

Global Financial Crisis and Accounting Rules: The Implications of the New Exposure Draft (ED) “Financial Instruments: Expected Credit Losses” on the Evaluation of Banking Company Loans

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During the financial crisis, the delayed recognition of credit losses on loans and other financial instruments was identified as a weakness in existing incurred loss model of impairment stated by International Accounting Standards (IAS) 39, because it is believed that this delay might generate pro-cyclical effects. In response to the recommendations of G20, Financial Crisis Advisory Group (FCAG), and other international bodies, the International Accounting Standards Board (IASB) has undertaken, since 2009, as a part of the project to replace IAS 39, a project (partially shared with Financial Accounting Standards Board (FASB)) aimed at introducing an expected loss model of impairment. Within the scope of this subset project, the IASB has previously issued two exposure documents proposing models to account for expected credit losses: an exposure draft (ED) *Financial Instrument: Amortized Cost and Impairment*, published in November 2009, and a supplementary document (SD) *Financial Instrument: Impairment*, published jointly with the FASB in January 2011. However, neither of the two proposals received strong support from interested parties. Recently, the IASB, after the FASB's decision to withdraw from the joint project and to develop a separate expected credit loss model based on a single measurement approach consisting in the sole recognition of lifetime expected credit losses, published a third proposal—the so-called “expected credit losses” model (ED/2013/3 *Financial Instruments: Expected Credit Losses*).

Keywords: impairment, expected credit losses, International Accounting Standards (IAS) 39, financial instruments, global financial crisis, banking company loans, credit quality

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Introduction

The global financial crisis has drawn attention to the role of financial reporting in the banking industry during economic recessions. The debate developed after the onset of the crisis has focused mainly on the role of fair value accounting, considered by many to be one of the causes of the crisis or, at least, one of the factors that contributed to accentuating its severity (Boyer, 2007; Persaud, 2008; Plantin, Sapra, & Shin, 2008; Matherat, 2008; Allen & Carletti, 2008; Hellwig, 2009; Kothari & Lester, 2012)¹.

However, the greater part of the assets in the financial statements of banking companies is represented by loans that, for both United States Generally Accepted Accounting Principles (US GAAP) and International Financial Reporting Standards (IFRS), are not accounted for at fair value but at cost. Deterioration of credit quality of loans is recognized through loan loss provisions, by applying the impairment rules of the respective accounting regimes. Loan loss provisioning is a key element of financial reporting of banks (Gebhardt & Novotny-Farkas, 2011) that is often used, as many studies prove, as an instrument of implementation of earnings management policies (Ahmed, Takeda, & Thomas, 1999; Anandarajan, Hasan, & Lozano-Vivas, 2003; Anandarajan, Hasan, & McCarthy, 2007, among others)².

According to the current International Accounting Standards (IAS) 39 *Financial Instruments: Recognition and Measurement*, credit losses are recognized in accordance with the so-called “incurred loss model”, that is, when there is an objective evidence of impairment or when a credit loss is incurred³.

In the debate on the relationship between accounting and the financial crisis developed in the aftermath of the crisis, the incurred loss method has also been subjected to severe criticism, especially stigmatizing pro-cyclicality (Dugan, 2009)⁴. It is argued that only accounting write-downs attributable to circumstances already incurred at the reporting date, in times of positive cycles, there is an underestimation of losses and an overestimation of net interest income, while in downturns losses are emphasized, fuelling pro-cyclical effects⁵. The main element of concern arises from this, summed up in the expression “too little, too late”, according to which with the current model, there is a risk that the loan losses, particularly for those not deteriorated, are consistently inadequate in amount, recorded late, and unevenly distributed during the life of the loan⁶.

¹ The theory, though widely supported, is not shared by all. Among those who doubt that fair value accounting may have worsened the effects of the crisis, please see Veron (2008), Laux and Leuz (2009), Barth and Landsman (2010), and Pinnuck (2012).

² For the possible meanings that can be attributed to the expression “earnings management”, please refer to the wide and comprehensive overview carried out by Dechow and Skinner (2000).

³ Similar rules are provided by the US GAAP. Particularly, the Financial Accounting Standard (FAS) 5, *Accounting for Contingences*, refers to loans assessed collectively and FAS 114 *Accounting by Creditors for Impairment of a Loan*, as amended by FAS 118 *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosure—An Amendment of Financial Accounting Standards Board (FASB) Statement No. 114*, loans evaluated on an individual basis.

⁴ Pro-cyclicality can be alternatively defined as: (1) the reinforcing interaction within the financial sector and between the financial sector and the real economy, leading to unsustainable economic growth during in upturns and deep recession in downturns (Bank for International Settlements [BIS], 2008; Clement, 2010); (2) the tendency of banks to significantly ease their lending standards in the upturns and stiffen them in downturns; (3) all banking practices that reinforce the current phase of the economic cycle; and (4) the mechanism by which the business cycle, the financial cycle, and the cycle of risk-taking behaviour represented by fluctuations in asset prices move simultaneously in the same direction.

⁵ Athanasoglou and Daniilidis (2011), in their recent paper, have widely explored the different definitions of the term pro-cyclicality, clarified the main causes that make pro-cyclicality inherent to the financial sector, analyzed the pro-cyclical supply of and demand for bank loans, and also discussed the pro-cyclical behaviour of Basel II and accounting rules.

⁶ The pro-cyclicality of bank loan loss provisioning is well documented with cross-country data by several papers (Cavallo & Majnoni, 2001; Bikker & Hu, 2002; Leaven & Majnoni, 2003; Bikker & Metzmakers, 2005; Bouvatier & Lepetit, 2008; Pérez, Salas-Fumás, & Saurina, 2008; Gebhardt & Novotny-Farkas, 2011; in contrast, Handorf and Zhu (2006) found a positive correlation between provisions and concurrent gross domestic product (GDP) changes and argued that their “empirical tests do not support the claim that bank loan loss provisioning is pro-cyclical”). The papers which demonstrate the pro-cyclicality of bank loan loss provisioning have generally one feature in common: They use the model traditionally employed, mainly by US researchers (Greenawalt & Sinkey, 1988; Collins, Shackelford, & Wahlen, 1995; Beatty, Ke, & Petroni, 2002; Kanagaretnam, Lobo, & Mathieu, 2003; Liu & Ryan, 2006), to test income smoothing hypothesis (Olszak, 2012). Income smoothing, as is known, is an example of earnings management to reduce the volatility of banks’ profits (Wall and Koch (2000) analyzed possible consequences of this strategy).

Precisely because of this widespread concern, the “Report of the Financial Stability Forum on Addressing Pro-cyclicality in the Financial System” issued by the Financial Stability Forum (FSF), now the Financial Stability Board, in April 2009, in response to the global financial crisis, identified among the main priorities of political action the revision of bank’s impairment rules and recommended FASB and the International Accounting Standards Board (IASB) to identify a common pattern that would be linked to an expected loss concept and allow a more timely recognition of credit losses (FSF, 2009).

Similar suggestions were made by the Financial Crisis Advisory Group (FCAG) which, in July 2009, in pointing out to the two most important international standard setters the first area of intervention for the improvement of existing accounting standards imposed by the global crisis, had strongly recommended to explore alternatives to the incurred loss model that would use more forward-looking information (FCAG, 2009).

In response to these requests, in November 2009, as part of the broader project of replacement of IAS 39, the IASB published an exposure draft (ED)/2009/12 *Financial Instruments: Amortized Cost and Impairment* (IASB, 2009) and the FASB, in May 2010, also in this case as part of a broader approach aimed at the replacement of all the accounting rules laid down in the US GAAP with regard to financial instruments, issued an ED *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (FASB, 2010).

The criticism, often very severe, received by the two boards in relation to the first two individual proposals and the increasing demands of interested parties and political, accounting, and supervisory bodies to achieve a common solution, had led the IASB and the FASB to undertake a joint process resulted in the supplementary document (SD) *Financial Instruments: Impairment*, published in January 2011 (IASB/FASB, 2011).

