

IFRS 9 loan impairment

Comments to the supplementary document

Question 1

Do you believe the approach for recognition of impairment described in this supplementary document deals with this weakness (ie delayed recognition of expected credit losses)? If not, how do you believe the proposed model should be revised and why?

There are many situations in which the proposed model would result in earlier recognition of the expected credit losses.

However, **there are some situations in which the delay in recognition will not be remedied.** This includes the following circumstances:

- a significant change in the estimates or some unexpected (much different than expected) behavior of credit exposures (e.g. heavy downgrade of some material part of a portfolio) that
- either causes losses outside the foreseeable time horizon or concerns only a part of a portfolio for which the floor is significantly lower than impairment losses recognized on the portfolio using the linear approach.

The conditions presented in the first bullet regard the situations under which a loss (or a gain) incurred was actually unexpected at origination but the linear approach still intends to smooth them during the lifetime of exposures. This is a major difference to the result that would be obtained if the original IASB model was applied i.e. the changes in discounted cash flows were recognized immediately in the profit and loss account. The conditions presented in the second bullet focus on cases when the floor approach does not remedy this weakness of the linear approach. **In particular, it may be the case if the foreseeable time horizon for floor calculation will be only 1 year.**

These circumstances might cause additional problems during the period of downturn. Consider a situation in which, the estimates have just changed unfavorably, there will be no further changes in the estimates and the exposures will behave accordingly. It might happen that the expected increase in the impairment allowance will be higher than the gains on the portfolio causing shrinking value of the portfolio. In an exaggerated case, the current financial statement might look safe, but the institution might be expected to go bankrupt in some longer time horizon. As this expectation is already known, it should be reflected in the financial statement.

From this point of view, discounting future expected cash flows with an appropriate interest rate (in particular, including immediate recognition of changes in estimates in the profit and loss account) might be perceived as an ideal model with all other models judged upon the differences in results to the ideal model.

One more issue needs to be raised here. There might be a great difference between the following two situations:

1. The standards expects impairment allowances to be calculated as discounted future expected cash flows, but allows portfolio/statistical approaches and some approximations.
2. The standard explicitly defines the calculation algorithm that approximates the original approach (considered as too complex to be implemented directly).

The difference emerges in situations under which the approximation produces results inconsistent with the direct approach. If the approximation is developed by a financial institution, an auditor might question it. If the approximation is explicitly defined in the standard it cannot be rejected (even, as in the case of portfolio value expected to shrink in the future, it does not provide a fair view)

Question 2

Is the impairment model proposed in the supplementary document at least as operational for closed portfolios and other instruments as it is for open portfolios? Why or why not?

Although the supplementary document seeks views on whether the proposed approach is suitable for open portfolios, the boards welcome any comments on its suitability for single assets and closed portfolios and also comments on how important it is to have a single impairment approach for all relevant financial assets.

The proposed impairment model have a weakness of **producing different results depending on the decomposition** of the whole portfolio on parts in which it would be calculated. Therefore, when one open portfolio is considered as several closed ones (for which the same approach would apply), the total result might be much different.

The first reason is that the sum of maximums might be higher than the maximum of sums. The second reason is that the expected loss might be different for different vintages. Therefore if we for instance decompose a portfolio on 2 vintages, we might obtain different results when we first multiply the expected losses and relative ages and after that we add them. This is another weakness of the linear approach.

Question 3

Do you agree that for financial assets in the 'good book' *it is appropriate* to recognise the impairment allowance using the approach described above? Why or why not?

In addition to the weaknesses of the proportional approach that we indicated in answers to question 1 and question 2, I would like to emphasize that **a clarification is needed on the manner of calculation of the floor.**

The term 'expected loss during some (given) time horizon', in contrast to the term 'ultimate expected loss' could be understood in several ways. $PD \cdot LGD$, where PD is a probability of default (during the given time horizon) and LGD is the ultimate loss conditional on default event is one of the interpretations. If that was the intention, two additional elements might be worth considered in the definition of the expected loss.

The first one is the **downgrade risk** (the risk, that at the end of the foreseeable future the composition of the 'good book' asset might be different with respect to rating grades, days past due, etc. and therefore some changes in further expectations should be accounted for).

