
Project	Financial Instruments: Replacement of IAS 39
	Amortised Cost and Impairment –
Topic	Treatment of initial expected loss

Introduction

Background and purpose of this paper

1. At its July and August 2010 meetings, the Board discussed:
 - (a) a summary of feedback received from comment letters to the exposure draft *Financial Instruments: Amortised Cost and Impairment* (the ED), users, and the Expert Advisory Panel (EAP);
 - (b) a ‘roadmap’ diagram summarising the key possible features of an expected loss (EL) approach (see below), and interaction of possible key features;
 - (c) the general approach for redeliberations¹ ;
 - (d) an EL approach versus a different approach for amortised cost and impairment; and
 - (e) the outlook period and conditions (at a summary level) to consider when calculating EL.

¹ Including that we will first consider **open portfolios**. We will later address any specific issues for individual financial assets after a general impairment model for open portfolios has been developed.

This paper has been prepared by the technical staff of the IFRS Foundation for discussion at a public meeting of the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the IASB.

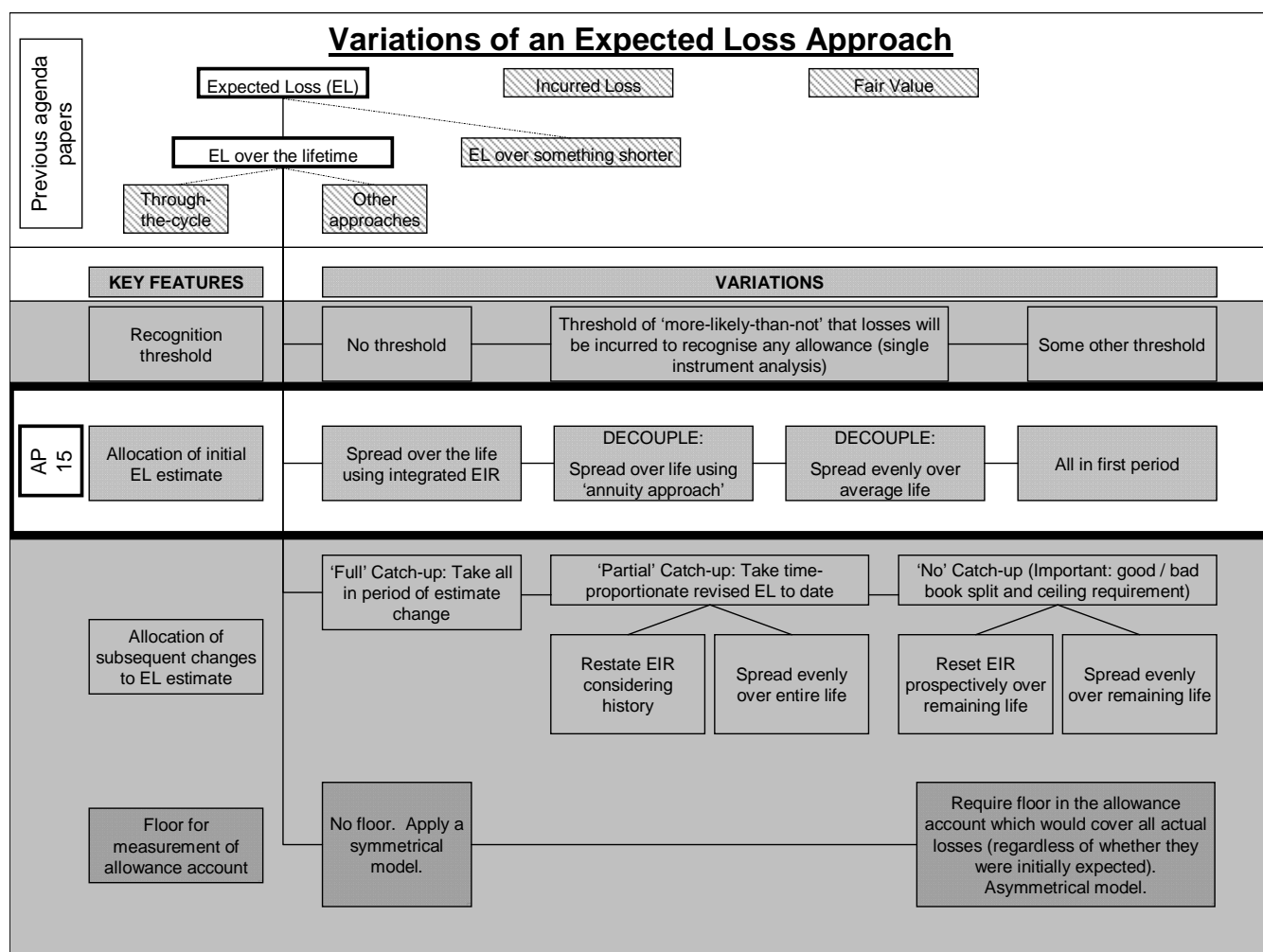
Comments made in relation to the application of an IFRS do not purport to be acceptable or unacceptable application of that IFRS—only the IFRS Interpretations Committee or the IASB can make such a determination.

