Financial Instruments: Amortised Cost and Impairment
Summary of Outreach activities

Background

1   In November 2009, EFRAG decided to follow a "twin-track" approach in responding to the IASB Exposure Draft *Financial Instruments: Amortised Cost and Impairment* (the ED). Under this approach, EFRAG issued an initial draft comment letter (DCL) in February 2010 that covered only the conceptual aspects of the proposals. The DCL was to be followed by an outreach program to determine the practical and implementation issues arising from the proposals in the ED. The results of the outreach program would determine if any amendment to the DCL was necessary.

2   On 18 March 2010, EFRAG issued a questionnaire to facilitate the outreach program. Constituents were asked to respond either via written completion of the questionnaire, conference call or physical meeting. The consultation period ended on 16 April 2010.

3   EFRAG staff concluded 18 consultations, the industrial and geographical split of which are depicted below:

	Responses
Belgium	1
Britain	3
Europe	1
France	2
German	6
Global	1
Italy	1
Spain	2
Swiss	1
Total	18

	Responses
Banking	12
Audit	1
Industrial	2
Insurance	3
Total	18

4   It is important to note that the questionnaire was primarily directed at preparers. The objective of the consultation was to gain a better understanding of the implementation and practical implications of the proposals.

5   The questionnaire covered the following topics:

(a)   Pricing of financial assets;

(b)   Estimating cash flows (including credit losses);

(c)   Effective interest method/allocation mechanism;

(d)   Practical expedients;

(e)   Presentation and disclosure;

(f)   Alternative impairment models; and

(g)   Overall view and any other matters.

6   In summary, respondents indicated that:

(a)   Credit risk is generally not explicitly priced into most financial assets on origination. Other market-based factors such as competitive forces and strategic behaviour are often more important (refer to Pricing of financial assets below);

(b)   Financial assets are often managed on an open portfolio basis. It is believed that the proposals in the ED are not fully compatible with open portfolios (refer to *Estimating cash flows (including credit losses)* below);

(c)   These portfolios are managed on an "expected loss basis", being a statistical measure based on past experience and other data, rather than an expected cash flow (ECF) basis (refer to *Estimating cash flows (including credit losses)* below);

(d)   In most instances the effective interest rate (EIR) is not embedded in an entity's systems. Rather, it is calculated based on a practical expedient taking into account materiality. Most entities would therefore have to change their current procedures, systems and controls to embed this allocation mechanism into their systems even before overlaying the allocation of credit losses (refer to *Effective interest method/allocation mechanism* below;

(e)   The practical expedients would probably not be used by banks. Non-financial institutions are likely to benefit from these proposals, however the presentation of credit-losses in net revenue remains a concern;

(f)   Most respondents see the disclosures proposals as onerous. Stress-testing, vintage and loss triangle information was identified as the most onerous;

(g)   Most respondents from the banking environment indicated support for the EBF proposals, which they believe, are more in line with the way their businesses, and credit risk specifically, are managed. However, almost all respondents indicated that an interaction with Basel requirements would be preferable. This could achieved by either using the same data, or to use an extended Basel provision to cover the life of the financial asset; and

(h)   Overall, most respondents believe that the cost of implementation will outweigh the benefits of the proposals unless they are significantly simplified.

The following sections provide further detail.

Pricing of financial assets

7   The IASB considers that the proposed approach would reflect lending decisions more faithfully than existing requirements because the proposed amortised cost measurement separates out the portion of the lender's return that compensates for the credit losses expected when the asset was originated. Therefore, the initial estimate of expected credit losses would be included in determining the effective interest rate. It is implicit that entities price financial assets after considering credit risk and that the interest revenue generated should reflect this.

8   Respondents were asked if and how expected credit losses were taken into account upon initial recognition of a financial asset. The key feedback was:

(a)   Financial assets purchased on the secondary market inherently include the market's view of expected credit losses. However, information about such expectations is not always visible. It may be difficult to determine what portion of the price reflects credit risk as opposed to liquidity risk;

(b)   Originated financial assets will include an amount representing credit risk in the margin charged. However, it is not the only component. Other factors such as funding and administration cost, liquidity and profit are also included. Depending on the product, market and the respondent, these components may not be explicitly identifiable; and

(c)   Competitive forces and strategic behaviour often determines the margin rather than an assessment of the relevant credit risk.