Even the common proposal did not receive strong support to the extent that it induced the two boards to immediately start a stage of revision of the document, in an attempt to reach the desired shared solution. Once this quick review was completed in June 2011, the two boards decided to develop a new model: the so-called “three-bucket approach”, in which the expected losses, recognized since the initial recognition of the credit, should have reflected the deterioration of credit quality.

In August 2012, when the three-bucket approach was already defined in all its fundamental aspects and ready to merge into a new ED, the FASB, unexpectedly and due to the significant concerns expressed by its constituents in terms of complexity and comprehensibility of this proposal, announced its intention to withdraw from the joint table and began exploring an alternative model, still based on expected losses, but without any distinction on the level of credit deterioration. In December 2012, the FASB issued, separately, the new ED *Financial Instruments: Credit Losses* (FASB, 2012).

The IASB, following the decision by the FASB, promptly conducted outreach in order to understand to what extent was it still appropriate to continue to develop the three-bucket approach. From this survey, it was found that although the three-bucket approach was a difficult model to implement, it was necessary that a model based on expected losses distinguishes those financial assets that have deteriorated in credit quality from those that have not. On the basis of these indications, in March 2013, the IASB published the new ED/2013/3 *Financial Instruments: Expected Credit Losses* (IASB, 2013) in which a model similar to the three-bucket approach is proposed, but clearer and easier to apply, at least in intention.

After having recalled the characteristics of the incurred loss model, the objective of this research is to analyze the steps of the process of replacement of the current impairment model and to highlight main features and critical aspects of the new model proposed by the IASB.

The Current Incurred Loss Approach and the Bank Regulation

According to the current IAS 39, at the end of each reporting period, it is necessary to assess whether there is any objective evidence that a financial asset or a group of financial assets is impaired. This test must be carried out with reference to all loans, including those that apparently show no sign of deterioration in terms of credit quality (IAS 39.58, IAS 39.AG85).

In principle, a financial asset or a group of financial assets (except those carried at fair value through profit or loss (FVTPL)) is impaired and impairment losses are incurred if, and only if, there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset (a “loss event”) and that loss event (or events) has an impact on the estimated future cash flows of the financial asset(s) that can be reliably estimated (IAS 39.59)⁷.

As a result, the assessment of the loans is based on the experiences of past losses or current events but not yet considered by the company in the estimate of the degree of credit risk. Expected losses as a result of events expected to occur after the reporting date may not be recognized. Further, general loan loss provisions for unspecified credit risks are not accepted under IAS 39 rules. In particular, the implementation guidance of IAS 39 clarifies that:

Amounts that an entity might want to set aside for additional possible impairment in financial assets, such as reserves that cannot be supported by objective evidence about impairment, are not recognized as impairment or bad debts losses under IAS 39 (IAS 39.IG.E.4.6).

The impairment for financial assets carried at amortized cost, such as loans, may be measured and recognized individually or, for a group of similar financial assets, on a portfolio basis.

Impairment on an individual basis is required by the IAS 39: (1) for loans that are individually significant; (2) for loans, even if not significant, for which there is, individually, objective evidence of impairment; and (3) for loans already subjected to impairment whose conditions are still in existence. For these financial assets, the loss is measured as the difference between the asset’s carrying amount and the present value, at the original effective interest rate, of all the financial cash flows that are expected to be collected from the same, considering the implications of any collateral, but excluding the expected losses that have not yet been realized (IAS 39.63).

A reversal of a previously recognized impairment is permitted, when there is clear evidence that the reversal occurred subsequent to the initial impairment recognition, and it is the result of a discrete event, such as the improved credit rating of the debtor. However, the amount of recovery recognition is limited, so that the new carrying value of the asset is not greater than what its carrying value would have been had the impairment not occurred, adjusted for any amortization over the intervening period (Epstein & Jermakowicz, 2010; IAS 39.65).

If no objective evidence of impairment exists for individually assessed loan, whether significant or not, the loan is included in a group of loans with similar credit characteristics and collectively assessed for impairment.

⁷ Objective evidence that a financial asset or a group of financial assets is impaired includes the following loss events: (1) significant financial difficulty of the issuer or obligor; (2) breach of contract, such as a default or delinquency in interest or principal payments; (3) the lender, for economic or legal reasons relating to the borrower’s financial difficulty, granting the borrower special concessions; (4) existence of the probability that the borrower will enter bankruptcy or other financial reorganisation; (5) the disappearance of an active market for that financial asset because of financial difficulties; and (6) observable data indicating a significant decrease in the estimated future cash flows expected for a group of financial assets since the initial recognition, although the loss of value cannot yet be attributed to individual assets in the group.

Loans that are individually assessed for impairment and for which an impairment loss is or continues to be recognized are not consistent with a collective assessment of impairment⁸.

The collective assessment requires that credits are grouped on the basis of similar credit risk characteristics, for example, on the basis of a credit risk evaluation or grading process that considers asset type, industry, geographical location, collateral type, past-due status, and other factors revealing the debtors' ability to pay all amounts due according to the contractual terms (to develop comprehensible synergies, the collection into homogeneous groups is often carried out using methods similar to those required by "Basel II").

The estimate of future cash flows in a group of loans that are collectively evaluated for impairment must be based on the historical loss experience for loans with credit risk characteristics similar to those in the group. If there is no specific information available derived from previous experience or the data available are not sufficient, peer group experience for comparable groups of loans may be used. In any event, the historical experience must be constantly adjusted on the basis of observable data in order to: (1) reflect the effects of current conditions that did not affect the period on which the historical experience is based; and (2) eliminate the effects of conditions in previous years that have influenced historical experience, but that no longer exist at the time of assessment (IAS 39.AG89).

To determine impairment losses in a group of loans, IAS 39 does not provide specific guidance. Any formula-based approach or statistical method that does not require recognition of losses at inception is acceptable, provided that it incorporates the effect of the time value of money and considers the cash flows for all of the remaining life of loans included in the portfolio (not only the next year) and the age of the loans within the portfolio. Even for the collective assessment, therefore, the recognition of impairment losses does not include expected losses related to future events (IAS 39.AG92)⁹.

The current measurement approach in IAS 39 differs significantly from the rules governing loan loss provisioning stated in the Basel regulatory framework.

In prudential regulation, expected losses are defined as the ratio of the amount expected to be lost on an exposure from a potential default of a counterparty or dilution (i.e., the risk that an amount receivable is reduced through cash or non-cash credits to the obligor) over a 1-year period to the amount outstanding at default. Basel II, the new capital adequacy framework, clarifies that the purpose of regulatory capital is to cover unexpected losses only, and under Basel III, it will be the same. Expected losses should be covered by individual and general loan loss provisions. In case the accounting provisions are estimated to be too low (or too high), a correction is done to regulatory capital. Thus, in order to determine if the accounting provisions are sufficient, a separate regulatory calculation of expected losses is required.

According to Basel II, banks using the internal ratings-based (IRB) approach (typically large or more complex banks) calculate expected losses for a 1-year period as the product of the probability of default (PD) and the loss given default (LGD). Particularly, the amount of expected losses is determined by applying the product of PD with LGD to the exposure at default (EAD), which gives an estimate of the amount outstanding in case the borrower defaults, considering, if appropriate, a maturity adjustment (M). Depending on the

⁸ IAS 39 requires that if an asset has been individually assessed for impairment and was found not to be individually impaired, it should be included in the collective assessment of impairment. However, some argue that if an analytical assessment performed while having access to all relevant information does not show evidence of impairment, it should not be necessary to insert the loan into a collective assessment (Ernst & Young, 2007).