The tentative decisions made by the IASB at its public meetings are reported in *IASB Update*. Official pronouncements of the IASB, including Discussion Papers, Exposure Drafts, IFRSs and Interpretations are published only after it has completed its full due process, including appropriate public consultation and formal voting procedures.

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- At the 24 August 2010 meeting, the Board decided to proceed with developing an expected loss approach based on lifetime EL, and that entities should consider all reasonable and supportable information (including forecasts of future conditions) when calculating EL.

Purpose of this paper



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3. The purpose of this paper is to address variations of the layer 'Allocation of initial EL estimate' in the above 'roadmap'.
4. Agenda paper 4B presented at the 3 August 2010 Board meeting describes each of the layers of the roadmap and its key features. Paragraphs 4-12 of that paper (see extract in Appendix A) can be used as a reference as this paper will not again describe each of the variations of allocating initial EL in detail.
5. Specifically, this paper asks whether:
 - (a) the entire initial EL should be recognised in the first period; or
 - (b) the initial EL should be allocated (over the life of the portfolio).
6. Should the Board decide to allocate the initial EL over the life of the portfolio, this paper also asks whether to allocate the initial EL using an:
 - (a) integrated effective interest rate (EIR); or
 - (b) a non-integrated EIR (ie a 'decoupled' method).
7. This paper **does not** ask the Board to make any decision on whether to require a specific decoupled method. That decision will be requested at a future meeting *if* the Board decides today to use a non-integrated EIR approach to allocate initial EL over the life of the portfolio.
8. There are some possible interactions between the allocation of an initial EL and how the effects of any *subsequent changes* to estimates of EL (subsequent changes in EL estimates) are treated. This paper also identifies those possible interactions so that you consider them when answering the questions in this paper.

Structure

9. The rest of the paper is structured as follows:
 - (a) broad methods for treatment of initial EL estimates;
 - (i) recognising EL in the first period
 - (ii) allocating EL over the life of the portfolio
 - (iii) possible interaction with treatment of subsequent changes in EL estimates

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- (iv) staff analysis and recommendation – Question 1
- (b) methods of allocating the EL over the life of the portfolio;
 - (i) integrated EIR
 - (ii) non-integrated EIR (ie a ‘decoupled’ approach)
 - (iii) decoupling – interaction with open portfolios and method selected for allocation of the effects of subsequent changes in EL estimates
- (iv) Staff analysis and recommendation – Question 2

Broad methods for treatment of initial EL estimates

- 10. As described at the 3 August 2010 Board meeting, there are two broad methods for the treatment of initial EL estimates. An entity could:
 - (a) recognise the entire lifetime EL in the first period, or
 - (b) allocate the lifetime EL over the life of the portfolio.

Recognising EL in the first period

- 11. Recognising the entire EL in the first period (which some consider to be a ‘day-1’ loss) would not require:
 - (a) historical information about (or related to) previous EL estimates to be kept in the systems; nor
 - (b) calculation of an integrated EIR
- 12. The lack of those two requirements lead it to be perhaps the (operationally) simplest of all variations for the treatment of initial EL estimates.
- 13. Other than being operationally simpler, proponents of recognising the initial EL fully to profit or loss in the first period believe that it is inappropriate to allocate an impairment loss over the life of the portfolio. In their view, once an entity estimates a credit loss, an impairment exists in that entire amount and should be recognised in full immediately. Therefore, they do not believe that the EL should be allocated over the life of the portfolio.

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14. However, the staff notes that this treatment would be inconsistent with the way that other estimated cash flows for financial assets (such as prepayments) are accounted for in an amortised cost measurement in IFRS today.

Allocating EL over the life of the portfolio

15. The ED proposes to allocate the EL over the life of the portfolio. The reasons supporting the allocation of EL over the life of the portfolio have been discussed in detail in agenda papers 4A of the 3 August 2010 meeting and 1C of the 24 August 2010 meeting².
16. In summary, the pricing of a financial asset inherently includes some estimate for initial EL. Therefore, allocating the EL over the life of the portfolio more accurately reflects the effective return of the instrument. Many respondents agree that the amount should somehow be allocated over the life of the instrument in an amortised cost measurement³.

