at amortised cost (broadly cost adjusted for repayments of principal, interest accruals and prior impairment reductions), will be the subject to a single model of 'impairment' for financial reporting purposes.

15   Therefore the models of impairment considered by this paper are in relation to financial assets that will be reported at amortised cost and will primarily include loans, but will also be applicable to other types of financial assets such as debt securities and trade receivables.

16   It is important to note that proposals regarding impairment of financial assets will impact all entities that hold such assets measured at amortised cost, including commercial and industrial companies that hold trade receivables or invest in financial assets to manage their liquidity, or insurance companies that invest in financial assets as a placement to cover their insurance liabilities.

Summary of the proposals in the Exposure Draft

17   In June 2009 prior to issuing the Exposure Draft the IASB issued a Request for Information: *('Expected Loss Model') Impairment of Financial Assets: Expected Cash Flow Approach,* which invited comments by 1 September 2009. The purpose of the Request for Information was for the IASB to obtain information on the feasibility and operational aspects of the expected cash flow approach. Responses received highlighted the fact that implementing an expected cash flow approach (i.e. an expected loss model) would be operationally challenging, particularly in deriving estimates of future cash flows over the life of the instrument.

18   Despite the operational challenges associated with an expected loss model for impairment, the IASB decided to proceed with exposing the model for comment. An Expert Advisory Panel will also be created in parallel with the Exposure Draft, in order to provide further advice to the IASB on practical and operational issues.

19   In terms of the proposals in the Exposure Draft, the impairment model for financial assets is drafted as an integral component of the way amortised cost is calculated.

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[4] Refer to IAS 36 *Impairment of Assets*, paragraph 1

[5] IFRS 9 *Financial Instruments*

The Exposure Draft provides that amortised cost shall be calculated using the effective interest method i.e. amortised cost represents the present value of:

(a)   the expected cash flows over the remaining life of the financial instrument; and

(b)   the effective interest rate as the discount rate.

20   For this purpose, the Exposure Draft requires that an entity shall estimate the expected cash flows considering:

(a)   All contractual terms of the financial instrument (e.g. prepayment, call and similar options);

(b)   Fees and points paid or received between parties to the contract that are an integral part of the effective interest rate (see IAS 18 *Revenue*) to the extent they are not included in the initial measurement of the financial instrument; and

(c)   For financial assets, credit losses over the entire life of the asset.[6]

21   Estimates of the amounts and timing of cash flows are probability weighted.

22   Hence by defining amortised cost as an amount that includes an estimate of expected credit losses, the Exposure Draft adopts an expected loss model for impairment of financial assets.

23   For more information on the IASB's Impairment Project readers can go to Impairment of Financial Assets' project page on the IASB's website.[7]

General Description of the Expected Loss Model for Impairment of Financial Assets

Conceptual

24   The term "expected loss model" has been used to describe various models, including an expected cash flow approach. For the purposes of this paper, a more descriptive term for the expected loss model could be an 'Expected Cash-Flow Loss Provisioning Model'. When describing the expected loss model, as proposed in the Exposure Draft and as detailed in paragraph 31 below, we refer to a model that recognises expected losses, and changes in expected losses, on existing financial asset portfolios. In paragraphs 108-114 below we contrast this with dynamic provisioning models which provide a more stable pattern of losses over a longer period, without regard to the maturity of existing portfolios or changes in expectations of losses on those portfolios over time.

25   The incurred loss model and the expected loss model report credit losses from different perspectives. The incurred loss model is based on the perspective of allocating a credit loss to the period when that loss is incurred. The expected loss

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[6] The Exposure Draft : Paragraph B3

[7] See the following link:
http://www.iasb.org/Current+Projects/IASB+Projects/Financial+Instruments+Impairment+of+Financial+Assetseplac ement+of+IAS+39+Financial+Instruments+Recog/Financial+Instruments+Impairment+of+Financial+Assets.htm

model allocates the initially expected credit loss to the periods when revenue is recognised from the financial asset.

26 Under an expected loss model, revenue is reduced to reflect expected future credit losses at inception. Over the life of the financial asset the income is the same under both models. However, provided credit losses occur as expected the expected loss model will mean lower net income in the early periods and higher net income towards the end of the financial asset's life (after losses have been incurred) compared to the incurred loss model.

27 This compares with the incurred loss model, where revenue (e.g. the effective return) is recognised in full without considering expected credit losses, which are recognised separately as impairment charges only when they have actually been incurred. The incurred loss model is therefore characterised by higher revenues recognised in the period immediately after initial recognition, followed by lower net income if credit losses are incurred.

28 Put another way, an expected loss model is an approach where initially expected credit losses are reflected over the period of the loan (or other financial assets including recognised commitments existing at the reporting date) using the same basis as for interest income recognition i.e. credit losses like interest and repayments of principal are future cash flows which are considered when calculating amortised cost using the effective interest method.

29 Revenue is therefore more consistent with interest revenue recognition. Income and loss recognition is also consistent with the way in which financial assets are priced, excluding recognition of a risk margin to cover expected credit losses.

30 There is a risk when the concept is applied to short- and medium-term loans and receivables where the average duration of the life is significantly shorter than the economic cycle that provisions are set up for loans which have not yet been granted. The model should be based on estimates of losses on loans that are recognised and irrevocable loan commitments that have been entered into and should not provide for losses on future transactions and events.

Practical – Components

31 The key components of an expected loss model as proposed in the Exposure Draft are as follows:

(a) Net interest revenue is recognised on the basis of expected cash flows considering expected credit losses. That is, net interest revenue reflects the total net return expected at inception. It is noted that for presentation purposes, an entity would report gross interest revenue (before the impact of expected credit losses) and separately the portion of initial expected credit losses recognised in the period, the difference being net interest income;

(b) 'Impairment losses' are recognised from an adverse change in credit loss expectations. It is important to note that these reflect changes in expectations and do not necessarily represent an actual or incurred loss;

(c) Gains arising from an improved change in credit loss expectations are recognised; and

(d) Impairment losses and gains are recognised in a separate line item in profit or loss when expectations change. There is no impairment trigger (e.g. evidence

that losses have been incurred) so expected cash flows and expected losses are subject to periodical re-estimation.