Estimating cash flows (including credit losses)

9   The ED provides that amortised cost be calculated as the expected cash flows over the remaining life of the financial instrument discounted using the effective interest rate. Expected cash flows are determined based on probability-weighted estimates considering both amounts and timing. Credit losses, in the case of financial assets, are included in the estimates.

Current Treatment under IAS 39

10   Constituents were asked how they currently apply the provisions of IAS 39. The responses indicate that constituents use different approaches for different types of financial assets to determine the "trigger event":

(a)   Some constituents are very conservative and impair individual assets at the first objective sign of impairment such as a downgrade in credit rating or negative market change;

(b)   Other respondents interpret objective evidence of impairment to require more evidence that often prevents the early recognition of an impairment; and

(c)   Other constituents use statistical data and historical experience as an indicator for homogenous financial assets as they believe this is a fair representation of the assets at the balance sheet date.

11   Once a trigger event has occurred a variety of models (all in accordance with IAS 39) are used to determine the amount of impairment:

(a)   For large individual assets the present value of future cash flows are often determined based on the best estimate of losses incurred. This methodology is similar to the ECF approach in the ED. Under this approach, it is often difficult to distinguish between the losses already incurred and those that will be incurred. Most respondents therefore impair the whole asset value mitigated by the value of any collateral. Most insurance and non-financial institutions also impair financial assets on this basis;

(b)   For portfolios made-up of a large volume of small value homogenous financial assets (e.g. consumer loans), a statistical provision is calculated based on the probability of default, loss given default and the exposure to default;

(c)   Entities also disaggregate homogenous financial assets into categories that are impaired on individual cash flow assessments and collective statistical impairment. This is based on a performing/non-performing distinction.

Proposed Approach

12   The vast majority of performing financial assets carried at amortised cost by respondents are not managed on an expected cash flow basis where the timing and amount of credit losses are tracked. Rather, financial institutions manage these assets on an expected loss basis that relies on statistical evidence to determine the amount but not the timing of the loss. The proposals would be a significant move away from the current credit management systems of these entities.

13   Assets purchased on the secondary market are managed on a expected cash flow basis. However, expectations of future losses do not feature in this measurement. Holders of such assets often do not have access to information about the counterparty as they did not originate the asset and they would have great difficulty to acquire such information. Insurance companies hold many such assets. The insurance respondents noted that the outcome of the EAP and its assessment of the use or market data could address this concern.

14   Financial assets that arise from other revenue generating activities such as trade receivables are managed based on approved credit terms where there is no implicit concept of expected losses – entities do not sell items to clients that they believe

will not pay. One industrial respondent mentioned that in certain jurisdictions it is unlawful to include an interest component in the price of goods sold.

Effective interest method/allocation mechanism

15 The ED proposes that the initial estimate of expected credit losses for a financial asset is included in determining the effective interest rate. The effective interest method then allocates interest (including a margin for expected future credit losses expected on initial recognition) over the remaining life of a financial asset.

16 "Impairment" losses result after initial recognition of a financial asset from an adverse change in the estimate of expected credit losses. An "impairment" gain would result from a favourable change in the estimate of expected credit losses. The effect of a change in estimate would be recognised in profit or loss in the period of the change.

Current Treatment under IAS 39

17 Respondents were asked how they currently calculate the EIR (i.e. whether it is embedded in their systems, an overlay thereto or a materiality-based expedient). Most respondents use either an overlay or practical expedient to calculate the EIR. In addition, two banks and the three insurance companies have embedded the calculation in their systems for some of their assets.

Proposed Approach in the ED

18 Only one of the respondents believes that it would be feasible to leverage off their current EIR calculation. All other respondents either would have to incur significant cost to change their systems, or would have to design and implement new systems. The following would have to be established:

(a) Databases with significant storage space for both historical data that would not have been maintained and for the expected future outcomes;

(b) Policies and procedures to model the data; and

(c) Internal controls.

19 Not all respondents commented specifically on the appropriateness of the EIR as the allocation mechanism, but those who did believe it is an appropriate mechanism to allocate interest revenue. However, not all of these respondents agreed that expected credit losses should be included in the calculation of the EIR.

20 In response to the proposal to book changes in estimate through profit and loss in the year of the change, none of the respondents supported the catch-up adjustment proposals. They argued that it:

(a) Results in the same cliff effect as the incurred loss model;

(b) Increases volatility compared to the incurred loss model; and

(c) Emphasises the effect of management judgement and the potential for earnings management.