Possible interaction with treatment of subsequent changes in EL estimates

17. It is important to understand how the method selected for treatment of initial EL estimates may affect the treatment of subsequent changes in EL estimates.
18. The staff believes that if the initial EL is recognised immediately in profit or loss in the first period, the effect of any subsequent changes in EL would also be required to be recognised immediately to profit or loss (ie a ‘full’ catch-up). Based on the reasons provided in paragraph 12, the staff can see no basis for not using a ‘full’ catch-up method.
19. The staff also believes, however, that if initial EL estimates are allocated over the life of the portfolio, then all of the variations for allocating the effect of subsequent changes in EL estimates remain possible choices. (The treatment for the effects of the subsequent changes in EL estimates will be presented and discussed at a future meeting.)

² See paragraphs 4-14 of agenda paper 4A and paragraphs 12-18 and 27-33 of agenda paper 1C in Appendix A.

³ See paragraphs BC25, BC31, and BC37 in the ED’s *Basis for Conclusions*.

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Staff analysis and recommendation

20. Because the pricing of a financial asset inherently includes some estimate for initial EL, on day 1 the staff believes there is no economic loss. The EL is reflected in (and covered by) the margin (pricing) on the instruments. Further, allocating the entire initial EL in the first period results in an accounting return that does not accurately reflect the effective return of a financial instrument over its life. During the first period, revenue would be understated and during future periods revenue would be overstated (under the incurred loss approach today revenue is overstated before a loss event).
21. In the view of the staff, allocating the EL over the life of the instrument better reflects the pricing of the instruments in the portfolio and the effective return over the life of the portfolio. Also, by allocating initial EL estimates over the life of the portfolio, a subsequent measure is used that is internally consistent with the initial measurement at fair value (that includes expected losses)⁴.
22. Therefore, the staff recommends that the initial EL estimate should be allocated over the life of the portfolio.

Question 1 – Treatment of initial EL estimate

Does the Board agree with the staff recommendation to move forward using an approach that allocates initial EL estimates over the life of the portfolio?

If not, would the Board like to move forward using an approach that recognises initial estimates of lifetime EL in the first period?

Allocating the EL over the life of the portfolio

23. The rest of this paper is only applicable if the Board agrees with the above staff recommendation.
24. Two general methods available for allocating the initial EL over the life of the portfolio are by using:
- (a) an integrated EIR, or

⁴ See paragraphs 14-18 of agenda paper 1C of 24 August 2010 meeting in Appendix A.

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- (b) a non-integrated EIR (ie ‘decoupling’ the credit losses from the EIR)

Integrated EIR

25. The ED proposed requiring the use of an integrated EIR approach based on all expected cash flows, including expected credit losses. Reasons for that proposal included that such an approach:
- (a) would avoid overstatement of interest revenue in periods before a loss event occurs;
 - (b) uses a subsequent measurement that is internally consistent with the initial measurement of the financial asset; and
 - (c) facilitates an amortised cost measurement that at any point in time is a present value of the future cash flows.
26. We learnt from the EAP and others that an integrated EIR is operationally difficult. These operational difficulties have been described in the ‘Summary of EAP discussions’ document posted on the website in July 2010. This summary was also presented to the Board at the 3 August 2010 meeting⁵.
27. The suggested solution to the operational difficulties was to ‘decouple’ the EIR. ‘Decoupling’ refers to the process of keeping the EIR calculation (as in IAS 39) separate from an EL estimate and recognition of credit losses.
28. Many respondents to the ED expressed their view that the costs associated with calculating an integrated EIR far exceed any benefits that can be derived from its use.
29. In addition to the operational difficulties, some respondents suggest that even though the pricing of a loan may include some expectation of EL, an integrated EIR may not be appropriate. In their view, the IAS 39 EIR is based on highly predictable information resulting from contractual terms (including prepayment features). They believe that the integrated credit-cost adjusted EIR would be significantly *more* subjective by requiring much greater use of management judgement in estimating the timing and amounts of expected credit losses.

⁵ See paragraphs A14-A25 of agenda paper 9B of July 2010 meeting in Appendix A.

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Those respondents see no basis for integrating the ‘highly predictable’ (ie less subjective) information (for example, about prepayments or contractual maturities) with more subjective information related to estimated credit losses. They believe integrating that information will lead to less transparent and reliable information in the financial statements.