Practical – Development of an expected loss model

32 In practice, the model inputs would require a prior development of the specific model tailored to the specific circumstances of each reporting entity. One approach would be to reflect the financial asset's specific (idiosyncratic) risk margins assumed by and priced in by the credit institutions on acquisition of a particular financial asset. Another approach would be to reflect the expected cash flow fall-outs at a homogeneous portfolio level, with or without instrument reclassifications among such portfolios. In the following sections we identify the typical model inputs needed for the development and maintenance of these models.

Practical – Model Inputs

33 The expected loss model should incorporate management's estimates based on past and expected future loss events on existing loans.

34 The Exposure Draft does not stipulate what an entity should consider when estimating the effect of credit losses on expected cash flows. It does however give high level guidance[8] that provides that an entity may use various sources of data, which may be internal or external. For example:

   (a)   Internal or external historical credit loss experience;

   (b)   Internal or external credit ratings;

   (c)   External reports and statistics; and

   (d)   Peer group experience for comparable financial assets (or groups of financial assets).

35 It is not clear in arriving at management's estimate of expected cash flows whether any particular source would have precedence over another. The reliability of data inputs may also need to be considered in this context.

36 Management's estimates are not the same as market estimates. Changes in credit spreads reflected in market prices, for example on corporate bonds, will not automatically be reflected in an expected cash flow estimate for that same bond. This means that management cannot solely rely on changes in market credit spreads in order to adjust their expectations about expected cash flows.

37 Management should also consider historic loss data and other information related to the financial asset, including the nature of the borrower, the product, the market, the economic outlook etc. However, market data, including implied credit spreads would be considered in management's estimates of future losses. That is, historical data such as credit loss experience should be adjusted on the basis of current observable data in order to reflect the effects of current conditions.

38 Also management's estimates will not necessarily be the same as a regulator's estimate of expected losses. In particular, management's estimate will need to cover the duration of a financial asset or portfolio of financial assets and take into consideration the idiosyncratic characteristics of the credit exposure and expected

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[8] See paragraphs B7-B10 of the Exposure Draft

economic conditions over that period. So where a regulator provides loss information, for example in Basel II's standard approach, management would need to use its own judgement to incorporate and justify use of a regulator's data in its own expected loss model, considering inter alia portfolio duration, historic loss data, current point in the economic cycle and exposure and portfolio specifics.

39   Finally an estimate of expected cash flows needs to take into account the concept of probability. The Exposure Draft requires that the estimates for cash flow inputs are expected values[9]. Hence, estimates of the amounts and _timing_ of cash flows are the probability-weighted possible outcomes. That is, a probability weighted approach that results in frequent changes in estimates based on both the timing and amount of expected cash flows. A probability-weighted approach is more consistent with the way a market value is calculated and therefore is consistent with how a financial instrument is priced on initial recognition.

40   It is also noted that expected losses based on probability-weighted possible outcomes only include an estimate of the maximum loss that can be suffered based on what is expected to be lost on average in a time specific horizon and based on historical exposures. The unexpected loss is the portion that exceeds the expected loss. The expected loss will be measured as the standard deviation from the average expected loss within a certain level of probability/confidence (e.g. 95 or 99% of outcomes). The calculation does not incorporate losses outside that level of probability (e.g. such as worst credit loss in over 30 years). Hence the unexpected losses would be covered by equity or prudential provisioning rather than the expected loss model for impairment.

41   Estimating expected losses on large individual financial assets based on a probability-weighted approach will be less accurate than estimating losses in large portfolios of homogeneous financial assets. The IASB has identified the difficulties associated with estimating cash flows for individual financial assets and has indicated that the Expert Advisory Panel will address the issue.[10]

42   Given that judgement will be involved in management making expected credit loss estimates, periodical back testing of actual results against forecasts will be important. Such periodical back-testing will test the impairment methodology used by management, with results being immediately applied to expected loss models going forward. However, this should not prevent incorporation of new facts, like economical cycle considerations, continuing to be in forecasts of expected losses.

43   Collection of historical data will be a challenge for many entities. For those entities that do not currently collect historic data, e.g. those that are not part of a regulated industry that requires credit expected loss reporting such as non-financial and insurance companies, the lack of historic data could present a big challenge in implementing an expected loss model. Also impacted are entities operating in emerging markets. Larger banks and other regulated financial institutions operating in mature markets may be able to utilise data already required by regulators, although it is unlikely to cover all historic data required by the expected loss model such as data on new financial products.

44   All entities might also have issues with extrapolation of data. For example it is understood that current regulatory requirements under Basel II only require one

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[9] Paragraph 8 of the Exposure Draft

[10] IASB Application Information – Candidates for Expert Advisory Panel Membership, October 2009, Appendix A

year expected loss data and the expected loss model would require development of that data to maturity.

Application

Individual Financial Assets

45   Generally a reporting entity, such as a bank or other financial institution will manage high volume of low-amount loans on a portfolio basis (for the reasons set out in the Portfolio section below). Where entities manage financial assets on portfolio basis, financial assets will generally be managed on an individual basis by exception, if their size or specific characteristics make individual management more suitable. Further, some types of entities generally do not manage their financial assets on a portfolio basis, e.g. trade receivables held by some non-financial institutions. In addition, as businesses develop, the way an entity manages its financial assets may change over time, moving from management on individual asset basis to a portfolio basis as the number of financial assets held by that entity increases.

46   Since the expected loss model incorporates credit losses expected at inception into a financial instrument's effective interest rate, the expected loss model can, in principle, be applied to individual loans in the same way as the effective interest rate approach currently required by IAS 39.