⁹ Rules similar to those illustrated so far are stated by FAS 5 and FAS 114, respectively, for loans assessed on a collective basis and for those assessed on an individual basis.

application of the foundation IRB approach or the advanced IRB approach, expected losses are calculated by using, respectively, internally determined inputs of PD and inputs fixed by regulators of LGD, EAD, and M or only internally determined inputs (subjected to approval by regulators) of PD, LGD, EAD, and M (Basel Committee On Banking Supervision [BCBS], 2005, 2006). For banks using the standardized approach (typically smaller, less complex banks), Basel II does not require a specific method to determine expected losses, thus in regulatory field, loan loss provisions recognized at profit or loss are considered (Erzegovesi & Bee, 2008; Risaliti, 2012).

Under the IRB approach, banks are required to fully cover expected losses with loan loss provisions. In case there are insufficient provisions foreseen (a shortfall), IRB banks need to deduct the difference from their own funds. Under Basel II, any shortfall is deducted 50% from Tier 1 and 50% from Tier 2 capital. Under Basel III and the Capital Requirements Directive IV, the shortfall needs to be deducted entirely from Common Equity Tier 1 (BCBS, 2011). However, banks using the standardized approach still have the opportunity to include general loss provisions as part of their Tier 2 capital. Thus, for banks applying the standardized approach, the capital regulation does not change the regulatory treatment of loan loss provisions.

Given their focus on financial stability, bank regulators prefer forward-looking provisioning that covers all expected loan losses. Thus, the IAS 39 incurred loss approach is in conflict with regulatory objectives because, generally, it understates expected losses (Gebhardt & Novotny-Farkas, 2011)¹⁰.

For this reason, it would be appropriate that the new impairment model that will feed in IFRS 9 would allow not only overcoming the pro-cyclical effects of incurred loss approach, but also a greater convergence with the regulatory rule.

The Stages of the Credit Impairment Project

The First Proposal: The “Expected Cash Flow Model”

In April 2009, the IASB and the FASB announced their timetables for replacing their respective financial instrument standards. In setting these timetables, the boards considered the views and information that they had received as a result of their work when responding to global financial crisis, the G20 leaders’ conclusions and the recommendations of other international bodies such as the Financial Stability Board.

Especially, the IASB decided to replace IAS 39 and divided the project into several phases. This paper sets out the proposals of the IASB’s second phase of the project: the impairment of financial instruments.

Consistent with the recommendations from the international bodies and the FCAG, the purpose of this second phase was to identify methods of impairment of financial assets alternative to the incurred loss model, which would use information relating to future events in view of the definition of an expected loss model.

From this perspective, the IASB, independently, developed the first proposal, which merged into the ED/2009/12 *Financial Instruments: Amortized Cost and Impairment* (the “2009 ED”), called the “expected cash flow model”. The 2009 ED proposed to underpin the objective of amortized cost measurement with measurement principles, by requiring an entity to measure a financial asset at amortized cost, such as a loan, at the present value of expected cash flows discounted at the credit-adjusted effective interest rate. More precisely, the main features of that proposal were:

- (1) Amortized cost had to be calculated using the effective interest method. Hence, amortized cost was the

¹⁰ The intersection between Basel II and IFRS is analyzed by Borio and Lowe (2001), Benston and Wall (2005), PricewaterhouseCoopers (2006), Cluse, Jörg, and Lellmann (2005), Grünberger (2007), and Leitner (2005).

present value of the expected cash flows over the remaining life of the loan or other financial instruments discounted using the effective interest rate;

(2) The estimates of cash flows were expected values at each measurement date determined on the basis of probability-weighted possible outcome. As a result, changes in expected cash flows caused modifications in expected credit losses (catch-up adjustment);

(3) The effective interest method was the allocation mechanism for interest revenue and interest expense.

The expected cash flow model allowed some improvements compared with IAS 39. It used more forward-looking information and also resulted in an earlier recognition of credit losses, because it avoided the delay resulting from the loss event threshold of the incurred loss model.

Although, in the IASB's view, the 2009 ED model is the most faithful representation of the expected losses, comments received on that proposal and during outreach indicated support for the concept of such a model, but highlighted the operational difficulties of applying it. In particular, it seemed overly complex, costly to implement, applicable only to closed portfolios or individual loans, and especially unfit to reduce pro-cyclicality. In effect, the mechanism of catch-up adjustment, sensitive to the expectations of recovery of the loans made by management, would have resulted in a measurement of loans much closer to fair value than to the amortized cost, which could result in high volatility in the income statement.

In May 2010, the FASB published a proposed accounting standards update *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* that included proposals for impairment as part of its comprehensive approach to replace the accounting requirements for financial instruments in US GAAP. The FASB's objective for credit impairment was to ensure that the loss allowance reflected all estimated credit losses for the remaining life of the instrument. To accomplish this objective, the FASB proposed that: (1) An entity should recognize credit impairment when it does not expect to collect all contractual amounts due; (2) Credit losses would not need to be considered as "probable" to be recognized; and (3) Interest income should be recognized by applying the effective interest rate to the amortized cost basis, net of any loss allowance. In this way, the "too little, too late" concern was solved: The initial and immediate provision of all expected losses would guarantee coverage of credit losses irrespective of the time of their occurrence.

Many respondents to the FASB's 2010 proposal agreed with the recognition of the entire credit losses in the estimated period and the elimination of the current probability threshold for recognizing credit losses. While most stakeholders supported the objective of having a single impairment model, some asserted that the proposal should retain three different impairment models (that is, one for pools, one for individual assets, and one for purchased assets). Finally, stakeholders (including users of financial statements) generally opposed the proposal that interest income should be recognized by applying the effective interest rate to the amortized cost basis net of any loss allowance, preferring instead to maintain the approach in existing US GAAP that measures interest income and credit losses separately.

The IASB/FASB Joint Proposal: "Good Book" vs. "Bad Book"

As a result of the criticism received and of the widespread demand to achieve a common outcome for impairment accounting, the IASB and the FASB, in January 2011, published jointly the *SD Financial Instruments: Impairment*.

The main feature of this proposal was the classification of loans and other financial assets into two groups:

the “good book” where loans and other financial assets had to be allocated for which recognition of lifetime expected credit losses over time was appropriate; and the “bad book” where loans and other financial assets had to be allocated for which the immediate recognition of lifetime expected credit losses was appropriate.

Particularly, the loss allowance for the “good book” would have been calculated at the greater of:

- (1) A time proportionate loss allowance (the IASB’s preferred approach)¹¹;
- (2) Expected credit losses for the foreseeable future, which would be not less than 12 months, i.e., a “floor” for expected credit losses (the FASB’s preferred approach).

The “expected credit losses for the foreseeable future” represented a lower limit (floor) of losses. The idea was to avoid that the total amount of provisions, especially in a positive cycle, was too low and that the risk of loss for those portfolios that exhibited higher rates of default in the first years of their existence was adequately faced.

The transfer of credit from the “good book” to the “bad book” determined the immediate recognition in the income statement of the entire amount of the remaining expected losses related to that exposure, more precisely, a proportion of the portfolio “good book” calculated on the basis of seniority of the transferred assets had to be transferred to the portfolio “bad book”.

The proposal met the objectives of the two boards, because on the one hand, it maintained the objective of the IASB’s gradual allocation of expected losses over the life of the portfolio, thus preventing the immediate and full recognition; on the other hand, with the introduction of a minimum level of provision related to estimated losses for the foreseeable future, meeting the needs of the FASB to put a limit to the “too little, too late” recognition of losses on portfolios of performing loans.

The proposed model showed also a concrete attempt to overcome the problem of pro-cyclicality and volatility in the income statement. The minimum level of provision attenuated the problem of untimely and insufficient recognition of impairment losses, limiting, therefore, the overestimation of the interest margin in the expansionary phase of the business cycle, while in downturns, the major write-downs would concern only the credits transferred to the “bad book”, because for performing loans, the gradual allocation of expected losses would have continued.