Non-integrated EIR (ie a ‘decoupled’ approach)

30. As described in agenda paper 4B of the 3 August 2010 Board meeting, there are at least two methods for decoupling the EIR:
 - (a) an ‘annuity approach’ (non-linear method)
 - (b) a straight-line method (linear method)
31. Remember, though, that ‘decoupling’ refers to the process of keeping the EIR calculation (as in IAS 39) separate from an EL estimate and recognition of credit losses.
32. Under an annuity approach, a separate discounted cash flow calculation is performed on the EL to determine a present value of the EL. That amount is then transformed into an annuity and allocated over the life of the portfolio and recognised in profit or loss as a periodic charge.
33. Another suggested method for ‘decoupling’ is to determine the EL and allocate it over the average life of the portfolio using a straight-line method.
34. Both of these methods could approximate the proposed treatment of initial EL in the ED (with the annuity approach having the ability to be come very close to the results in the ED).⁶
35. Operationally, both of these ‘decoupled’ methods are simpler than an integrated EIR approach because they source the risk data separately from the accounting data.

⁶ In order to fully approximate the ED a ‘full’ catch-up would also be required to record the effect of subsequent changes in EL estimates. Any time the ‘full’ catch-up method is used in conjunction with allocating the initial EL over the life of the portfolio, operational difficulties remain because of the necessity to maintain historical information

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36. However, decoupling the integrated EIR does not, in and of itself, eliminate the operational difficulty of applying the ED's model to open portfolios. Therefore, it is important to understand how such decoupling methods interact with open portfolios and the method selected for allocation of the effect of subsequent changes in EL estimates.

Decoupling – Interaction with open portfolios and the treatment of subsequent changes in EL estimates

37. While gathering feedback, we learnt that risk systems typically do not maintain historical data related to initial expectations. Generally, only forward looking data is kept in the risk systems. As loans are added and removed, the profile of the open portfolio will change and replaces the historical data with current data.
38. The amortised cost and impairment model proposed in the ED requires maintaining the initial EL data because:
- (a) the credit-cost adjusted EIR is used as the discount rate for calculating the present values of the expected future cash flows; and
 - (b) subsequent changes in the EL estimate are taken immediately and fully to profit or loss in the period of the change in estimate.
39. In order for a decoupling method to approximate the full model in the ED, the initial EL data will still need to be maintained in order to differentiate the initial allocation of EL and the 'full' catch-up amount. This maintenance of historical data adds to the operational difficulty of applying the ED's approach to an open portfolio.
40. Note also that the presentation requirements in the ED proposed the initial allocation of EL to be presented as a separate line item. Because of the use of the credit-cost adjusted EIR for measurement and presenting the EIR without credit losses as a single line item, the information for presenting the initial EL allocation is available. If, however, a non-integrated EIR is used and the presentation requirement to show the allocation of initial EL is still required, historical data would need to be maintained.
41. In order to more fully alleviate the operational difficulty, not only should the EIR be decoupled, but the amount of historical data required to be maintained would need to be reduced. If a decoupled approach uses a different variation of

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the key feature ‘allocation of subsequent changes in EL estimate’ (ie ‘partial’ or ‘no’ catch-up, instead of the proposed ‘full’ catch-up), the concern around carrying forward historical data may be alleviated⁷.

42. However, using a different variation of that feature also moves a decoupled approach away from being a close approximation of the approach proposed in the ED. Even so, some feel such an approach provides a more cost-beneficial result. In other words, changes to current systems would not be as costly and expected losses would still be recognised sooner than an incurred loss model.
43. There is a trade-off though to making the model operationally easier. By using a decoupled approach that reduces the requirement to keep historical data, interest revenue recorded in future periods may not reflect the effective return of the portfolio. Further, the amortised cost of the instrument will no longer be the present value of the expected future cash flows at each reporting date as proposed in the ED.

Staff analysis and recommendation

44. In the staff’s view, the model proposed in the ED accurately represents the economic theory underlying the pricing of instruments and appropriately reflects that theory in its requirement to allocate the initial EL estimate over the life of the instrument using an integrated EIR. Some respondents to the ED agreed with this.
45. However, the staff also agrees with the feedback received that the model in the ED is operationally difficult and should be simplified.
46. Even though using a non-integrated EIR may not give the exact results as would be determined in the ED, the staff believes that decoupling the EIR could still provide results that are in line with the underlying principles of the ED’s model with regard to estimates of initial EL. In other words, recognising that there is inherently some credit losses included in the pricing of the instrument that

⁷ Paragraphs 13-30 of agenda paper 4B describe the different methods for allocating the effects of subsequent changes in EL estimates. With a ‘partial’ and ‘no’ catch-up, a target level of the allowance account is calculated and profit or loss is adjusted to that target level (depending on how the new estimate compares to what was the most recent EL expectation).

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should be spread over the life of the instrument and not waiting until a loss even occurs to recognise it.

47. Therefore, the staff recommends that the Board move forward using an approach that spreads the initial EL estimates using a non-integrated EIR (i.e. a ‘decoupled’ approach).