47   However it is problematic applying the expected loss model to individual loans, since it is difficult to arrive at an accurate estimate of expected cash flows as changes are less likely to be recognised until evidence of such change becomes apparent, unless the applied risk margin is simply deducted from the instruments contractual effective interest rate.

Portfolios

48   Portfolios of financial assets are an important element when applying both the incurred and expected loss models. Expected losses normally can be more accurately determined in the context of a clearly homogeneous portfolio than for individual financial assets. For example, as with the existing incurred loss model[11], expected losses may have increased, on a probability-weighted basis, in a portfolio of loans as economic conditions worsen, although the increased expected loss on any individual loan may not yet be apparent. The probability-weighted basis seems to be one of the key considerations in the development of a robust model and sufficiently homogeneous and granular portfolios seems to be a necessary prerequisite for such model.

49   For example, when a lender issues a loan to a borrower, it does so in the expectation that the borrower will perform and repay interest and principal in accordance with the terms of the loan. Its best estimate is likely to be that the borrower will not default. However, if a lender issues 100 similar loans to similar counterparties, it may have historical evidence to support the expectation that 3 out of the 100 loans will default. The lender is therefore able to estimate expected losses more accurately at the portfolio level (provided such portfolio is sufficiently homogenous and granular), than at the individual loan level where expected losses are less likely to be recognised until specific evidence of impairment becomes apparent or measurable.

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[11] IAS 39 *Financial Instruments: Recognition and Measurement* paragraphs 58-65

50 The Exposure Draft specifically provides that expected cash flows may be estimated on a portfolio or individual basis[12].

51 It is generally considered to be feasible and efficient to group high volume, low amount populations of financial assets into portfolios, provided portfolio homogenity is ensured.[13] Although there will be variance in approaches to creating portfolios, these should be based on the credit risk characteristics that are indicative of the debtor's ability to pay all amounts due according to the contractual terms e.g. quality (i.e. credit risk), and maturity date to ensure as homogenous population as possible. As a result, such portfolios are viewed and managed as a single financial asset with the added benefit of better quality of expected loss information due to its portfolio nature.

52 One of the benefits of an expected loss model relates to the treatment of individual financial assets that underperform or default but which form part of a portfolio of otherwise performing assets. Since the portfolio of financial assets is treated as a single financial asset, underperforming and defaulted individual assets would not need to be necessarily removed from the portfolio. The adverse changes in cash flow estimates attributable to the individual asset would however be reflected in the reporting entity's review of the portfolio's expected cash flow analysis and may indicate further expected losses. The Exposure Draft provides that an entity should use the basis (individual or portfolio) to estimate cash flows that provides the best estimate whilst ensuring no double counting of credit losses.[14]

53 If the individual financial asset impairments do not change the amount of losses expected for the portfolio as a whole, no additional impairment loss would be reported. If the individual financial asset's underperformance contributes to an adverse re-estimation of the cash flows for the portfolio as a whole, then an additional impairment loss would be recognised. A similar analysis would apply to favourable changes in cash flows at the individual and portfolio level.

54 It is noted that for internal reporting purposes a reporting entity (generally a bank or other financial institution) may want to remove the underperforming or defaulted financial asset from the original portfolio and treat it prospectively on an individual basis or within a portfolio of defaulted loans.

55 It is also worth noting that correlation is important since if losses on two loans are highly correlated, calculating the probability-weighted loss of each loan separately and adding those losses together would not achieve the same result as calculating the probability-weighted loss of a portfolio containing both loans. Correlation needs to be considered when estimating expected cash flows and that judgment will be required in determining the make-up of homogenous portfolios to which that correlation relates.

Periodical updates and back-testing

56 As with the incurred loss model, judgement is required in order to estimate the impairment losses applicable to a particular financial asset or group of financial assets held at amortised cost. Regular updates for changed circumstances and

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[12] Paragraphs B4-B6 of the Exposure Draft

[13] BNP Paribas - IASB Education Session Paper: Operational Challenges with the Expected Cash Flow Model, 15 June 2009

[14] Paragraph B5 of the Exposure Draft

back-testing of assumptions, inputs and methodologies is therefore key to ensuring the cash flow estimates produced are reliable and relevant.

57　Homogeneous portfolios are critical for periodically updating and back-testing assumptions. Again judgement is key in grouping loans and other relevant financial assets into portfolios based on similar characteristics, initial recognition and maturity, repayment terms, etc.

Variable rate financial assets

58　Variable rate financial assets present a practical difficulty in both the incurred and expected loss models. The complexity arises from fact that amortisation of fees, transaction costs and other premiums or discounts ('up-front costs') over the expected life of a financial asset are incorporated into an effective interest rate that is constantly updated to reflect market interest rate moves affecting only the "coupon" pay-outs.

59　The Exposure Draft proposes an approach to variable rate financial assets that is based on the effective interest rate reflecting how a contract sets the interest payments for the financial instrument (i.e. what part of the contractual interest rate, if any, is reset). The effective interest rate of a variable rate instrument is first determined on initial recognition and is based on the benchmark interest rate and an initial effective spread. Subsequently, periodic re-estimations of cash flows in relation to the benchmark interest component are reset however the initial effective spread remains constant.[15]

60　Therefore the result of the above approach is that when an entity re-estimates future cash flows as a result of a decrease or increase in credit loss expectations, it is required to adjust the carrying amount of the financial asset in order to ensure that the financial instrument unwinds to the remaining expected cash flows (i.e. a catch-up adjustment). It is the IASB's view that this adjustment to the carrying amount reflects the underlying economic phenomenon (i.e. it reflects interest rate indexed principal repayments) and is consistent with the notion of amortised cost (i.e. the effective interest rate continues to reflect conditions that existed on initial recognition). [16]

Revolving Financial Assets

61　There is some uncertainty about how an expected loss model is applied to portfolios containing financial assets that are replaced on a regularly occurring basis (for example portfolios of credit card receivables, over-drafts and certain trade receivables). Expected losses on these types of portfolios could relate to financial assets that may be considered as not yet on an entity's balance sheet, i.e. on uncommitted exposures, and the level of expected loss may appear as impacted by the nature of the customer relationship rather than by existing commitments at the balance sheet date, unless such uncommitted exposures are explicitly scoped out in an operational way. However, it may also be considered that business practices in terms of automatic renewal of these revolving financial assets reflect the effective duration of existing loans and receivables and thus the effective credit risk exposure duration of the entity.