Moreover, under this model, the basis of assessment was the credit quality at a specific point in time, and this assessment was consistent with the current credit risk management systems. Thus, compared with alternative models, the SD would not have required entities to assess the deterioration of quality credit since initial recognition, and it would have been sufficient to state when an asset should be in a “bad book”.

The “Three-Bucket Approach” and the FASB’s Current Expected Credit Loss (CECL)

Overall, the boards did not receive strong support for the proposal in the SD. The major concerns were related to dual calculation which seemed to be operationally complex, lacking conceptual merit and providing confusing information to users of financial statements (IASB, 2013). Moreover, the three options for the implementation of the time-proportional approach and the discretion in the identification of the discount rate to be applied in the determination of expected losses (applying the discounted straight-line approach and the

¹¹ The portion of the losses could be determined (according to the IASB, but not according to the FASB), alternatively: (1) by multiplying the entire amount of credit losses expected for the remaining life of the portfolio by the ratio of the portfolio’s age to its expected life (i.e., a straight-line approach using either a discounted or undiscounted estimate); or (2) by converting the entire amount of the credit losses expected for the remaining life of the portfolio into annuities on the basis of the expected life of the portfolio and accumulating these annuities for the portfolio’s age (i.e., an annuity approach, which by definition, uses a discounted estimate).

annuity approach) had raised serious misgivings¹².

The importance of achieving convergence forced boards to jointly develop a different solution. In this context, in May 2011, the boards announced their intention to develop a new model, which would reflect the general pattern of deterioration in the credit quality, the so-called “three-bucket approach”. The activity carried out by the joint working group led, in July 2012, to a general framework of the new model.

This approach was based on the distinction of financial assets no longer into two, but into three categories to which were related increasing risks and, therefore, provisions for losses. The breakdown of the portfolio into three categories should have, on the one hand, brought the model closer to the risk management policies adopted by banks, which normally measured the level of credit risk in a continuous and non-binary manner, and on the other hand, mitigated the so-called cliff effect, i.e., the recognition at profit or loss of higher provisions attributable to a sudden change in the credit quality.

At initial recognition, all loans had to be placed in Bucket 1 and be transferred, as appropriate, to one of the other two categories when credit quality deteriorated (“general deterioration approach”), with the sole exception of purchased or originated credit impaired financial assets which had to be classified, according to their specific characteristics, directly in Bucket 2 or Bucket 3.

The occurrence of a “not insignificant deterioration in credit quality” with respect to its initial recognition and a PD that was “at least reasonably possible” that the expected cash flows on the contract could not be fully collected were the conditions which determined the transfer of a credit (or a group of credits) from Bucket 1 into one of the other two (the so-called “transfer criteria”). In particular, Bucket 2 was intended to accept impaired loans assessed on a portfolio basis, and Bucket 3 was intended to accept impaired loans assessed on an individual basis.

Of course, the classification of the loan was on the basis of different criteria for determining expected losses—This was the distinctive feature of the three-bucket approach. As for loans classified in Bucket 1, the provision had to reflect expected losses over the next 12 months, for loans classified in Buckets 2 and 3, the provision had to reflect the expected losses for the entire remaining life of the loans themselves.

Although the general framework of the three-bucket model, as a result of the joint effort of the boards, was defined, in August 2012, the FASB, due to the significant concerns expressed by its constituents in terms of understandability, operability, and audit ability of this approach, unexpectedly decided to independently explore an alternative model that did not include a dual-measurement approach and reflected all credit risks in the portfolio at each reporting date.

Following this decision, in December 2012, the FASB updated its proposed accounting standards which set forth a CECL model (FASB, 2012). The CECL model uses a single “expected credit loss” measurement objective for the allowance for credit loss. Under this model, the allowance for expected credit losses would reflect management’s current estimate of the contractual cash flows that the company does not expect to collect, based on its assessment of credit risk as of the reporting date—the estimate would be neither a “worst case” nor a “best case” scenario, and it would never be limited to losses expected over a specific period of time (as was the case with Bucket 1, measured under the three-bucket impairment model). This model removes the “transfer

¹² Among the various criticisms, particularly severe were those of European Financial Reporting Advisory Group (EFRAG), contained in the letter of comment to SD, sent on April 8, 2011 to the IASB, retrieved from <http://www.efrag.org/files/EFrag%20Output/EFrag%20comment%20letter%20on%20the%20IASB%20SD%20Impairment.Pdf>.

criteria” trigger in the three-bucket model that stakeholders indicated was inoperable and might inhibit the timely recognition of credit losses.

Using the CECL model, the credit deterioration (or improvement) reflected in the income statement would include changes in the estimate of expected credit losses resulting from, but not limited to: (1) changes in the credit risk of assets held by the institution; (2) changes in conditions since the previous reporting date; and (3) changes in reasonable and supportable forecasts about the future. The balance sheet would reflect the current estimate of expected credit losses at the reporting date and the income statement would reflect the effects of credit deterioration (or improvement) that has taken place during the period¹³.

The key difference between the three-bucket model and the CECL model is quite evident. It arises when the remaining life of the asset is greater than 12 months, and a loss event is not expected to occur in the next 12 months. The three-bucket impairment model would defer the full recognition of an allowance for the expected credit loss until the “transfer criteria” trigger is met. Conversely, the CECL model requires the recognition of full expected credit losses at each reporting date, even if the loss event is expected to occur beyond 12 months.

The Latest IASB’s Proposal: The Expected Credit Losses Model

Background, Scope, and Key Features

As a consequence of the July 2012 FASB’s decision to withdraw from the joint project, the IASB conducted outreach to understand whether it should continue to develop the three-bucket approach. Overall, the majority of participants in the IASB’s outreach supported a model that distinguishes loan loss provisioning of loans and other financial instruments that have deteriorated in credit quality from those that have not. As a result, the IASB decided to carry out a model similar to the three-bucket approach with some simplifications based on the issues that it had received.

Particularly, the IASB decided to pursue a dual-measurement model under which an entity must recognize: (1) a portion of the lifetime expected credit losses from initial recognition as a proxy for recognizing the initial credit losses over the life of the financial asset; and (2) the lifetime expected credit losses when credit quality has deteriorated since initial recognition. Thus, in the IASB’s view, unlike the opinions of some interested parties, (full) lifetime expected credit losses since initial recognition should not be recognized.

The new proposal (the “expected credit losses model”) in the ED/2013/3 *Financial Instruments: Expected Credit Losses* (the “2013 ED” or the “ED”) reflects the IASB’s view for depicting expected credit losses, namely that: (1) When an entity prices a loan or other financial instruments, part of the yield, the credit risk premium, compensates the entity for the initial expected credit losses, consequently, no economic loss is suffered at initial recognition, simply because a financial instrument has a lower credit quality at that time, since those expected credit losses are implicit in the initial pricing of the instrument; and (2) An entity considers those credits that are expected at initial recognition when pricing the financial instrument and subsequent changes in expected

¹³ In the FASB’s view, all expected credit losses have to be recognized at initial recognition, because: (1) There is a fundamental disconnection between the economics of lending and a time-based accounting approach that attempts to link the recognition of expected credit losses at initial recognition with the recognition of interest revenue; (2) It is impractical (if not impossible) to reliably isolate and measure the portion of the credit spread that is intended to compensate the lender for undertaking the credit risk; (3) The evaluation of the creditworthiness that influences pricing is based on historical experience for groups of similar assets, the credit spread on any individual asset is not necessarily established in a way that compensates the lender for expected credit losses on that particular asset; and (4) The amortized cost amount of a financial asset should reflect the present value of the cash flows that are expected to be collected, discounted at the original effective interest rate (i.e., a rate that is not adjusted for initial expected credit losses).

losses that are not reflected in pricing adjustments are economic losses in the period in which they occur (2013 ED, BC19).

