F I N A N C I A L   S T A B I L I T Y   F O R U M

Report of the FSF Working Group on Provisioning

March 2009

Introduction

Consistent with statements made in the "Report of the Financial Stability Forum on Enhancing Market and Institutional Resilience" (7 April 2008) (FSF Report – April 2008), and as described more fully in a follow up to that report issued on 10 October 2008 (FSF Report – October 2008), the Financial Stability Forum (FSF) has set in train an examination of the forces that contribute to procyclicality in the financial system and possible mitigating options. This work centers on four areas: (i) the Basel II capital accord; (ii) loan loss provisioning; (iii) compensation arrangements; and (iv) valuation and leverage.

As part of that effort, the FSF Working Group on Provisioning (WG on Provisioning) is tasked with assessing the contribution of current loan loss provisioning practices to procyclicality, and whether changes in existing loan loss provisioning accounting standards could reduce procyclicality. Also, from a longer term perspective, the WG on Provisioning will consider whether changes in accounting standards could reduce procyclicality (e.g., by recognizing changes in loan loss provisioning earlier in the credit cycle) while still meeting the needs of investors for transparency in order to understand changes in credit trends.

The WG on Provisioning and its technical team met on three occasions since December 2008 to discuss the substantive issues that comprise its mandate. In addition, the working group convened an outreach session with groups representing investors, auditors, and financial institutions. At these meetings, the WG on Provisioning received input and reactions on various questions and possible alternatives to address procyclicality. Membership on the WG on Provisioning is comprised of an internationally-diverse group of technical experts representing national authorities and international bodies representing prudential supervisors, securities regulators, accounting standard setters, auditors, regulators, central bankers and international financial institutions.

Provisioning for loan losses refers to the accounting mechanism used in the recognition of credit losses and is a critical issue to effective financial reporting and separately to prudential supervision. Provisions for loan losses reduce an institution's reported net income in the period in which the provision is recognized and decreases the carrying value of the loans held by the institution. The basic principles provided in generally accepted accounting principles in the United States (US GAAP) as issued by the Financial Accounting Standards Board (FASB) for recognizing loan loss provisions have been formally in place since 1975, and, after enhancement in 1993, have remained relatively unchanged. The basic principles provided in International Financial Reporting Standards (IFRS) as issued by the International Accounting Standards Board (IASB) for recognizing loan loss provisions are very similar to those provided in US GAAP and the principles have been in place since the IASB revised its standards in 2003. Many financial institutions in Europe and other parts of the world began to report using IFRS in 2005.

Under both US GAAP and IFRS, the accounting model for recognizing credit losses is commonly referred to as an "incurred loss model" because the timing and measurement of losses is based on estimating losses that have been incurred as of the balance sheet date.

Provisions for loan losses should cover estimated loan losses that have been identified for individual loans, as well as estimated losses for loans in a company's portfolio that have likely been incurred, but have not yet been individually identified. Given the subjective nature of estimates of loan losses that have not yet been individually identified, provisioning for loan losses necessarily requires judgment. For a given loan portfolio, there will likely be a range of loan loss estimates that are considered reasonable.