Question 2 – Method for allocating initial EL estimate

Does the Board agree with the staff recommendation to move forward using an approach that spreads initial EL estimates using a non-integrated EIR (ie a ‘decoupled’ approach)?

If not, does the Board want to move forward using an integrated EIR approach for initial EL estimates?

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Appendix A – Extracts from previous agenda papers

Agenda paper 4B from 3 August 2010 meeting – paragraphs 4-12

4. As described in agenda paper 4A, EL are included in the initial pricing of an instrument. Many respondents argue that amount should somehow be allocated over the life of the instrument. The variations for that allocation are:
- (a) Spread the initial estimate of EL over the life of the instrument using an integrated effective interest rate (EIR);
 - (b) Spread the initial estimate of EL over the life of the instrument using a ‘decoupled’ EIR. We have learnt from the Expert Advisory Panel (EAP) that ‘decoupling’ can be at least applied in the following two ways:
 - (i) Perform a separate discounted cash flow calculation on the EL, convert that amount to an annuity and allocate over the life of the instrument (the ‘annuity’ approach);
 - (ii) Estimate EL and then spread it using a straight-line method over the average life of the portfolio/instrument⁸;
 - (c) After estimating the EL, record the entire amount in the initial period when EL are determined.

Spread EL over life of instrument using an integrated EIR

5. The ED specifically requires the use of an integrated EIR, considering expected cash flows including future credit losses.
6. By including the initial estimate of EL in determining the EIR, the proposed approach would avoid the systematic overstatement of interest revenue in periods before a loss event occurs and use a subsequent measurement that is

⁸ Note that for this approach, the suggestion for the allocation of subsequent changes in estimates is to include experience adjustments (difference between actual and expected losses from current period) and changes in future expectations to the current period. But the initial EL is always allocated on a straight-line basis.

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internally consistent with the initial measurement of the financial asset (see agenda paper 4A for further discussion on consistency with initial measurement). It also facilitates an amortised cost measurement that at any point in time is a present value of the future cash flows.

7. However, we learnt from the EAP and others that an integrated EIR is operationally difficult. Most entities use separate credit risk systems and accounting systems which are rarely, if ever, linked to one another. Therefore it can be difficult to derive an integrated EIR in a cost-effective manner. Further, we also understand that some entities calculate the contractual rate on an individual instrument basis, whereas credit losses are often calculated on a portfolio basis. Integrating these two items would require precise identification of the period during which the losses would occur. The suggested solution: ‘decouple’ the EIR.

Decouple the EIR

8. One method of decoupling the EIR is to use an ‘annuity approach’. As described in paragraphs 18-21 of the EAP Summary paper included on the website (and reproduced in Appendix A for convenience), such an approach would require performing a separate DCF calculation on the EL to determine a present value of the EL. That amount is then transformed into an annuity, allocated over the life of the instrument and recognised in profit and loss as a periodic charge. The annuity approach can be applied in a way that results in a very close approximation to the proposed integrated EIR approach outlined in the ED.
9. Another suggested method for ‘decoupling’ is to determine the EL and allocate it over the life of the instrument using a straight-line method (see paragraphs 22-23 of the EAP summary included in Appendix A). Such a method may be useful in practice, albeit not as accurate as an integrated EIR or an annuity approach for allocating the initial EL. Even so, this method could provide a reasonable approximation to the ED.
10. Operationally, both these ‘decoupled’ methods are simpler than an integrated EIR calculation because they separately source the risk data from the accounting data.

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11. However, as with the current proposal, these methods would still require carrying forward historical data (ie the initial annuity or EL) for purposes of determining the amount to be recorded when estimates change in the future. If a different variation of the key feature ‘allocation of subsequent changes in EL estimate’ (see below section) is used, the concern around carrying forward historical data may be alleviated.

Record the entire EL in the first period

12. Perhaps the simplest (operationally) of all variations is to record the initial estimate of EL in the first period. Such an immediate recognition of EL is akin to a ‘day-1 loss’. Although no historical information would be required to be kept in systems, and no integrated EIR would be required to be calculated, requiring a loss to be recorded in the first period creates an accounting loss that economically does not exist. This also results in an accounting return that does not accurately reflect the effective return of a financial instrument over its life.