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[15] Paragraph B12 of the Exposure Draft

[16] Paragraph BC41 of the Exposure Draft

Loan Commitments and Guarantees

62   The Exposure Draft does not address the issue of financial guarantees and irrevocable loan commitments that are expected to result in loans held at amortised cost although these may impact the expected future credit losses of a portfolio of related financial assets.

Trade Receivables

63   To the extent that trade receivables are usually short-term financial assets held at amortised cost, the impairment model will apply equally to these types of instruments as it would for loans.

64   Under an expected loss model, reporting entities, including non-financial institutions, would be required to include adjustments to the carrying amounts of those receivables as credit loss expectations change after inception. It also presumes that the initial carrying amount of receivables reflects the expected credit losses, whether estimated on an individual or portfolio basis. This initial recognition adjustment is consistent with the current IAS 39 requirement to recognise receivables initially at fair value however in practice no adjustment to the nominal amount of trade receivables is generally made.

65   We also note that some non-financial institutions do not manage their receivables on a portfolio basis and as a result, it may be difficult to accurately estimate future cash flows on an expected (probability-weighted) basis.

66   Given the reasons stated in the above paragraphs and the short-term nature of receivables, this will be a difficult implementation issue for non-financial services companies. In addition, IAS 39 does not require an effective interest calculation for trade debtors, so this will add an additional layer of complexity, unless the model is simplified to reflect these operational issues.

67   The proposals in the Exposure Draft recognise the difficulties associated with applying an expected loss model to trade receivables. It provides that entities may use practical expedients in calculating amortised cost if their overall effect is immaterial and is consistent with set-out principles. The use of a provision matrix for trade receivables is cited as an example of a practical expedient that may be used. In that example, a provision matrix might specify fixed provision rates depending on the number of days a receivable is past due (e.g. 3 per cent if less than 90 days, 20 per cent if 90-180 days etc). In addition, assuming that the trade receivables are without a stated interest rate and are so short-term that the effect of discounting is immaterial, the entity would not impute interest.[17]

Collateralised Financial Assets

68   An estimate of expected cash flows of a collateralised financial asset should reflect the cash flows that may result from foreclosure, less the costs of obtaining and selling the collateral, whether or not foreclosure is probable.

Improvements in Expectations

69   Where credit loss expectations improve, gains are automatically taken into account by adjusting the expected cash flows. The gain would be recognised as a lump-sum

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[17] Paragraphs B15-B16 of the Exposure Draft

increase to profits in the period where those expectations change mirroring the same way impairment losses are recognised.

Examples Comparing the Expected Loss Model and the Incurred Loss Model

70   The following example compares the financial statement impact of the incurred loss and the expected loss model[18].

Facts

71   The key assumptions include:

  (a)   A portfolio of 1,000 loans of CU 2,500 is initially recognised on 1/1/X1. Each loan matures in 10 years and carries an interest rate of 16%;

  (b)   Management estimates that no loans will default in years X1 or X2;

  (c)   From year X3 onwards, loans will default at an annual rate of about 9 per cent. If defaults occur as expected, the rate of return from the portfolio will be approximately 9.07 per cent;

  (d)   The number of loans are fixed ('closed book' / 'frozen book'), without any new lending or prepayments, or any collective impairment provisions;

  (e)   Note that additional complexities have been excluded. These include:

    (i)   Transaction costs, fees, and origination costs that must be included in the effective interest rate computation; and

    (ii)   Prepayments, partial payments and late payments.

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18 This is a simple example adapted from the example used by IASB staff at the IASB meeting in May
IASB Agenda Paper 5A *Amortised Cost – an expected cash flow approach,* May, 2009

Worked Example – Computation One

	Incurred loss						Expected loss			
	Interest income (Coupon) (a)	Loans, net of loan loss (b)	Loan loss expense (incurred) (c)	Interest less loan loss (a)-(c)	Return, net of loan loss		Loans, net of loan loss (d)	Expected loss adjustment (e)	Interest less loan loss (a)-(c)-(e)	Return, net of loan loss
01/01/X1		2,500,000					2,500,000			
31/12/X1	400,000	2,500,000	0	400,000	16.00%		2,326,689	173,311	226,689	9.07%
31/12/X2	400,000	2,500,000	0	400,000	16.00%		2,137,662	189,027	210,973	9.07%
31/12/X3	364,000	2,275,000	225,000	139,000	5.56%		1,967,496	– 54,834	193,834	9.07%
======	======	======	======	======	======		======	======	======	======
31/12/X9	208,000	1,300,000	127,500	80,500	5.64%		1,260,320	– 41,572	122,072	9.07%
31/12/Y0	189,600	0	115,000	74,600	5.74%		0	– 39,680	114,280	9.07%
				1,634,600					**1,634,600**	

72   Findings:

   (a)   The total net return of 1,634,600 (interest less loan loss) over the life of the instrument is the same under both models.

   (b)   The expected loss model matches the credit loss on the same basis as interest revenue recognised from the financial asset. Under an expected loss model revenue is set aside to cover expected future credit losses. The expected loss model has the effect of smoothing the reported income for cash flows that are not expected to accrue evenly over the life of the portfolio as impairment is recognised earlier.