The expected credit losses model would apply to the following instruments not accounted for at FVTPL under IFRS 9 *Financial Instruments*:

(1) Loans and other financial assets measured at amortized cost under IFRS 9 or mandatorily measured at fair value through other comprehensive income (FVOCI) under ED/2012/4 *Classification and Measurement: Limited Amendments to IFRS 9* (the “C&M ED”)¹⁴;

(2) Loan commitments where there is a present contractual obligation to extend credit;

(3) Financial guarantees within the scope of IFRS 9;

(4) Lease receivables within the scope of IAS 17 Lease (or leases accounted for in accordance with the tentative decision in the IASB’s lease project).

The scope of the 2013 ED enables some observations. Under the current IAS 39, there are several impairment models for different financial assets (amortized cost assets, available for sale debt instrument, available for sale equity instruments) and, in addition, losses related to loan commitments and financial guarantees are generally accounted for under IAS 37 *Provisions, Contingent Liabilities, and Contingent Assets*. This has created complexity, many practical issues and forced banks to typically separate accounting and credit risk management systems. A single set of impairment requirements for all financial assets, loan commitments, and financial guarantees within the scope of IFRS 9 (that are not accounted for at FVTPL) reduces a significant source of complexity for entities and may align requirements more closely with the way entities manage their credit risks (2013 ED, BC55).

The key features of the proposed expected credit losses model could be summarized in Figure 1 which illustrates the measurement basis for credit loss allowance related to the different types of financial instruments.

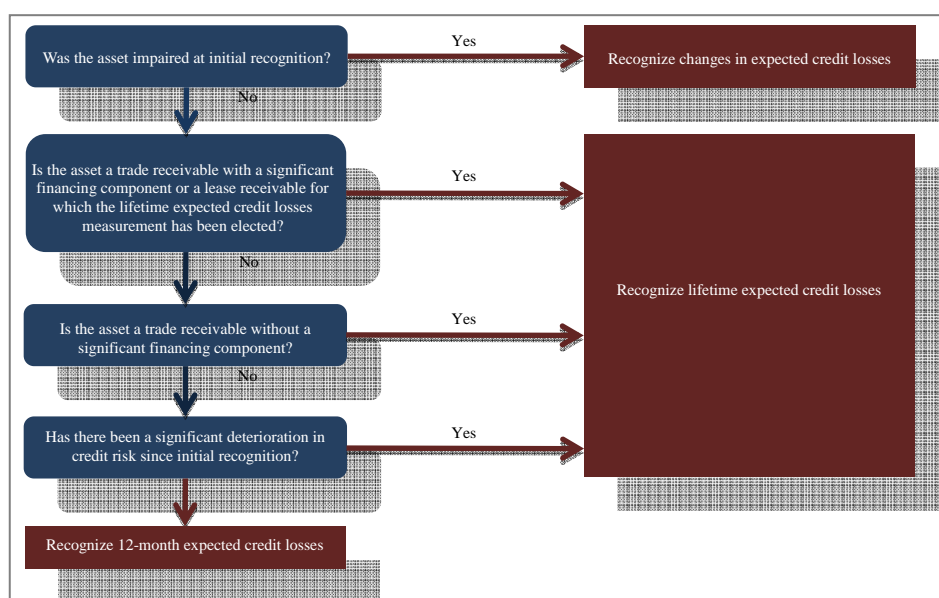


Figure 1. Flow chart—Key features. Source: Klynveld Peat Marwick Goerdel [KPMG] (2013).

¹⁴ The C&M ED, issued in November 2012 by the IASB, introduced a mandatorily FVOCI measurement category for particular financial assets that are solely payments of principal and interest. The objective of that measurement category is to disaggregate changes in fair value recognising interest revenue and gains or losses arising from changes in expected credit losses or from derecognition of the financial asset in profit or loss and the other changes in other comprehensive income.

As above mentioned, the 2013 ED refers not only to the impairment of credit, however in the following paragraphs, consistent with the purpose of this article, the authors generally refer to loans instead of to all financial instruments within the scope of the 2013 ED.

The General Approach

Overview

The 2013 ED proposes a general model under which an entity is required to recognize:

(1) A loss allowance or provision at an amount equaling to 12-month expected credit losses if a loan does not meet the lifetime expected loss criterion at the reporting date;

(2) A loss allowance or provision at an amount equaling to lifetime expected credit losses if the credit risk of the loan has increased significantly since initial recognition unless the credit risk is low (2013 ED, 4-6).

More specifically, the general model consists of the following three stages, which differ from each other for expected credit losses accounting, financial assets, and calculation and presentation of interest revenue:

(1) Stage 1: Involves loans that have not deteriorated significantly in credit quality since initial recognition or loans that have low credit risk at the reporting date. For these items, 12-month expected losses are recognized and interest revenue is calculated on the gross carrying amount of the asset;

(2) Stage 2: Involves loans that have deteriorated significantly in credit quality since initial recognition (unless they have low credit risk at the reporting date) but that do not have objective evidence of a credit loss event. For these items, lifetime expected credit losses are recognized but interest revenue is still calculated on the gross carrying amount of the asset;

(3) Stage 3: Involves loans that have objective evidence of impairment at the reporting date. For these items, lifetime expected credit losses are recognized and interest revenue is calculated on the net carrying amount (amortized cost reduced for expected credit losses).

The recognition of impairment (and interest revenue) under the general approach could be summarized in Table 1.

Table 1

Recognition of Impairment and Interest Revenue

Stage	1	2	3
Recognition of expected losses	12-month expected credit losses	Lifetime expected credit losses	
Interest revenue	Effective interest on gross carrying amount		Effective interest on net carrying amount

Twelve-Month Expected Credit Losses and Lifetime Expected Credit Losses

At each reporting date, an entity shall measure the expected credit losses at an amount equaling to the 12-month expected credit losses, unless the requirements for recognizing lifetime expected credit losses are met (2013 ED, 4).

To address concerns raised about the ambiguity of “foreseeable future” concept in the SD, the 2013 ED defines the 12-month expected credit losses as the lifetime cash shortfalls that will result if a default¹⁵ occurs in the 12 months after the reporting date, weighted by the PD occurring (2013 ED, Appendix A). Thus, the 12-month expected credit losses are a portion of the lifetime expected credit losses, which, in contrast, are

¹⁵ The 2013 ED does not define the term “default”, so an entity can use different definitions of default including, where applicable, regulatory definitions of default. The IASB observes that it does not expect that the expected credit losses would change as a result of a difference in the definition of default because of the counterbalancing interaction between: (1) the way in which an entity defines default; and (2) the credit losses that arise given that definition (2013 ED, BC97).

defined as the expected credit losses that result from all possible default events over the life of the loans (2013 ED, Appendix A).

However, the 12-month expected credit losses are neither the expected cash shortfalls over the next 12 months nor the credit losses on only those loans that are forecast to default in the next 12 months (in fact, if a default is expected in the next 12 months, it means that the credit quality has deteriorated significantly, since the loan would be in Stage 2 and lifetime expected credit losses would be required to be recognized) (Binder Dijker Otte [BDO], 2013).

In the IASB's view, the 12-month expected credit losses concept, combined with the earlier recognition of the full lifetime expected credit losses, would achieve an appropriate balance between the benefit of a faithful representation of expected credit losses and the operational cost and complexity. In fact, even if there is no conceptual justification for the 12-month horizon (as IASB knows), 12-month expected credit losses are similar to some prudential regulatory requirements for the 12-month PD, thus the expected credit losses model would be less costly to implement (2013 ED, 61-62). However, entities that have already applied a 12-month expected loss concept for regulatory rules will have to assess any difference between the regulatory measurement of the PD and the new proposed requirements (2013 ED, 64)¹⁶.