Agenda paper 4A from 3 August 2010 meeting – paragraphs 4-14

4. An expected loss approach takes the view that the credit loss expectation – including the initial expectation – is a characteristic of the portfolio rather than looking at whether future defaults are ‘inherent’ in a portfolio. Future default expectations are implicitly or explicitly reflected in the pricing of the financial asset and do not depend on whether a credit loss is inherent in a portfolio. The expected loss approach links the profitability of the portfolio to *expected* credit losses. It views credit losses as an integral part of the lending decision (including pricing).
5. Lenders expect some credit losses from their lending activities already when making a lending decision. The contractual rate charged could be broken into different components reflecting:
 - (a) time value of money (‘risk-free rate’);
 - (b) compensation for expected credit losses at the outset;

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- (c) compensation for accepting risk (eg unexpected credit loss, liquidity risk etc); and
- (d) a profit margin.

Expectation of credit losses ((b) above) forms a component of the contractual interest rate. Different expectations about credit losses are reflected in different contractual interest rates.

6. The initial carrying amount implicitly includes a deduction for expected losses⁹. Consistent with initial measurement, the expected loss approach records the financial asset subsequently based on a return that reflects a deduction for initially expected losses (instead of the current IAS 39 model, which does not deduct those expected losses from the return).
7. Most respondents to the ED agree that an expected loss approach better reflects the economics of a lending transaction and how financial institutions manage credit risk.
8. The incurred loss approach on the other hand views credit losses as caused by loss events, and *until* a loss event occurs there is no loss inherent in a financial asset or portfolio. The incurred loss approach in IAS 39 has been criticised for many reasons. Some of these reasons are set out in the ED's Basis for Conclusions¹⁰.
9. The incurred loss approach is internally inconsistent with the initial measurement of a financial asset as expected losses are implicit in the initial measurement of the asset. The subsequent accounting under the incurred loss approach ignores the expected loss until a loss event has occurred.
10. Credit losses occur because of a chain of events. It is rarely, if ever, possible to pick out one of those events and say that the loss occurred at that time. However, that is the premise under the incurred loss approach. Thus, any

⁹ At inception, the carrying amount of a financial asset can be regarded as the *contractual* cash flows, discounted at the contractual interest rate for which the contractual interest rate includes a return to cover expected credit losses. Or alternatively (which leads to the same answer) the initial carrying amount equals the *expected* cash flows discounted at the expected effective interest rate that is adjusted for the effect of expected credit losses [ie the risk free rate plus a risk premium plus a profit margin].

¹⁰ Paragraph BC11 of Basis for Conclusions on Exposure Draft *Financial Instruments: Amortised Cost and Impairment*.

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attempt to distinguish between losses that have already occurred and future losses will often be arbitrary. This has been reflected in practice where there is significant diversity and many application problems. This also became apparent during the Expert Advisory Panel (EAP) discussions. Entities have used different loss events or have assessed the same loss event differently when determining whether to record impairment losses.

11. A few respondents suggest that diversity in application of the incurred loss approach can be addressed by increased and/or improved application guidance. However, the staff notes that any additional application guidance for the notion of incurred loss would likely be arbitrary and re-create today's application problems in a different form. In particular the application problems regarding incurred but not reported (IBNR) credit losses demonstrate that it is impossible to distinguish an incurred loss and a future loss because it is not possible to say *when* the specific loss event occurred. Depending on the indicator used, a credit loss that is not yet incurred on the basis of one indicator can be incurred on the basis of another, more leading indicator.
12. A few respondents suggest that a threshold should be introduced as a minimum for when to consider expected losses (eg 'more-likely-than-not' that the entity will incur future losses on the instrument). While they note that such a threshold may only be useful for evaluating single instruments (as opposed to a portfolio), they argue that an introduction of a recognition threshold for impairment would reduce the burden and limit the recognition of impairment to cases where a minimum threshold is breached. In the staff's view the introduction of any threshold to recognising credit losses (whether on a single instrument or portfolio basis) has the same disadvantages as the incurred loss approach. It does not view credit losses as an integral part of the lending decisions and is inconsistent with the initial measurement of a financial asset. Setting a threshold ignores the expected loss until the threshold is met and would lead to the same application problems that the incurred loss approach causes in practice.
13. Respondents who support the current incurred loss impairment approach also commented that moving to an expected loss approach would increase significant, subjective management estimates. However, estimating credit losses inevitably involves judgement irrespective of the impairment approach. The

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incurred loss approach (and the threshold approach mentioned in paragraph 14) leaves room for considerable judgement in determining *when* a loss event has occurred. Moving from an incurred loss to an expected loss approach *shifts* the judgement from identifying the loss event to measurement of the impairment loss. The expected loss approach reflects lending decisions more faithfully than the incurred loss approach and provides more relevant and useful information for the users.

14. The Board also considered (but rejected) fair value based and through-the-cycle impairment approaches in its deliberation. Respondents to the ED overwhelmingly rejected these approaches mainly for the reasons set out in the ED's Basis for Conclusions¹¹.