   (c)   The incurred loss model is based on the perspective of matching a credit loss to the period in which that loss was incurred. This results in loan loss expenses being recognised later in the life of the instrument. Revenue (e.g. interest income) is recognised in full without considering expected credit losses until they have actually been incurred. The incurred loss model is therefore characterised by higher revenues due to the period immediately after initial recognition, followed by lower net income if credit losses are incurred.

Worked Example – Computation Two

73   Assume the same facts as for Computation One, but that on 31/12/X2, there is a loss event and management expects that an additional 100 loans will default in X3, and after X3 the default rate continues at 9%.

	Incurred loss						Expected loss			
	Interest income (Coupon) (a)	Loans, net of loan loss (b)	Loan loss expense (incurred) (c)	Interest less loan loss (a)-(c)	Return, net of loan loss		Loans, net of loan loss (d)	Expected loss adjustment (e)	Interest less loan loss (a)-(c)-(e)	Return, net of loan loss
01/01/X1		2,500,000					2,500,000			
31/12/X1	400,000	2,500,000	0	400,000	16.00%		2,326,689	173,311	226,689	9.07%
31/12/X2	400,000	2,500,000	250,000	150,000	6.00%		1,900,576	176,113	– 26,113	(1.12)%
31/12/X3	324,000	2,025,000	225,000	99,000	4.40%		1,748,900	– 73,335	172,335	9.07%
======	======	======	======	======	======		======	======	======	======
31/12/X9	184,800	1,155,000	112,500	72,300	5.70%		1,119,398	– 36,127	108,427	9.07%
31/12/Y0	168,400	0	102,500	65,900	5.71%		0	– 35,602	101,502	9.07%
				1,264,100					**1,264,100**	

74   Findings:

(a)   The additional defaults (change in expectations) alter the expected cash flows from the entire portfolio. An adjustment is necessary in X2 to increase the estimate of defaults and restate the net carrying amount of the loans to the new expected cash flows, discounted at the original 9.07 percent.

(b)   The expected cash flow approach reports a net loss as a result of the revised estimate in year X2, while the incurred loss approach still reports a net positive amount. That is a consequence of continuing to discount the revised cash flows at the originally computed 9.07 percent effective rate.

(c)   If the revised cash flows were discounted at the new inherent rate in the carrying amount and remaining cash flows (about 7.36 percent), the expected cash flow approach would not report a net negative amount in year X2.

(d)   While the expected loss model is generally more conservative, in X2 it results in similar volatility in the income statement due to the change in circumstances and so, in this example, is as volatile as the incurred loss model when expectations change. This might contrast with a dynamic or through-the-cycle model in which the additional loss in X2 would typically be offset by a release of provisions established in previous periods to cover such unforeseen events, regardless if caused by idiosyncratic or systemic reasons.

Model Communication (What does the Expected Loss model tell us?)

Does the Expected Loss Model Provide Useful Information

75   In terms of users of financial statements, the information provided by the expected loss model is generally seen to provide more relevant information since it treats credit loss (impairment) on a consistent basis as revenue recognition. In addition, the results of the model will more closely reflect current economic conditions at the reporting date i.e. it will reflect management expectations at that point in time.

76   In terms of financial institutions, the expected loss model is considered to be more in line with the economics of lending businesses (i.e. expected credit loss information taken into account when granting a loan are also considered for the purposes of impairment) and therefore more useful to users of a financial institution's financial statements. However, these point-in-time estimates shall take into account the entity's current best estimates of the development of the economic cycle throughout the lifetime of the assessed loan or throughout the duration of the relevant loan portfolio.

77   However, increased relevance needs to be considered in the context of operational complexity. In assessing whether to adopt the expected loss model for impairment, consideration of whether the operational costs of implementation by preparers is outweighed by the benefits to users would be necessary. Furthermore, the expected loss model results in an increase in the use of management judgement required to calculate the amortised cost of financial assets. Concerns have been raised that an increase in the reliance on management judgement to estimate future cash flow may reduce the reliability of amortised cost information in the financial statements and may make auditing of such information more difficult.

Gains and losses arise as forecast cash flows change (not market moves)

78   As discussed earlier in the paper, market estimates of future cash flows are not necessarily reflected in management's estimates of those cash flows. Use of the expected loss model does not result in fair value movements in credit spreads being automatically reflected in profit or loss. However, the market price of an entity's credit may indirectly be used to determine whether there has been a change in loss expectations similarly as credit ratings are used for such internal estimates.

79   The expected loss model as proposed by the IASB discounts all expected cash flows at the original effective interest rate, not current market rates (credit, liquidity and interest) which means that gains and losses arise as forecast cash flows change, not interest rates, liquidity or credit spreads. This better matches the principle of how revenue (e.g. interest) is recognised on instruments held at amortised cost.

80   To the extent that initial expectations remain unchanged, loss recognition is less volatile since estimated credit spreads are deducted from interest income. Part of the interest payment received is used to reduce the carrying amount of the financial asset. This is (or should be) consistent with the way in which the financial asset was originally valued on initial recognition. It might be regarded as somewhat counter-cyclical (or perhaps cycle-independent) in the sense that income is restricted, and financial asset carrying amounts reduced, in good years as well as bad.

Furthermore, financial assets recognised in a bad year will include higher initial credit spreads accruing these effects over a longer time-span.

81   However, the expected loss model will result in income volatility, in particular when estimates change. Where estimates change because of changes in inputs that have wide-ranging impact, for example management's economic outlook, adjustments to expected cash flows and hence the impact on profit and loss could be material. Therefore, significant impairment adjustments will result from management's change in view of expected cash flows (e.g. economic outlook and/or relevant general economic cycle forecasts).

Losses are front-loaded but not upon initial recognition

82   Expected loss model front-loads the loss recognition compared to the current incurred loss model by reducing revenue margins from the first day that margin is accrued. To the extent that expectations are revised downwards, new expected losses are recognised before they are incurred.