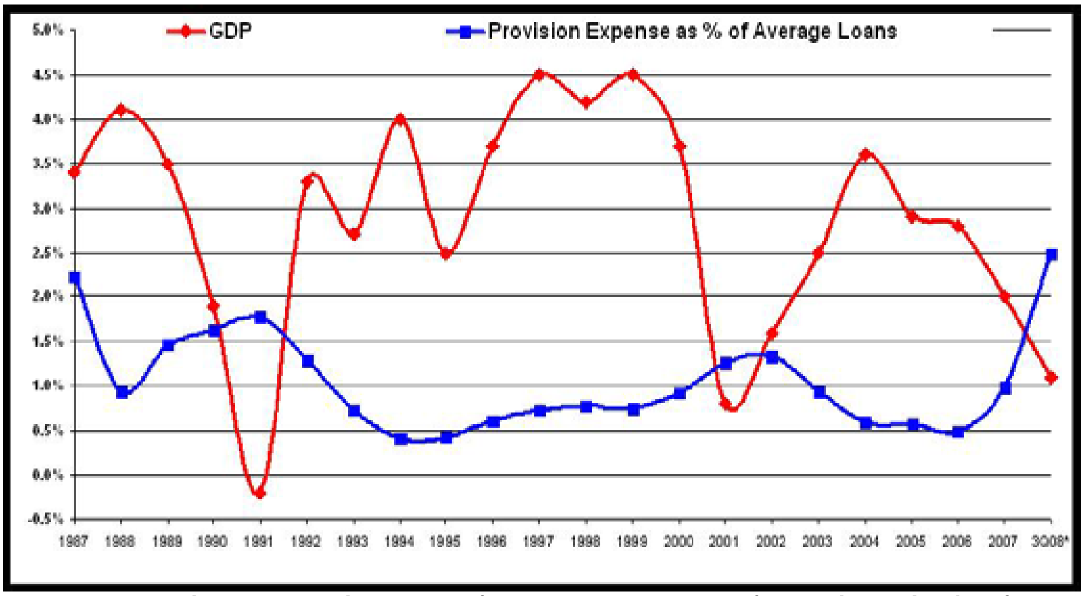
As described more fully in Appendix A, current provisioning accounting guidance requires that loan loss estimates incorporate all observable data on losses. This observable data may include both specific and general sources of evidence, such as a specific borrower experiencing financial difficulty or changes in general economic conditions that are likely to affect default rates. Current provisioning requirements limit provisioning to losses that are considered probable. In addition, the current accounting standards do not permit credit losses based on events that are expected to occur in the future to be included in provisions until the event or events that are probable to result in a loss have occurred (e.g., borrower loss of employment, decrease in collateral values).

1. The cyclicality of loan loss provisioning

As a foundational element of its work, WG on Provisioning considered the relationship between current loan loss provisioning practices and procyclicality.[1] The current financial crisis has brought into focus the important relationships among bank profitability, lending activity, capital adequacy, and provisioning practices. Of particular interest to the WG on Provisioning is the association between loan loss provisions and the current state of the economy. The chart below shows the association between loan loss provisioning (blue line) and gross domestic product (red line). Though only a single country's data is shown and, therefore, it may not represent the accounting practices and growth rates of other countries, the chart is suggestive of a correlation between provisioning levels and real economic activity. During periods of economic growth, provisions fall as a percentage of loan volume, and conversely, provisions rise during downturns. Thus, the evidence suggests that the cyclicality of provisioning levels is reflective of the cyclicality of the macro-economy.

[1] In this context, the term "procyclicality" refers to the amplification of otherwise normal business fluctuations.

Chart 1
US Nationally-chartered Banks: Loss Provisioning and US Gross Domestic Product (GDP)