Timing of the Recognition of Lifetime Expected Credit Losses

An entity measures the loss allowance (or provision)¹⁷ at an amount equaling to lifetime expected credit losses if, at the reporting date, the credit risk "has increased significantly since initial recognition", unless the credit risk is low (2013 ED, 5)¹⁸. In making this assessment, the change in the PD¹⁹ is used, rather than changes in the total amount of the loss if the default were to occur²⁰. Especially, an entity is required to compare the PD occurring over the remaining life of the loan as at the reporting date with the PD occurring on the loan over its remaining life at initial recognition (2013 ED, 8). However, because of the difficulty in estimating lifetime PD, the use of the 12-month PD is also permitted if the information considered does not suggest that the outcome would differ (2013 ED, B11). This opportunity could be useful, especially in order to reduce the cost of implementation of the new impairment model, given that the 12-month PD is commonly used in prudential regulatory requirements (such as Basel II and Basel III).

The PD occurring is a measurement of the credit quality of the loan that does not require a full estimation of the expected credit losses. In the IASB's view, and not only, this would result in a relevant practical simplification, because using the PD as a measure of credit risk would be less costly to track than tracking of the initial expected losses and the measurement of the subsequent changes in expected credit losses.

¹⁶ For example, regulatory rules might require the expected credit losses to reflect downturn LGD values that are the worst case figures, whereas the 2013 ED requires an estimate based on actual expectations at the end of the reporting period (BDO, 2013).

¹⁷ The expected credit losses are usually recognized as loss allowance except for loan commitments and financial guarantees for which expected credit losses are recognized as a provision, because for these instruments, there is no corresponding asset with which to refer the loss allowance (2013 ED, BC136).

¹⁸ The assessment of whether there has been a significant increase in credit risk is based on an increase in the PD without referring to evidence of an actual default or objective evidence of impairment. This is a relevant difference with respect to IAS 39.

¹⁹ The impairment model proposed is based on a relative assessment of the credit quality. An absolute assessment of the credit quality at each reporting date would be easier to apply and more closely aligned with the risk management process. The IASB considered that alternative concept, however, it concluded that such an approach would not approximate the economic effect of initial credit loss expectations and the subsequent changes in expectations and that it would be difficult (if any impossible) to define a unique threshold for all types of financial instruments (2013 ED, BC61, BC74).

²⁰ So changes in LGD would not be considered in the assessment whether the credit risk is increased significantly since initial recognition, instead, the LGD would be incorporated in the measurement of expected credit losses.

However, the change in credit risk cannot be assessed simply by comparing the change in the absolute PD occurring over time²¹. The term of the loan and the initial credit quality shall also be considered. The failure to consider these two aspects would lead to systematically advantaging short-term loan with low level of risk, penalizing those with long-term structure and high level of risk²².

To assess whether there has been a significant increase in credit risk, an entity would consider the best information available (2013 ED, B20). In some cases, qualitative and non-statistical information may be sufficient, in the sense that it will not be necessary to flow through to a statistical model or credit ratings process to determine the change in the credit risk of the loan. In other cases, a statistical model or credit ratings process may be used. Alternatively, the use of both qualitative factors and specific internal rating category is allowed. This flexibility would appear to allow entities to use both sophisticated and simpler information, depending on the complexity of the risk management process used. Consequently, the timing of recognition of lifetime expected losses depends not only on the entity's definition of significant increase in credit risk, but also on the sophistication of its systems and processes (KPMG, 2013). However, to simplify the assessment whether a significant increase in credit risk has occurred, the 2013 ED introduces a useful presumption that the condition for recognizing expected credit losses is met when contractual payments are more than 30 days past due. It is a rebuttable presumption, since the entity, based on historical evidence, could demonstrate that there is no causal link between a significant increase in the PD and loans on which payments are more than 30 days past due (2013 ED, 9).

To reduce the operational costs and to make the model more cost-effective, the 2013 ED states an exemption to the general approach for loan with low credit risk. Especially, the credit risk is considered low when default is not imminent and any adverse economic conditions or changes in business or financial circumstances could, at most, lead to a weakened capacity of the borrower to meet the contractual cash flow obligations. Such credit risk is normally equivalent to the "investment grade" rating; thus, loans with this credit risk do not have to be tracked to assess the deterioration of credit quality. For such items, an entity should therefore continue to recognize 12-month expected losses only (2013 ED, 6, B16, BC76).

In accordance with the general approach, loans that improve their credit quality after having experienced a significant deterioration in credit quality and move into the lifetime expected credit losses category should move back from that category and re-measure the loss allowance balance at an amount equaling to 12-month expected credit losses with a resulting gain in profit or loss (2013 ED 10, BC78).

In principle, 12-month or lifetime expected credit losses should be recognized on an individual basis. In fact, in accordance with IFRS 9 and using amortized cost measurement, the unit of account is the individual financial instrument. However, the assessment on a collective basis (for example, on a group or portfolio basis) is also permitted for loans that have shared risk characteristics that are indicative of the borrower's ability to pay all amounts according to the contractual terms²³. Using a collective-based assessment, lifetime expected credit losses have to be recognized for all the instruments included in the group, even though only a part of

²¹ For example, if the PD occurring for a loan with a remaining life of 10 years at initial recognition is identical to the PD occurring in that financial asset when its remaining life is in a subsequent period only five years, it may indicate an increase in credit risk. In fact, the PD occurring over the remaining life usually decreases as time passes (2013 ED, B14).

²² In fact, other things being equal, an AAA-rated loan with a residual life of 10 years has a higher PD than a loan with similar rating but with a residual life of five years. Similarly, and always other conditions being equal, given a change in absolute value of the PD of 2%, it will be more important for a loan with an initial PD of 5%, rather than for a loan with an initial PD of 20%.

²³ Risk characteristics that could be used to aggregate loans for a collective-based assessment include, among others, the following: (1) instrument type; (2) credit risk ratings; (3) collateral type; (4) date of origination; (5) remaining term to maturity; (6) industry; (7) geographical location of the borrower; and (8) the value of collateral relative to the commitment (2013 ED, B19).

them have experienced a significant deterioration in credit quality. Consequently, collective evaluation is not advisable for groups of loans wherein lifetime expected credit losses should be recognized only for part of the items included in the group (2013 ED, B17, B18).

Measurement

The 2013 ED states that expected credit loss is an estimate of the present value of cash shortfalls over the remaining life of the financial instrument. The cash shortfall is defined as the difference between the cash flows that are contractually due and the cash flows expected to be received. A cash shortfall arises even if cash flows are expected to be paid in full but later than when contractually due, since expected credit losses consider not only the amount but also the timing of payments (2013 ED, B27). Especially:

(1) For loans and other financial assets, a cash shortfall is the difference between the present value of the principal and the interest cash flows due to an entity under the contract and the present value of the cash flows that the entity expects to receive;

(2) For undrawn loan commitments, a cash shortfall is the difference between the present value of the principal and interest cash flow due to the entity if the holder for the loan commitment draws down the loan and the present value of the cash flows that the entity expects to receive if the loan is drawn down;

(3) For a financial guarantee contract, a cash shortfall is the expected reimbursement the holder of a credit loss that it incurs, less any amounts that the entity expects to receive from the holder, the debtor, or other parties.

In the proposed expected credit losses model, the estimate of expected credit losses²⁴ should reflect, firstly, an unbiased and probability-weighted amount²⁵ to be calculated by evaluating a range of possible outcomes, rather than a best or a worst scenario. In estimating expected credit losses, it is not necessary to identify any possible scenarios. In some cases, relatively simple modeling may be sufficient, without the need for a large number of detailed simulations of scenarios. Indeed, in the IASB's view, the calculation of an expected value needs not to be a rigorous mathematical exercise whereby every possible outcome and its probability are identified. In other cases, the identification of scenarios that specify the amount and timing of the cash flows for particular outcomes and the estimated probability of these outcomes may be necessary. In those situations, the expected credit losses should reflect at least two possible outcomes: the possibility that a credit loss occurs and the possibility that no credit loss occurs (2013 ED, 17, B28, BC90)²⁶.