83   However, this is not to be confused with initial recognition of losses. Unlike some through-the-cycle approaches, the expected loss model does not result in losses being recognised upon initial recognition, unless there has been a change in the expectations from the time the contractual terms were agreed and the time the financial asset is recognised. Measurement of financial instruments at initial recognition under IFRS is outside the scope of the expected loss model since all financial instruments are recognised initially at fair value. Generally, the price at which an entity acquires or issues a financial asset already incorporates management's best estimate of future cash flows including expected cash flow losses at that point in time.

Gains are recognised when expectations are revised upwards

84   To the extent that cash flow expectations are revised upwards, gains will be recognised immediately as a catch-up of previously unrecognised interest income. This mirrors the recognition pattern for losses recognised when expectations are revised downwards. Negative impairment charges may seem counter-intuitive, and there might be calls that such gains should be restricted in some way, perhaps by limiting changes to the amount of previous downward changes in estimates or being spread forward to maturity on the basis of a revised expected interest rate. However these proposals would seem inconsistent with the way impairment losses are recognised under the expected loss model and consistently the Exposure Draft requires full recognition of these gains as cash-flow estimates are revised upwards.

Results of the Expected Loss model are pro-cyclical (not through-the-cycle provisioning)

85   Through-the-cycle provisioning can mean several things, but some see key difference to both the incurred and expected loss models is that losses would be recognised on contracts that have not yet been entered into at the balance sheet date. Through-the-cycle models are based on the consideration that existing portfolios of financial assets will be prolonged or replaced with similar instruments when they contractually mature. Through-the-cycle provisioning makes sense only for financial assets that are in existence at least through the estimated length of the economic cycle. This would be the case for many mortgage loans, loans granted to finance long term investments of corporates or long term bonds issued by States. However, this is more an exception than a rule since the average duration of most loan and receivables portfolios is significantly shorter than the economic cycle.

86 Standard-setters are unlikely to accept creating provisions (withholding profit) for future transactions and events which may or may not occur. Recognising losses on 'expected assets' would be inconsistent with accounting frameworks which are based on present rights and obligations and fairly reflecting performance in the current reporting period. Provisions or reserves for future losses on future assets would therefore, from a technical accounting perspective, have to be dealt with as reserves within equity and not as liabilities affecting profit or loss.

87 The expected loss model only applies to financial assets existing at the balance sheet date. As a result, the model does not reduce the volatility of the loan portfolio value and related earnings during an economic cycle since the loss expectations take into account the part of the economic cycle from the date of assessment to maturity of the loan. In reality, financial results do objectively worsen in an economic downturn in a way similar to the rise in unemployment rates. Therefore the increase in impairment losses resulting from applying the expected loss model through an economic downturn is arguably a faithful representation of current conditions.

Implementation

88 For many reporting entities including financial institutions, insurance companies and non-financial companies implementing an expected loss model could represent a significant operational challenge.

89 To address these concerns the Exposure Draft proposes to allow reporting entities to use practical expedients in calculating amortised cost, if the overall effect is immaterial and the expedient is consistent with the following principles:

   (a) The calculation incorporates the effect of time value of money (except for cash flows relating to short-term receivables if the effect of discounting is immaterial);

   (b) The calculation includes all expected cash flows for all of the remaining life of the financial instrument (not only for some part of the remaining maturity); and

   (c) The calculation results in a present value that equals the initial measurement of the financial instruments. [19]

90 This concession should allow many entities (in particular non-financial entities) to lessen the burden of applying the expected loss model. However application issues will still arise.

Application

91 In theory to apply the expected loss model, reporting entities could utilise their systems that already compute and apply the effective interest rate to their financial assets held at amortised cost. However, in practice many reporting entities may not have calculated an effective interest rate under IAS 39, i.e. utilising an exemption for trade receivables or by using a straight-line amortisation as a proxy for an effective interest rate.

92 Where entities did calculate an effective interest rate (or used a straight-line proxy) two systems would be maintained, one that keeps a track of contractual cash flows (e.g. for reporting account balances to customers, keeping track of cash payments, reporting to tax authorities etc) and another to report the effective interest rate and

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[19] Paragraph B15 of the Exposure Draft

carrying amounts for accounting purposes. Under the expected loss model, it is likely that a separate expense/income item would be kept for expected credit losses as well as similar items for fees, prepayment and other upfront costs, that are then spread over the life of the loan or receivable.

93   The separate expense/income item would need to be periodically adjusted from updates from the credit risk systems (e.g. credit downgrades or changes in model parameters). These credit risk systems would provide consistent input from pricing to management, regulatory and financial reporting.

94   Data used for prudential reporting should come from the same source as data for financial reporting.

95   The expected loss model will require an adjustment to the currently required effective interest rate computation to take account of any change in expected credit loss expectations. Variable rate loans present an additional operational burden since the calculation of the effective interest rate under an expected loss model will become more complex as it could require changing the net effective interest rate at each change in either interest or credit loss expectations.

96   In addition, since the effective interest rate calculation will be more complex under the expected loss model, entities may have to introduce changes to front-end accounting systems. This will be very costly and may take a considerably long time to implement.

Calculating the Expected Credit Losses

97   Financial institutions could potentially use existing models developed for the impaired loans under the incurred loss model to calculate the net present value of expected cash flows discounted at the historical effective interest rate.

98   As stated above, what may represent a challenge for many entities is the availability and extrapolation of historical data needed to calculate those credit losses. The reliability of data will also need to be considered.

Transition

99   Generally retrospective application is required on implementation of a new standard under IFRS. In this context transitioning from an incurred loss model to an expected loss model could be operationally challenging since retrospectively determining what would have been the credit loss expectations in the past could present significant difficulties.

100   Assessments would need to involve cash flow expectations for comparative periods and therefore any transition arrangements need to minimise the use of hindsight.