Agenda paper 1C from 24 August 2010 meeting – paragraphs 12-18

12. The ED defines amortised cost as '[a] cost-based measurement of a financial instrument that uses amortisation to allocate interest revenue or interest expense.' The ED proposes using the effective interest method for amortisation. Under the expected cash flow (ECF) approach in the ED, initial expected lifetime credit losses are included in the amortisation to provide information about the effective return of a portfolio. The proposal therefore provides a link between the overall profitability of the portfolio and *expected* credit losses estimated at the outset. The ECF approach is one particular form of an expected loss approach. Other expected loss approaches vary by when the expected loss is recognised and for what time horizon and how it is determined.
13. Most respondents support the Board's proposed move towards some form of an expected loss approach to impairment. However, some respondents disagreed. Their main concerns are discussed in the remainder of this section.

Consistency with initial measurement

14. Some respondents disagree that estimates of expected credit losses should initially be included in the calculation of amortised cost. They argue that by

¹¹ Paragraphs BC 15 to BC 24 of Basis for Conclusions on Exposure Draft *Financial Instruments: Amortised Cost and Impairment*

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incorporating credit loss expectations in the effective interest method, the measurement moves away from the cost-based *initial* measurement of financial assets. Some are also concerned that at inception of a financial instrument, using an interest rate other than the contractual interest rate would be tantamount to moving away from the market view at that date.

15. Firstly, the staff note that all financial assets are *initially* measured at their *fair values* at inception¹² rather than at cost. Amortised cost is solely a *subsequent* measurement.
16. Secondly, the initial carrying amount (ie fair value plus transaction costs) of financial assets (at least) implicitly includes a deduction for expected losses. The initial carrying amount can be regarded as the present value of:
 - (a) the contractual cash flows discounted at the *contractual* effective interest rate; or alternatively
 - (b) the expected cash flows discounted at the expected effective interest rate *adjusted* for the effect of expected credit losses.

Both alternatives lead to the same present value.

17. Hence, including expected losses in amortised cost measurement results in a subsequent measurement that is consistent with the initial measurement at fair value plus transaction costs.
18. This also demonstrates that the use of an effective interest rate that is adjusted for the effect of expected credit losses is *not* tantamount to moving away from the market view (at inception of the instrument). Instead, the market view is inherent in the initial measurement (ie fair value plus transaction costs) and different discount rates¹³ that can be derived from it, each reflecting the market view inherent in the fair value of the asset.

¹² Plus transaction costs for assets not subsequently measured at fair value through profit or loss (see IFRS 9.5.1.1 and IAS 39.43).

¹³ The difference in the rates is due to the difference in the type of cash flow used as the numerator of the present value calculation. It is a matter of consistency, ie that there must not be double counting nor omission of any effect. For example, discounting certainty equivalents of the cash flows using the risk free rate would result in the same initial carrying amount (present value).

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Agenda paper 1C from 24 August 2010 meeting – paragraphs 27-33

Consistency with the pricing of the financial asset

27. Future expected credit losses form an implicit component of the pricing of a financial asset.¹⁴ Based on history, lenders typically expect some credit losses when making lending decisions and this is reflected in the contractual interest rate charged by the lender. The expected loss approach therefore is a faithful representation of the economics of loan pricing.
28. Hence, many respondents agree that the spread¹⁵ on a financial asset includes an amount that covers expected credit losses. Also, many financial institution respondents believe that the expected loss approach is more consistent with the way credit risk is managed, assessed and priced.
29. However, some respondents argue that because the spread covers a range of future expected losses it is not possible to identify a separate, single amount relating to future expected loss within the contractual interest rate. Hence, they are concerned that an expected loss model uses initial estimates that are not based on sufficiently robust information, which would result in the recognition of gains or losses from changes compared to the initial estimate.
30. The staff consider that this concern relates to how and when gains and losses from changes in expected loss estimates should be recognised in profit or loss. It reflects the trade-off between reliable and relevant information. An increase in the reliability of the loss estimate comes at the expense of later recognition of impairment losses (when the losses are more ‘observable’ and less uncertain, and hence loss estimates are less likely to change in amount or timing). In a wider sense, this relates to whether amortised cost is considered as a ‘cost’ measurement or as a present value of estimated future cash flows (see paragraph **Error! Reference source not found.**).
31. Under ‘cost’ measurement, one might take the view that losses must be reliably and accurately measured before they are recognised. In contrast, if amortised

¹⁴ See paragraphs 4 and 5 of agenda paper 4A of the 3 August 2010 meeting.

¹⁵ This is the spread above the risk free rate (sometimes it is referred to as the ‘credit spread’ but it includes other elements as well, eg profit margin, liquidity, etc.)