In estimating expected credit losses, any collateral asset has to be taken into account. Especially, the 2013 ED states that the estimate of expected cash flows on a collateralized financial instrument should reflect the amount and timing of cash flows that are expected from less foreclosure costs for obtaining and selling the collateral (2013 ED, BC32)²⁷. This requirement is similar to the existing requirements in IAS 39. However, based

²⁴ Conveniently, the ED underlines that the term "expected" as used in the terms "expected credit losses", "expected values", and "expected cash flows" is not a loose term, but a technical term that refers to the probability-weighted mean of a distribution and not have to be confused with a most likely outcome or an entity's best estimate of the ultimate outcome (2013 ED, BC84).

²⁵ That is a relevant difference with respect to IAS 39. Currently, under IAS 39, estimations of incurred losses that produce a range of possible amount imply the recognition of the best estimate within the range. By contrast, for estimations that produce a range of possible amount of expected credit losses, the ED requires to reflect the probability-weighted outcome, but not the most likely outcome. This approach is consistent with the requirements of some regulators in some jurisdictions.

²⁶ The IASB also permits that an entity may use various techniques to measure expected credit losses, including, for the 12-month expected credit loss measurement, techniques that do not include an explicit 12-month PD as an input, such as loss rate methodology (2013 ED, BC91).

²⁷ The term "collateralized financial instrument" is not defined in the ED; thus, some operational challenges may arise. For example, it is not clear whether an instrument issued by a third party or the borrower, e.g., financial guarantee received, might be considered collateral for the purpose of the expected credit losses model.

on the implementation guidance to IAS 39, entities may elect under IAS 39 to measure impairment using the fair value of the collateral at the end of the reporting period, by contrast under the expected credit losses model, entities should focus on the cash flows that are expected in the future from the collateral asset.

In applying the general model to loan commitments and financial guarantees, additional uncertainty may arise in respect to one of the input factors: the exposure at default. In effect, to measure the exposure at default of such instruments, the issuers need to estimate the amount that will have been drawn down at the time of default. Therefore, the issuers, before estimating the amount of expected credit losses for these financial instruments, need, primarily, to estimate the amount that a borrower will draw down at the time of default (2013 ED, BC130)²⁸.

The estimate of expected credit losses should incorporate the best available information that is reasonably accessible without undue cost and effort, including information about past events, current conditions, and reasonable and supportable forecast of future events and economic conditions. For this purpose, various sources of data could be used, such as internal historical credit loss experience, internal and external ratings, and credit loss experience of other entities, reports, and statistics (2013 ED, B6)²⁹. The judgments required by management seem to be wider and significantly more complex than under IAS 39. In effect, under IAS 39's current incurred loss model, the expected cash flows from an asset have to be estimated only when a trigger event has been verified; by contrast, under the proposed expected credit losses model, estimates would be needed for all financial assets. The issue is that for assets maturing in the medium and longer term, these estimates involve making assumptions about changes in economic conditions relatively far in the future, however, at each reporting date, there may be a number of possible views on the future economic conditions. Therefore, management is required to implement robust methodologies to ensure that their conclusions are reasonable and supportable (KPMG, 2013).

In the proposed expected credit losses model, under the general approach, the estimate of expected credit losses should also reflect the time value of money, except for purchased or originated credit impaired financial assets. At initial recognition, the 2013 ED permits to determine as discount rate for that asset any reasonable³⁰ rate that is between (and including) the risk-free rate and the effective interest rate (2013 ED, B29(a))³¹. This flexibility aims to provide operational relief and to allow preparers to choose a rate that is suitable for the level of sophistication of their systems and their operational capability (2013 ED, BC94). However, the size of the loss allowance is sensitive to the discount rate used. In effect, using the operationally simpler risk-free rate will generally result in a higher allowance (because the effective interest rate is usually higher than the risk-free rate), while using the operationally more complex effective interest rate will generally result in a smaller

²⁸ Respondents to the SD and participants in the IASB's outreach activities noted that estimating future drawdowns over the lifetime of the loan will introduce additional complexities. The IASB acknowledges that complexity, but retains that this estimate is necessary to have a consistent expected credit losses model (2013 ED, BC131-BC133).

²⁹ When using historical source of data, such as credit loss experience, a recurring adjustment is required. In the proposed expected credit losses model, historical data would have to be adjusted on the basis of current observable data to reflect current conditions and forecast future conditions that do not affect the period on which the historical data are based and to remove the effects of the conditions in the historical period that do not exist currently (2013 ED, B7).

³⁰ Operational challenges may arise from the interpretation of the term "reasonable", because the ED does not provide guidance on how to determine whether a rate is reasonable. In effect, it is not clear whether entities can simply choose a risk-free rate for simplicity or justify that the use of this rate or any other rate between the specified range is "reasonable" and in this case how reasonableness should be assessed (KPMG, 2013).

³¹ However, for undrawn loan commitments and financial guarantee contracts, the discount rate should reflect the current market assessment on the time value of money and the risks that are specific to the cash flows only if and to the extent that the risks are taken into account by adjusting the discount rate rather than by adjusting the cash shortfalls being discounted (2013ED, B27(b)). The different requirement is based on the observation that loan commitments and financial guarantees are unfunded. Therefore, the effective interest rate method and, hence, an effective discount rate, are not applicable (2013 ED, BC134).

allowance and, depending on the structure of interest rate in a particular jurisdiction, the difference between the two approaches may be large (KPMG, 2013).

Initial expectations of credit losses do not have to be considered in determining the effective interest rate on loans³². In effect, the 2013 ED proposes a decoupled approach consisting in the separate recognition of interest revenue and expected credit losses. This means that interests are generally recognized on the gross carrying amount without taking expected credit losses into consideration. That is a relevant difference compared with the 2009 ED, which proposed a model where the effective interest rate would have considered initial expectations of credit losses and represented the economic yield of the financial asset (2013 ED, BC98).

Thus, under the 2013 ED general approach, interest revenues are calculated by applying the effective interest rate to the gross carrying amount of loans, regardless whether they have significantly deteriorated in credit quality or not (2013 ED, 25).

However, for loans that have “objective evidence of impairment”³³ at the reporting date, as an exception to this general rule, the 2013 ED requires to calculate and present interest revenue using the effective interest rate on the amortized cost amount, that is, the gross carrying amount net of the loss allowance (2013 ED, 25(b))³⁴. That situation represented the “Stage 3” of the general approach (see the previous “overview” paragraph), referred to credits that have experienced objective evidence of impairment at the reporting date for which an entity, as in the “Stage 2”, is required to recognize lifetime expected credit losses but, differently from the “Stage 2”, has to calculate interest revenue on the net carrying amount.

The Special Approach for Credit-Impaired Asset at Initial Recognition

As an exception to the general model³⁵, the 2013 ED proposes a special approach for measuring the loss allowance and recognizing interest income in respect of purchased or originated assets that are credit-impaired since the initial recognition (purchased or credit-impaired or “POCI” assets). Especially, an asset is credit-impaired if there is objective evidence of impairment, because one or more loss events have occurred and those events have an impact on the estimated cash flows.

However, a loan has not been considered to be a POCI asset solely because of its low credit quality on initial recognition, since there must also be objective evidence of impairment at initial recognition (2013 ED,

³² The definitions of “effective interest rate” and “amortised cost” are substantially unchanged from those currently applied under IAS 39 (2013 ED, B1-B3).