101   In light of these the concerns, the Exposure Draft proposes neither a fully retrospective or prospective transition. Instead it requires that an entity adjust the effective interest rate on existing financial assets to approximate the rate that would have been determined at inception using the expected cash flow approach.[20]

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[20] Paragraphs 24-27 of the Exposure Draft

Presentation

102   Prima-facie it seems that interest margins would be hit by the reduced effective interest rate. That is, the interest margin will be a net amount, incorporating the recognised revenue (e.g. interest accruals) being reduced by a periodical charge representing expected credit losses. It may be that users would like to see the components of this net interest margin, either on the face of the statement of comprehensive income or in the notes to the financial statements. The disaggregated presentation proposed by the Exposure Draft[21] requires entities to recognise interest income first on a gross basis, then to deduct the expected loss adjustment from the interest margin to report net interest revenue. Adjustments from changes in cash flow estimates are reported as a separate line item on the face of the statement of comprehensive income. Such disaggregation may add an additional layer of complexity for preparers and therefore would need to be considered in terms of costs/benefits. In the notes to the financial statements, credit loss estimates also need to be separately disclosed from, for example, other adjustments of expected cash flows such as changing prepayment expectations.[22]

103   Accordingly the face of the statement of comprehensive income will include the following line items:

(a)   Contractual interest revenue;

(b)   Allocation of initial expected credit losses;

(c)   Net interest revenue (calculated as (a) minus (b) above);

(d)   Effect of changes in expectations (credit and others such as prepayments); and

(e)   Interest expense.

Disclosures

104   The disclosures proposed in the Exposure Draft focus on two aspects: expected credit losses and quality of financial assets held at amortised cost.[23]   The disclosures can be summarised as follows:

Expected credit losses disclosures

105   It is proposed that the following expected credit loss disclosures would be required:

(a)   Allowance account

(b)   Estimates and changes in estimates

(c)   Loss triangle

(d)   Others

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[21] Paragraph 13 of the Exposure Draft

[22] Paragraph 18 of the Exposure Draft

[23] Paragraphs 14-22 of the Exposure Draft

Quality of assets

106 It is proposed that the following disclosures about the quality of an entity's financial assets held at amortised cost would be required:

(a) Reconciliation in changes in non-performing assets

(b) Origination and maturity (vintage) information

The exposure draft also requires disclosure of stress tests where these are used to manage risk.

The disclosure requirements are significantly more extensive than under the current model

Comparison with Other Impairment Models

Incurred Loss Model

107 The key difference between the expected loss model and the incurred loss model is when credit losses are recognised. Under the incurred loss model, credit losses are recognised only when those losses have been "incurred", that is, there is evidence that the losses are probable and measurable. Under the expected loss model future expected credit losses form part of an initial determination of the effective interest rate, resulting in expected credit losses being recognised as a reduction of the interest accrual. Additional "impairment" adjustments to the carrying amount of the asset are made as future expectations about future credit losses change. This is a continuous re-estimation and does not rely on the "incurred trigger" of the incurred loss model. However, immediately after the loss event, the requirements to estimate loss outcomes under the two models are identical and existing systems could therefore be used to capture impairments from that point.

Dynamic Provisioning

108 Some forms of through-the-cycle provisioning requires reporting entities to recognise a "dynamic provision" (a general provision in addition to specific provisions) that provides for expected losses on credit expectations through an economic cycle. As an economic cycle is mostly longer than most loans and receivables, the provision will result in losses being held against financial assets that do not yet exist. The provision is calculated based on a set formula, using historical data that covers a full economic cycle and it envisages that relevant authorities (e.g. the local prudential regulator) will set the formula, and supply the data.

109 The dynamic provisioning model results in "day-one" and 'before day-one" losses since reporting entities are required to build-up the general provision immediately once they grant a new loan (although this loan is under current IAS 39 requirements recognised at fair value) and even in respect of loans that have not yet been granted. Under the expected loss model the losses expected at inception are spread over the period to maturity.

110 It is expected that relevant entities will be required to build up the dynamic provision in good times (when bad loans are granted) and use the dynamic provision during a downturn to cover the increase in losses occurring at that time. The effect is counter-cyclical.

111   The expected loss model is applied only to financial assets held by an entity at the reporting date. For financial assets held at amortised cost that will mature prior to the end of the current economic cycle, the expected loss model will generally be less pro-cyclical than the incurred loss model, as credit loss expectations will reflect current expectations about those assets held at that point to their maturity prior to the end of the economic cycle. The estimate therefore is generally not impacted by management's estimate on where in the cycle the reporting entity is.

112   The dynamic provisioning model would create day-one losses on inception of any new loan, unless the expected loss is above average losses and the provision is released/utilised (see paragraph 114). Initial recognition of loans and receivables under IFRS is at fair value, so any model which requires recognition of a day-one loss would conflict with the measurement standard. It would also be very difficult to define in the accounting policies, disclosed in the notes, what the actual measurement basis of a loan at inception is.

113   In addition, the expected loss model relies on management's estimates of future cash flows, and it is left to an entity to determine the methodology and the data used to support that estimation. Back-testing will be required to ensure the appropriateness of this methodology. The dynamic provisioning model is usually based on industry averages determined by the regulator, thus reflecting the systemic risks rather than specific idiosyncratic risks of the reporting entity.

114   The model is unclear regarding the critical question of when the dynamic provision is to be released/utilised. Although this is a key consideration also for prudential reporting, it is fundamental for financial reporting. If the model is not transparent and allows hiding worsening of a loan portfolio of the reporting entity, which would be the case of most automatic release triggers, it would be unacceptable for financial reporting. If the release/utilisation would be based on a regulatory decision, it is unclear on what factors such decision would be based.

Fair Value-based Impairment Approach

115   In a fair value based impairment approach, an entity would recognise impairment losses on a financial asset held at amortised cost to the extent that the fair value of that asset is less than its carrying amount. Fair value would include credit and non-credit related changes in fair value i.e. using market based values and discount rates. It is envisaged that a fair value-based impairment approach would incorporate a "trigger" of some sort, since automatic adjustments in fair value movements would seem contrary to carrying a financial asset at amortised cost, although the measurement principle at the lower of cost and market value has already been used in the past. However, this model would be very volatile and clearly pro-cyclical, although not as much as a full fair value model.