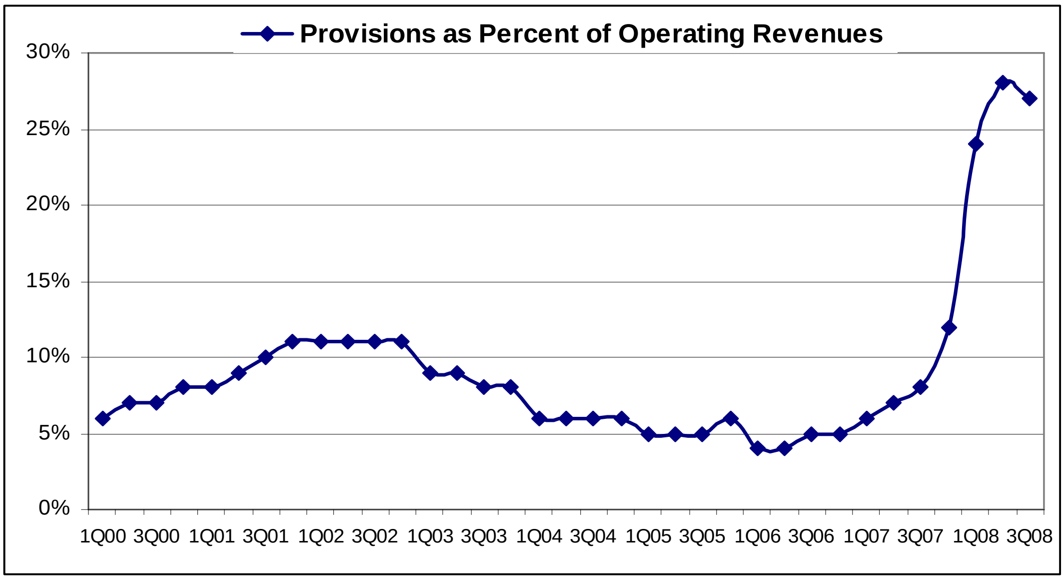


Sources: US Financial Institution Regulatory Reports for Provision as a percentage of average loans; Bloomberg for US GDP.

The more difficult issue is whether this data also indicates that current provisioning practices, including the effect of provisioning on regulatory capital levels, amplifies the business cycle. While, as noted above, the FSF has identified provisioning practices as one of the forces that have likely contributed to procyclicality in the financial system, it is beneficial to articulate the conceptual reasoning for the procyclicality of current provisioning practices. Bank actions to increase provisions lower the accounting measures of profits and retained earnings. These reductions, in turn, affect regulatory measures of capital adequacy and the market's appraisal of the soundness of an institution. Then, an institution's remedial steps might include a reduction in lending. Conversely, lower levels of provisioning during economic expansions result in higher levels of profit and capital and might lead an institution to increase lending. Thus, provisioning practices, as well as regulatory capital requirements, might have a procyclical effect on bank lending and the macro-economy. However, the size of this possible effect, if present, is unknown.

Though not undertaking a rigorous statistical analysis, the WG on Provisioning reviewed the historical time-series of the ratio of provisions for loan losses to operating revenues. Because loans are typically a significant portion of a financial institution's assets, provisioning for loan losses can have a material effect on reported income. As seen in the following graph, provisions for loan losses represented approximately 5 – 10% of operating revenues during 2000 – 2007. Then, the ratio rose to 25% in 2008.

Chart 2
US Bank Provisions as Percent of Operating Revenues



Sources: US Financial Institution Regulatory Reports.

This dramatic increase in the ratio occurred over a very short time frame, which is reflective of the change in the overall economy. The WG on Provisioning discussed whether the provisions for loan losses could have been recognized earlier. Earlier recognition would have lessened the subsequent impact by shifting the burden of higher provisions to earlier years (e.g., to 2005 to 2007), but may not have had an affect on the overall level of provision that was recognized. Particularly problematic was the fact that the large provisions were recognized at the same time that operating revenues were declining. The recent period has also been a very difficult environment in which to raise additional capital from the market.

The WG on Procyclicality notes that the accounting model for recognizing provisions for loan losses is based on the availability of evidence that a loss has been incurred. Therefore, the WG on Provisioning discussed how available evidence should be used in provisioning earlier in the cycle. In that context the WG on Provisioning explored whether the current accounting and capital regimes could be enhanced to recognize provisions for incurred loan losses earlier in the credit cycle and whether more fundamental changes to these regimes should be considered.

2. Consultative process

In an effort to solicit input on the various issues presented in its mandate, the WG on Provisioning consulted with a number of individuals representing internationally diverse groups of investors, auditors and financial institutions. Given the abbreviated time frame under which this work was conducted and the reliance on information collected through non-empirically based interviews and discussions, the information gathered by the working group should generally be seen as anecdotal. Despite these and other limitations, the oral and written feedback assisted the WG on Provisioning in understanding how differing groups might consider these issues. The comments made in the meetings were also considered in the conclusions reached by the working group and are noted in the recommendations.