21   Some respondents envisaged benefits from the proposed revenue recognition and allocation model proposed in the ED. Those benefits noted can be summarised as:

(a)   The proposals are conceptually pure;

(b)   Results in the earlier build up of a provision for expected credit losses;

(c)   Provides more information to users regarding credit risk practices;

(d)   It results in a smoother revenue allocation than the current IAS 39 model; and

(e)   Improves the comparability of data presented.

22   The general consensus among those who proposed simplifications to the proposals were:

(a)   Decoupling of interest revenue and the allocation of credit losses is important;

(b)   A simplified approach to determining the timing and amount of credit losses is necessary. Current credit management practices could be leveraged; and

(c)   Statistical provisioning on an open portfolio basis for large volume, low value homogenous assets would result in a significant simplification and would most likely approximate the result of the proposed approach.

Practical expedients

23   The ED proposes application guidance on practical expedients for calculating amortised cost. Practical expedients may be used if the overall effect is immaterial and should be consistent with certain specified principles.

24   In response to questions about the usefulness of the expedients respondents were split:

(a)   Non-financial institutions found the proposals very useful but are very concerned about;

(i)   The materiality filter and whether they would be able to apply them; and

(ii)   the presentation implications of the proposals (i.e. that revenue is shown net of expected credit losses);

(b)   Insurers found the proposals useful for the assets they purchased on the secondary market; and

(c)   Banks did not believe they were applicable to their businesses.

Presentation and disclosure

25   The ED proposes that the presentation and disclosure objective for amortised cost is that an entity shall disclose information that enables users of financial statements to evaluate the financial effect of interest revenue and expense, and the quality of financial assets including credit risk.

26   To achieve this it is proposed that the statement of comprehensive income shall include separate line items for gross interest revenue; the portion of initial expected

credit losses allocated to the period; net interest revenue; gains or losses due to changes in estimates; and interest expense. Disclosures proposed for the notes include an allowance account; explanations of estimates and changes in estimates (including a 'loss triangle' disclosure); stress testing in certain circumstances; credit quality of financial assets; and origination and maturity information.

27   Regarding presentation, respondents had diverse views:

(a)   Many argued that it is very difficult, if not impossible, to distinguish between the credit risk margin on initial recognition and the remainder (liquidity, funding, administration and profit). These respondents did not believe that the presentation of interest net of credit risk resulted in a faithful representation of the financial results; and

(b)   Others believed that the proposals provided useful information about the credit practices of an entity.

28   Respondents were more closely aligned in relation to disclosures:

(a)   Most believe that the disclosure suite is too voluminous;

(b)   It is difficult to predict how the proposals would work on an open portfolio basis. For instance, it would be very difficult to prepare the change in estimate disclosure in instances where the composition of the portfolio changed. It is not clear how an entity would distinguish between changes as a result of the portfolio mix and changes in the estimate of credit losses;

(c)   They do not think that stress testing information is appropriate as it does not portray economic reality; and

(d)   The loss triangle will be difficult to produce at a meaningful level of disaggregation and does not seem applicable to open portfolios.

29   It was also noted that if the model was changed the disclosures may have to change as well.

Alternative impairment models

30   Three possible alternative models were proposed although they had not been fully developed at this time:

(a)   Most bank respondents supported an approach that leverages off their current risk management systems:

(i)   The EBF model was noted as an approach that achieves this;

(ii)   Others mentioned that they supported the preservation of the incurred loss model for non-performing assets with an additional but separate provision for performing assets based on an expectation of future losses.

(b)   Many respondents mentioned that the interaction of the IASB and Basel regulatory capital requirements models would be useful in that it would not require two completely diverging provision calculations. Such interaction could be the use of an extended Basel provision to cover the life of a financial asset, or could be based on the same data;

(c)   It was noted that the development of the FASB extended incurred loss model should be assessed once it is published. One respondent thought that it would be best if all the expected credit losses were taken on day one.

Overall view and any other matters

31   Those who responded to this question noted that the proposals, as currently drafted, would most likely entail significant costs to implement and maintain. However, it was difficult to accurately assess this without the EAP concluding its work regarding implementation issues. In addition, these respondents did not believe that the benefits to users would outweigh the cost to preparers.