116   Under the expected loss an impairment loss would be based only on changes in expected cash flows due to changes in an entity's expectations about future credit losses, discounted at the original effective interest rate.

Summary Table of Impairment Models

117   The following table summarises the above models against the expected loss model.

The following table has been adapted from one presented to the IASB at its meeting in May 2009[24]:

Approach Topic	Incurred Loss Model	Expected Loss Model	Fair value-based Model	Dynamic provisioning
Initial determination of the effective interest rate (EIR)	• Based on initial measurement and expected (contractual) cash flows (but ignoring future credit losses)	• Based on initial measurement and expected cash flows (including future credit losses)	• Based on initial measurement and expected cash flows (including future credit losses)	• Based on credit risks over the full economic cycle (can relate to assets not yet held)
Trigger for impairment test	• Required; indicator-based (i.e. evidence to support loss has been incurred)	• No trigger (continual re-estimation of expected cash flows)	• Both indicator and value-based possible • Trigger is likely to be required	• Agreed rules and automatic triggers for build-up and release of the provision
Measurement of revised carrying amount	• Expected cash flows reflecting incurred losses discounted at the original EIR (for fixed rate instruments) • No market adjustments • No future credit losses	• Continuously updated expected cash flows reflecting expected losses discounted at the original EIR (for fixed rate instruments) • No market adjustments • Includes future credit losses	• Fair value (if less than carrying amount) • Including credit related changes (e.g. liquidity) in fair value	• Formula driven, creating day-one losses. • Competent authority to determine parameters
Reversals and related gains	• reversals required if triggered by event after recognition of impairment loss • up to amortised cost	• automatically by adjusting the expected cash flows (no trigger required) • upper limit is the full contractual cash flows discounted at the original EIR	• reversals possible • could be based on triggers or value recovery only	• Declines in the provision shall be reflected as a value adjustment (recognised in P&L to offset losses in an economic downturn)

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[24] IASB Agenda Paper 5D *Comparison between possible impairment approaches*, May 2009

APPENDIX A

TERMS AND DEFINITIONS (for the purpose of this paper)

Amortised Cost

Amortised cost is a cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense. It is the amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between the initial amount and the maturity amount, and plus or minus any addition or reduction from the effect of revising estimates of expected cash flows (e.g. regarding prepayments or uncollectibility) at each measurement date.[8]

Dynamic Provisioning

A form of through-the-cycle provisioning, dynamic provisioning is a countercyclical measure for timely capturing of *expected* losses at loan inception due to inherent credit risks. It can be differentiated from countercyclical capital approaches that provide a capital buffer for unexpected losses in equity. The result is a build up provisions for credit risks on debt instruments during good times (when bad loans are granted) and use of the dynamic provision during a downturn to cover all or some of the occurred losses.

Effective Interest Method

Is a method of calculating the amortised cost of a financial asset or a financial liability (or group of financial assets or financial liabilities) that uses the effective interest rate. [26]

Effective Interest Rate

The effective interest rate is the rate that (or spread that, in combination with the interest rate components that are reset in accordance with the contract,) exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument (or shorter if relevant). The calculation includes all fees and points paid or received between parties to the contract that are an integral part of the effective interest rate, transaction costs, and all other premiums or discounts.[25]

Expected Loss Model

Model for determining the timing and measurement of impairment of financial assets held at amortised cost where an entity's estimate of future expected credit losses is recognised as an adjustment to the contractual effective interest rate at loan inception and throughout its existence.

Fair-value based approach to impairment

Model for determining the timing and measurement impairment on financial assets held at amortised cost when the fair value of a financial asset is less than its carrying amount. Fair value measurement would include credit and non-credit related changes in fair value i.e. using market based values and discount rates and recognition would be subject to triggers.

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[25] Based on Appendix A and paragraph B1 of the Exposure Draft

Impairment model for Financial Assets

Any model to determine the recognition and measurement of decreases in value of financial assets not measured at fair value through profit or loss.

Non-performing

The status of a financial asset that is more than 90 days past due or is considered uncollectible for other reasons.[26]

Incurred Loss Model

Model for determining the timing and measurement impairment of financial assets held at amortised cost, where a reporting entity can recognise an impairment loss only if it can evidence that a credit loss has been "incurred" (after the loan recognition), meaning the credit loss is probable and future expected cash flow losses can be reasonably estimated (e.g. credit default, borrower loss of employment, decrease in collateral values).

Procyclicality

The term procyclicality refers to the dynamic interactions between the financial and the real sectors of the economy. These mutually reinforcing interactions tend to amplify economic cycle fluctuations and cause or exacerbate financial instability.

The current financial crisis is a systemic event of large proportions that illustrates the disruptive effects of procyclicality. Institutions that experience extensive losses face growing difficulties in replenishing capital. This, in turn, induced them to cut credit extension and dispose of assets. Their retrenchment precipitated a weakening of economic activity, thereby raising the risk of a further deterioration in their financial strength. The costs to the broader economy have been large and are mounting.[27]

Through-the-cycle provisioning

General term defining provisioning that spreads losses over the life of the economic cycle. This system requires that reporting entities recognise an impairment in good times for credit losses which, on past experience, will materialise later in the economic cycle. This is because an entity estimates impairment based on credit loss experience that covers a full economic cycle and that does not necessarily reflect the characteristics of financial assets held at the reporting date.

Write-off

A direct reduction of the carrying amount of a financial asset measured at amortised cost resulting from uncollectibility. A financial asset is considered uncollectible if the entity has no reasonable expectations of recovery of any cash-flows and has ceased any further enforcement activities[26].

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[26] Appendix A of the Exposure Draft

[27] Extract from *Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System,* 2 April 2009, section II (page 8)