To better understand current provisioning practices, the working group sought information about whether there are differences between the accounting requirements of US GAAP and IFRS that substantively affect provisioning. With the concurrence of representatives of the FASB and IASB, the WG on Provisioning concluded that the differences in the requirements of the standards were minor, even though the terminology differs in some respects. Additionally, based on internal deliberations and consultations with relevant groups, the WG on Provisioning concluded that the current US GAAP and IFRS accounting requirements for loan loss provisioning are viewed by financial institutions, regulators, auditors, and investor groups as being essentially the same. See Appendix A for a more complete comparison of US GAAP and IFRS.

The WG on Procyclicality also sought input on the degree of variability in current loan loss provisioning practices resulting from the judgmental application of qualitative factors affecting loan loss estimates. The working group obtained anecdotal evidence of a wide range of practices in this area. It was noted that there were many factors that contributed to the diversity of practice. Some expressed the view that institutions that recorded higher provisions earlier in the credit cycle were better positioned to withstand deteriorating economic conditions. The WG on Provisioning then elicited views on how best to address this variability of practice, and whether such options mitigated the procyclical effects of current provisioning practices. Specifically, the working group sought information on whether the issuance of a reminder of the significant judgment required by current accounting standards in the estimation of incurred losses and/or enhanced disclosures of provisioning practices could have a salutary affect on this problem. The WG on Provisioning concluded that, regardless of the cause of the diversity in practice, it would be helpful for standard setters to clarify any misinterpretations that may exist regarding the requirement to use their judgment to estimate losses based upon current estimates, rather than solely base their estimate on the historical charge-off rates. In addition, the WG on Provisioning concluded that improved disclosure could be helpful in informing investors and others about the judgments being made by management.

The WG on Provisioning also consulted on whether changes could be made to the existing loan loss accounting requirements that would reduce procyclicality while remaining faithful to the financial reporting objective of providing useful information to investors. As a result of the accelerated time frame, the working group did not attempt to explore the specific details of alternative accounting models or conduct a detailed examination of the potential mechanical and conceptual challenges that alternative approaches might bring. The feedback received from the inquiries was necessarily limited, because sufficient details regarding alternative approaches were not provided. Nevertheless, the working group received a diverse set of comments, and concluded that there was a willingness to explore alternatives to the current incurred loss model and related disclosures. The WG on Provisioning obtained feedback and concluded that alternative accounting models that consider a broader range of credit information than current accounting requirements could have conceptual appeal from both the perspective of a user of financial statements and a prudential regulator.

Given that a separate working group is considering changes in regulatory capital requirements to address procyclicality, this provisioning working group considered only limited changes to the regulatory capital standards that deal with the interaction between provisioning for loan losses under accounting guidance and regulatory capital standards. Specifically, this working group made inquires about whether the limits on the extent to which provisions for loan losses are included in regulatory capital provide a disincentive for institutions to increase their accounting provisioning for loan losses. The WG on Provisioning obtained feedback and concluded that the Basel Committee should consider refinements to the Basel II Framework that would reduce disincentives that may currently exist for banks to increase their level of provisions for loan losses. In addition, consideration should be given to possible enhancements to the Basel II Framework to assess the adequacy of disclosure of loan loss provisioning under Pillar 3.

3. Draft recommendations for inclusion in the Report of the FSF on Procyclicality

The FSF will continue to foster constructive dialogue between regulators, supervisors, and accounting standard setters on loan loss provisioning, from accounting, disclosure and capital perspectives.

The FASB and IASB should issue a statement that reiterates for relevant regulators, financial institutions, and their auditors that existing standards require the use of judgment to determine an incurred loss for provisioning of loan losses.

The FSF explored how judgment is used under existing accounting standards to recognize appropriate provisioning levels consistent with the credit losses that currently exist in the loan portfolio. The FSF reviewed the accounting requirements under the US and international frameworks to determine if there were differences in the requirements of those standards. The analysis prepared by the FSF, with concurrence of representatives of the FASB and IASB, concluded that the differences in the standards were minor even though the terminology differs in some respects. Additionally, based on internal deliberations and consultations with relevant groups, the FSF concluded that the current US GAAP and IFRS accounting requirements for loan loss provisioning are viewed by financial institutions, regulators, auditors, and investor groups as being essentially the same.