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cost is viewed as a present value of estimated future cash flows one would take into account more forward looking information in estimating cash flows.

32. Hence, the 'cost'-view implies to take into account changes in estimates later (nearer their crystallisation) than under the 'present value'-view.
33. The staff note that to the extent the initial expected loss is excluded from accounting for the asset the economic phenomenon of a lending transaction is ignored. This is because the (entire) initial expected loss is included in the pricing of the asset.

Agenda paper 9B from July 2010 meeting – paragraphs A14-A25

'Decoupling'

- A14. Under the IASB ED, interest revenue is recognised at the effective interest rate (EIR). The EIR is an internal rate of return calculation taking into account the expected cash flows (including any expected credit losses) over the remaining life of the financial instrument. In other words, the calculation of interest revenue under the IASB's ED requires entities to take into account the expected credit losses at inception.
- A15. We learnt that in practice, the ECF approach would give rise to operational difficulties because financial institutions and others typically store comprehensive contractual and accounting data (in particular effective interest rate data) and EL data information in separate systems ('accounting' and 'risk' systems). These operational difficulties were a major concern raised by members of the EAP. (The ECF approach proposed by the IASB features an integrated EIR calculation that would require integration of the data in the accounting and risk systems.)
- A16. We learnt that the ECF approach (*as an approximation*) could be simplified by 'decoupling' – separately sourcing the information in accounting systems (interest revenue as determined today under IAS 39 *Financial Instruments: Recognition and Measurement* that excludes EL estimates) and the information in risk systems. Such an approach would adjust the interest revenue calculated in the accounting system using an allocation profile for expected credit losses derived from EL data in the risk system. However, applying decoupling does

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not resolve the full set of operational complexities that were highlighted in the EAP discussions.

A17. We learnt that the following two ‘decoupling’ approaches (developed by the EAP) would avoid the complexity of an integrated EIR calculation while providing a close approximation to the ECF approach:

- the annuity approach to EL measurement; and
- the simplified approach using three building blocks for EL.

A18. Under the **annuity approach to EL measurement**, a separate discounted cash flow (DCF) calculation is used for EL. This DCF calculation is used to allocate the initial EL over the life of the instrument by converting the present value of the EL into an annuity, which is recognised in profit or loss (as a periodic charge). Subsequent changes in EL result in an adjustment to the present value of EL, which is immediately recognised in profit or loss.

A19. We learnt that this approach is flexible and can be applied to a wide range of instruments, including:

- fixed rate bullet loan or bond;
- amortising fixed rate loan;
- floating rate loan; and
- credit commitment (with fixed periodic fee).

A20. One advantage of this approach is that it also works for loan commitments, where an internal rate of return (IRR) calculation often does not work. The approach would also significantly simplify the approach for floating rate loans.

A21. We also learnt that under the annuity approach the calculation of the annuity can be simplified in the following scenarios:

- for financial instruments with a single period cash flow or with a maturity of one year or less (e.g. overdrafts, short-term revolving facilities and letters of credit), the annuity amount charge is equal to or can be approximated by the undiscounted EL;
- for financial instruments with multi-period cash flows that have constant conditional periodic credit losses the annuity is the periodic credit loss;

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- if the expected loss EL is not expected to change markedly (i.e. remain stationary) over the remaining life of the portfolio, the annuity can be approximated by the (geometric or simple) average loss; and would approximate the annuity charge; and
- for EL patterns that either have a constant growth rate or that change linearly over time the annuity can be determined using a closed form solution.

A22. Under the **simplified approach using three building blocks for EL**, the calculation is disaggregated into the following three building blocks:

- allocation of initial EL;
- an experience adjustment (ie the difference between actual cash flows/losses and the last estimate for the current period); and
- adjustment for changes in future expectations.

This approach uses EL as an indirect way of determining the amortised cost carrying amount and hence does *not* need any explicit, direct estimate of expected cash flows.

A23. We learnt that this simplified approach provides a good approximation for the following types of instruments:

- bullet loans and amortising loans;
- fixed and floating rate instruments; and
- changes in credit loss expectations and changes in forward rates.

A24. However, we also learnt that both of the above approaches would still require carrying forward historical information from the date of initial recognition (the initial EL), which is difficult for most systems (see paragraphs **Error! Reference source not found.** to **Error! Reference source not found.** below discussing ‘open portfolios’). Hence, any approach that involves retaining a link to the past, whether the initial cash flow estimate or the initial EL, amplifies the operational challenges. This would be particularly difficult in the context of transition requirements if those were to require reconstructing historical data.

A25. The EAP presented a prospective approach, dealing with expected loss without linking to past data, that would be more operationally expedient.