The second element concerns considering **expected net losses** (after taking into account expected gains). If an asset is expected to provide a positive return, what is the point in recognizing loss for it at origination?

However, the important question is how these expected losses during some (given) time horizon are to be calculated. They might be calculated as the difference between portfolio's current carrying amount (before considering the floor) and the sum of discounted future payments during the given time horizon and the portfolio's end of period net value discounted to the beginning of the period (recognized, if negative).

Such approach produces **zero floor at origination of an exposure** (assuming that new exposures are expected to bring profits) and therefore is consistent with an important IASB goal. However, it **recognizes excess losses when the most current forecast is less favourable than the original one** and therefore might address FASB downturn concern. In the proposed approach at the end of this paper the concept of floor is developed further.

I would like to point out that **the requirement of forecasting might be considered as the most important contribution of the floor to the main approach** (the main approach requires consideration of lifetime losses and therefore is likely to be calculated on long-term averages, perhaps with some adjustments for current situation, whereas the floor is expected to focus on a projection for a given time horizon). **If the concept of a floor is maintained in the final standard, I believe additional clarification is also needed that the floor should be based on the forecasts for the foreseeable time horizon rather than based on long-term averages of the historic behaviour of the portfolio.**

Question 6

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance clearly described? If not, how could it be described more clearly?

Question 7

Is the requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance operational and/or auditable? If no, how could it be made more operational and/or auditable?

Question 8

Do you agree with the proposed requirement to differentiate between the two groups (ie 'good book' and 'bad book') for the purpose of determining the impairment allowance? If not, what requirement would you propose and why?

There is a serious concern with respect to the **unclear definition coupled with financial incentive** (difference in modelling approach for 'good' and 'bad book') to 'appropriately interpret' it.

On the Polish market, due to recommendations given by the regulator, credit exposures are considered impaired, when there are overdue 90 (this is the only, or practically the only impairment indicator for retail loans; for corporate loans the other key indicator taken into account is the credit rating of the borrower) . However, even though the definition seems to be very clear, some of the financial institutions are very creative in making it more flexible in times of need. Their repayment schedule is modified; they are silently restructured in order to be considered as IBNR; they are processed in a way that allows disregarding them in the calculation of probability of revealing impairment indicator for other IBNR exposures. **If the differences are observed in practical application despite the clear guidance, what other approaches might be expected with much more flexible and interpretable definition?**

Therefore I would not differentiate rules for 'good book' and 'bad book'. They might be covered by different models, but the carrying value for both of them should have the same sense.

Question 14Z

Do you agree that the determination of the effective interest rate should be separate from the consideration of expected losses, as opposed to the original IASB proposal, which incorporates expected credit losses in the calculation of the effective interest rate? Why or why not?

I rather support the original concept of the IASB proposal. The motivation, as well as additional benefits of that approach is presented in the description of the proposed approach.

Proposed approach

Motivation

The original IASB proposal seems conceptually sound, but it required significant implementation effort. On the other hand, the linear approach that was proposed as a simplification of the original approach is affected by significant weaknesses. Therefore, the aim for the proposed approach was to obtain the final impairment model that satisfies the original goals of IASB and FASB to the greatest extent (actually it uses much of the already developed ideas), does not have weaknesses mentioned in the answers to the questions above and does not require evaluating all possible cash flow streams. The approach that might be potentially considered as a consensus for all the parties involved.

Actually, the core part of the model to be proposed might be considered from the theoretical point of view as consistent with the original IASB model. But different formulation of the rules allows different practical approaches, potentially making them more feasible. In particular, the problem of generating cash flow projections for the whole life of the portfolio taking into account credit risk and then discounting them with the credit adjusted interest rate is not required to be solved directly.

In this approach, the most important element is the final carrying amount that is obtained with less importance given to the steps that lead to it. In particular, there seem to be more important to obtain on a balance sheet date the carrying amount of each facility as the expected sum cash flows discounted with the credit-adjusted interest rate, than be able to on-going accrue interests on the carrying amount using the credit-adjusted interest rate (although the comparison of different portfolios by their credit-adjusted interest rates might be more valuable than the comparison by their original effective interest rates).