Given that accounting requirements for loan loss provisioning under US GAAP and IFRS are essentially the same, the FSF explored whether there are material differences in application of these requirements. The FSF held discussions with relevant regulators, auditors, financial institutions and investors on the current range of practice in the application of the accounting standards on loan loss provisioning. The discussions focused on the application differences between financial institutions applying the US GAAP and IFRS, as well as the range of practices that exist within those regimes. The FSF found anecdotal evidence of a wide range of practice used by financial institutions and accepted by auditors and regulators. Possible sources of the diversity in practice include: historical country practices, management biases, differing legal and tax requirements, influences of regulators and auditor practices. The wide range of practice was not perceived as a difference between US GAAP and IFRS, but rather, different application practices.

The FSF believes that the use of judgment and reasonable estimates are required for appropriate recognition and measurement of provisioning for loan losses under both the current US GAAP and IFRS accounting requirements. Under the current accounting requirements, the method used to determine loan loss provisions should reasonably assure the timely recognition of existing loan losses. While historical loss experience and recent economic conditions are a starting point for a financial institution’s analysis, these factors are generally not, by themselves, a sufficient basis to determine the appropriate level for loan loss provisions. Management should also take into account any current factors that are likely to indicate that existing loan losses associated with the bank’s loan portfolio differ from historical loss experience. Such factors could include changes in relevant economic and environmental trends, lending policies and procedures, and changes related to new loan segments and products.

The FSF believes that institutions that effectively use required judgment to incorporate the impact of changes in current factors (such as environmental indicators and relaxing underwriting standards) into the methodologies used to determine the provisioning for loan losses would likely recognize higher provisions earlier in the credit cycle than those that placed greater emphasis on historical loss experience. The FSF believes that improving the diligence used by all institutions to incorporate reasonable judgments regarding the impact of factors that are likely to cause loan losses to differ from historical levels may improve practice and help lessen procyclicality while enhancing the consistency of information provided to investors. Therefore, the FASB and IASB should issue a statement that reiterates the required use of judgment in incorporating the impact of factors that are likely to cause loan losses to differ from historical levels under existing requirements for the provisioning of loan losses. This statement should be developed and issued by end-2009.

The FASB and IASB should reconsider the incurred loss model by analyzing alternative approaches for recognizing and measuring loan losses that incorporate a broader range of available credit information. The FSF recommends that the FASB and IASB establish a resource group to provide input on technical issues and complete this project on an expedited basis.

In the context of the current crisis, the FSF discussed whether a different accounting model could have identified loan losses earlier in the credit cycle and effectively facilitated more through-the-cycle provisioning while providing the necessary transparency to users of the financial statements with respect to changes in credit trends. The FSF sought the input of auditors, financial institutions and investors on these issues and whether changes to the current standards should be considered to improve transparency of information provided to investors while also potentially helping lessen procyclicality. The FSF received a diverse set of comments, but concluded that there was a willingness to explore alternatives to the current incurred loss model.

The FSF believes that earlier recognition of loan losses could have potentially reduced procyclicality in the current crisis. The FASB and IASB (the “Boards”) currently have a joint project to improve the recognition and measurement of financial instruments. The FSF believes loan loss provisioning requirements should be reconsidered as part of the Boards’ joint project on financial instruments, and recommends that the Boards complete this project on an expedited basis while maintaining appropriate due process. Specifically, the Boards should consider whether changes to the loan loss accounting model could better reflect the underlying economics of lending activities and capture credit impairment information earlier in the credit cycle.