³³ The ED defines “objective evidence of impairment” as one or more events that have occurred and that have an impact on the expected future cash flows of the financial instruments. The definition includes observable data that have come to the attention of the holder of the financial instrument about the following events: (1) significant financial difficulty of the issuer or the borrower; (2) a breach of contract, such as a default or delinquency in interest or principal payments; (3) lender having granted a concession to the borrower for economic or contractual reasons relating to the borrower’s financial difficulty that the lender would not otherwise consider; (4) it becomes probable that the borrower will enter bankruptcy or other financial reorganization; (5) the disappearance of an active market for that financial asset because of financial difficulties; or (6) the purchase of a financial asset at a deep discount that reflects the incurred credit losses. In the IASB’s view, it may not be possible to identify a single discrete event; instead, the combined effect of several events may cause objective evidence of impairment (2013 ED, Appendix A).

³⁴ However, these requirements only affect the calculation and presentation of interest revenue and not the measurement of loss allowance (2013 ED, BC99).

³⁵ The 2013 ED proposes a further exception to the general approach that is not related to banking company loans—the *simplified approach* for trade and lease receivables. Particularly, this approach consists in: (1) a single accounting method for trade receivables that do not have a significant financing component consisting in the initial recognition at the transaction price as defined in the ED/2011/6 *Revenue From Contracts With Customers*, that is, the invoice amount in many cases, and in the recognition of loss allowance based on lifetime expected credit losses (the simplified approach); and (2) an accounting policy for trade receivables that have a significant financing component and lease receivables consisting in the choice between fully applying the proposed model (the general approach) and recognizing a loss allowance for lifetime expected credit losses (the simplified approach) (2013 ED, 12-13).

B9, BC 139).

As a result, differently from IAS 39, under which the (same) concept of “objective evidence of impairment” is used to identify incurred losses, under the 2013 ED, this concept is used both to determine whether:

(1) A loan is credit-impaired at the initial recognition, as in this case the special approach applies;

(2) A loan becomes credit credit-impaired after initial recognition, as in this case the abovementioned special interest recognition rules apply (effective interest rate on the net carrying amount).

The IASB decided to carry forward the scope and the requirements in paragraph AG5 of IAS 39, whereby it is required to include the initial expected credit losses in the estimated cash flows when calculating the effective interest rate for financial assets that have objective evidence of impairment on initial recognition (2013 ED, BC137). Therefore, for loans considered to be POIC assets that have objective evidence of impairment:

(1) As an exception to the general approach, the effective interest rate is calculated considering expected credit losses—the resulting effective interest rate is defined as the “credit-adjusted” effective interest rate (2013 ED, 25(a), Appendix A);

(2) As an exception to the general interest recognition rules, interest revenue is presented in the statement of profit or loss and other comprehensive income by applying the credit-adjusted effective interest rate to the amortized cost (adjusted for all any loss allowance) (2013 ED, 25(a));

(3) Changes in the initial expected credit losses, in the subsequent period, are recognized in profit or loss as impairment gains or losses, and in a corresponding allowance balance (2013 ED, BC140).

Conclusions: Acceptable Features and Critical Aspects of the Expected Credit Losses Model

The main proposal in the 2013 ED (the general approach) consists in the distinction between loans and other financial assets that have not deteriorated significantly in credit quality since initial recognition or that have low credit risk, for which 12-month expected credit losses are recognized, and loans and other financial assets that have deteriorated significantly since initial recognition, for which lifetime expected credit losses are recognized.

This dual-measurement approach should overcome the weaknesses of IAS 39 incurred loss model which only allows for the recognition of credit losses, once there is objective evidence that a loss event has occurred, in a pragmatic way. In effect, recognizing a portion of lifetime expected credit losses, and then the full lifetime expected credit losses only after a significant deterioration in credit quality, should ensure a more timely recognition and a better approximation of expected credit losses. The expected credit losses model proposed in the 2013 ED seems to be, also, an acceptable balance between the cost of implementation and the underlying economics, while meeting the need to provide earlier for expected credit losses as expressed by financial regulators. Moreover, the distinction between financial assets that have deteriorated in credit quality and those that should not provide relevant information about the likelihood of the collection of future contractual cash flows and the changes in financial asset credit quality providing users of financial statements with useful information. The extension of disclosure requirements, by including information about inputs, assumptions, and techniques used in assessing the criteria for the recognition and measurement of expected credit losses should mitigate the issue of the lower verifiability and comparability of the reported amounts that may derive from the significant amount of subjectivity that involves the assessment of expected credit losses.

As previously noted, it would have been preferable that the proposed expected credit losses model was aligned to the prudential capital frameworks and counter-cyclical, resulting in a loss allowance that is sufficient to absorb all credit losses. In the IASB's view, entities should use regulatory measures as a basis for the calculation of expected credit losses in accordance with the expected credit losses model. However, these calculations should be adjusted to meet the measurement requirements of the 2013 ED. Certain prudential regulation and capital adequacy systems, such as the framework developed by the BCBS, already require financial institutions to calculate 12-month expected credit losses as parts of their regulatory capital provisions. However, these estimates only use credit loss experience based on historical events to determine "provisioning" levels over the entire economic cycle, and through-the-cycle approaches consider a range of possible economic outcomes rather than those actually expected at the reporting date. From this perspective, the loss allowance compliant to regulatory requirements does not necessarily reflect the economic characteristics of loans and other financial instruments at the reporting date. By contrast, the expected credit losses model proposed in the 2013 ED is based on the information available at the reporting date and is designed to reflect economic reality, rather than adjusting the assumptions and inputs applied to achieve a counter-cyclical effect (2013 ED, BC192-BC197).

Furthermore, there are some critical aspects to be considered. Even though the expected credit losses model may result in a more timely recognition of expected credit losses, the recognition of a portion of lifetime expected credit losses at inception is really not conceptually sound, as stated by a dissenting member of the IASB (2013 ED, AV1) and confirmed by the EFRAG (2013). In effect, the 12-month expected credit losses proposal would result in an overstatement of expected credit losses, and a resulting understatement of the value of any related financial asset, both at and immediately after the initial recognition. Thus, the initial carrying amount of financial assets would be below their fair value. In addition, the proposed model, because of the decoupled approach consisting in the separate recognition of interest revenue and expected credit losses and of the estimation (except for POCI assets) of the effective interest rate without taking into consideration the expected credit losses, may not result in a faithful representation of the transaction. Therefore, recognizing a portion of expected credit losses at initial recognition and determining effective interest rate without including expected credit losses, could not appropriately reflect the economic link between the pricing and the initial credit quality, when the financial instrument has been priced at market terms (EFRAG, 2013).

Finally, a further criticality is represented by the problematic convergence between FASB's and IASB's expected credit losses proposals. It would be preferable for users of financial statement if the accounting for expected loss was aligned between IFRS and US GAAP, however, as previously noted, the FASB in July 2012 decided to withdraw from the joint project and to develop an expected credit loss model in which no distinction has been made based on the credit quality level. Thus, under the FASB's proposed CECL model, expected credit losses are always recognized at what is described as lifetime expected credit losses in the IASB's proposals. The contrast between the FASB's single measurement approach and the IASB's dual-measurement approach in estimating expected credit losses is the main difference between the two proposals. Notwithstanding, there exists a significant difference between the two models, they do share common features. In effect, both approaches should result in the same loss allowance for loans that have deteriorated significantly in credit quality since initial recognition and that do not have low credit risk and for trade receivables and lease receivables where an entity measures the loss allowance using lifetime expected credit losses. Furthermore, as both models use the same data and information sets, there would not be a significant difference in the loss

allowance on short-term assets and loans with low credit risk at any time (2013 ED, BC215). The two sets of proposals have overlapped the comment periods, enabled interested parties to comment on both proposals and IASB and FASB to discuss jointly the comments received on their respective proposals. This will provide the opportunity to consider whether it is still possible to achieve a converged solution that will promote coherent accounting for credit loss allowance and increase comparability for the users of financial statements. This would be consistent with the recommendations of G20, FCAG, and other international (accounting and political) bodies, that achieving a common outcome for impairment accounting is highly desirable.

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