With respect to the floor issue, it is directly integrated into the approach (after some modifications), rather than producing a second number that sometimes might be higher than the first number. The modifications are expected to comprehensively recognize expected credit losses in case of unfavorably changing projections. However, in line with IASB's goal, it will not result in inconsistency of recognizing different carrying amount at origination than the initial, net cash flow.

Rules of the model

1. The future is divided into foreseeable future (for which an institution is directly expected to construct forecasts) and more distant one (for which an institution is constructing current expectations using long term averages). For each part of the future an institution is expected to construct a process (scenario possibilities) that will be followed by exposures and estimate its parameters (i.e. process assumptions).
2. Under the process assumptions taken with respect to the future behavior of each exposure, its carrying amount (after considering impairment allowance), for each possible state shall be equal to the total discounted value of expected cash flows in any given time horizon (e.g. month, quarter, year) and the carrying amount at the end of that time horizon.
3. The discounting shall be performed with a credit-adjusted interest rate calculated as such an interest rate that equals the value of an exposure at its origination with the net cash flow at that moment.
4. Optionally, the discounting rate might be linked with some market rate and change in line with it. Rule 3 might be used to calculate the new rate after assuming the net value of the exposure just before the change as the initial net cash flow.

Proposed approach to the model for the more distant future

1. The length of a single time step (e.g. one month) is assumed.
2. There are constructed some process assumptions reflecting expectations of future behavior of exposures in the single time step depending on their initial state. This assumptions needs to specify likelihood of each state at the end of the time step and potential cash flows that might occur during the time step. The degree to which the assumptions are derived using statistical methods is flexible (e.g. currently used Markov chains approaches might be utilized).
3. Each initial state is assigned a carrying amount that equals expected, discounted sum of cash flows during the time step and the carrying amount at the end of the time step.

Proposed approach to the model for the foreseeable future

4. Each exposure is assigned the carrying amount equal to the expected, discounted cash flows during the foreseeable future and the expected, discounted carrying amount that results from the possible states at the end of the foreseeable future and the model for the more distant future.
5. The rule in the above point might be implemented directly or using a state based model proposed for the more distant future (but assuming different process parameters).
6. At origination, the carrying amount is equal to the net cash flow to the borrower and the discounting interest rate (named credit-adjusted interest rate) is found that satisfies the condition set in point 4 with the beginning carrying amount.

Properties of the approach

1. If a portfolio behaves exactly as expected under the model, than it grows (if the cash flows are appropriately considered) at credit-adjusted interest rate. This property might be directly used in back-tests providing strong auditing tool. This might be also a valuable piece of information given to investors.
2. The model is consistent with the original IASB approach of using credit-adjusted interest rate.
3. There is no loss and no gain at origination.
4. It is expected to take into account projections for the foreseeable future. Therefore it might address FASB downturn concern.
5. The modifications of process assumptions, as well as observed migration of exposures states are directly impacting provisioning assessments and therefore satisfy the FASB requirement to recognize incurred losses immediately. Furthermore, at origination, an exposure might be considered as having some gross value equal to the discounted contractual payments (without considering credit risk) and initial impairment allowance equal to the difference between the gross value and the carrying amount. Such impairment allowance would be equal to the discounted value of the expected credit losses. It is a matter of presentation, but such distinction allows identification of potential gain if the exposure is repaid according to the schedule.
6. There is no 'good'/'bad book' distinction with respect to the impairment assessment rules (although financial institutions might distinguish good and bad states in the process assumptions).
7. If there is a need to recognize changing credit risk in time, it might be performed by distinguishing different exposures states or directly in the foreseeable future model. Consequently, the issue of exposures with significant different credit risk just after origination could be resolved.
8. The financial institutions are free to define and evaluate process assumptions and therefore to adjust them to the business. The analysis might be performed on individual level, as well as collectively. In the second case, there might be build statistical tests to assess the adequacy and the performance of given process assumptions.
9. Although the goal is to determine the credit-adjusted interest rate, in case of operational difficulties it might be sufficient to determine some portfolio average.