Under the current accounting requirements of an incurred loss model, a provision for loan losses is recognized only when a loss impairment event or events have taken place that are likely to result in nonpayment of a loan in the future. Identification of the loss event is a difficult and subjective process that results in a range of practice and, potentially, a failure to fully recognize existing credit losses earlier in the credit cycle. Earlier identification of credit losses is consistent both with providing financial statement users transparency into changes in credit trends and regulators with the prudential objectives of safety and soundness. Therefore, the FSF recommends that standard setters give due consideration to alternative approaches to recognizing and measuring loan losses that incorporate a broader range of available credit information, including a fair value model, an expected loss model and dynamic provisioning. In addition, the current disclosures on loan loss provisioning should be assessed to determine adequacy and potential improvements on the information being provided. Moreover, any alternative to the current provisioning model must be assessed to determine whether it can be effectively implemented by preparers and whether it would provide better information than the existing requirement.

The Boards should establish a resource group comprised of investors, regulators, supervisors, auditors, preparers and industry representatives to evaluate related technical aspects of possible approaches that could be consistent with these objectives. The input received from the resource group should be considered by the Boards during the deliberations of the joint project on financial instruments.

The Basel Committee should undertake a review of Basel II to reduce or eliminate disincentives for establishing appropriate provisions for loan losses.

The FSF has discussed whether there are possible refinements to the Basel II Framework that would reduce disincentives that may currently exist for banks to increase their level of provisions for loan losses. The FSF notes that two features of the Basel II Framework are potentially significant disincentives for improved provisioning practices.

The first potential impediment is the manner in which provisions are included in the measure of a bank’s regulatory capital. The FSF believes that the Basel Committee should consider the allocation of general provisions in banks’ regulatory capital.

The second impediment is the Basel II Framework’s constraint on the amount of provisions that may count as Tier 2 capital. The FSF believes that the 1.25 percentage points and the 60 basis points constraints on the amounts of reserves that may be added to capital under the Standardized and IRB approaches, respectively, may create a disincentive for banks whose level of provisions approach those thresholds. Therefore, the Basel Committee should examine whether the removal or modification of the caps that limit the amount of provisions that may count as capital is warranted.

The FSF believes that, were the Basel Committee to make appropriate modifications to the Basel II Framework, some banks would increase their loan loss provisioning levels. The FSF understands that the Basel Committee is considering other broader modifications to the Basel II Framework to increase the capital position of banks so that more capital is available to absorb losses.

The Basel Committee should undertake a review of Basel II to assess the adequacy of disclosure of loan loss provisioning under Pillar 3.

Pillar 3 of the Basel II Framework recognizes that market discipline has the potential to reinforce capital regulation and other supervisory efforts to promote the safety and soundness of banks and financial systems. Market discipline imposes strong incentives on banks to conduct their business in a safe, sound and efficient manner. It can also provide a bank with an incentive to maintain a strong capital base as a cushion against future losses arising from its risk exposures. The Basel Committee believes that supervisors have a strong interest in facilitating effective market discipline as a lever to strengthen the safety and soundness of the banking system. The FSF understands that the Basel Committee aims to encourage market discipline through their development of a disclosure framework that will allow market participants to assess key information on the scope of application, capital, risk exposures, risk assessment and management processes, and hence the capital adequacy of the institution.

In the FSF's efforts in exploring aspects of loan loss provisioning, the FSF obtained feedback from various individuals that they seek improvements to the current information available on loan loss provisioning. The FSF believes that, given the objectives of the Basel Committee's Pillar 3, relevant disclosures about loan loss provisioning would also be important in enhancing market discipline. The FSF also believes that improving market discipline could be helpful in mitigating diversity in practice, as well as helping lessen procyclicality. Therefore, the Basel Committee should undertake a review of Basel II to assess the adequacy of disclosure of loan loss provisioning under Pillar 3.

Appendix A

Allowance for Credit Losses: US GAAP and IFRS Comparison

Overview of US GAAP Accounting

Basic Principle

An allowance for credit losses should be recognized only if events have occurred indicating that it is *probable* that an asset has been impaired or that a loss has been incurred as of the balance sheet date.

Allowance for Collective Impairment

FASB Statement No. 5, *Accounting for Contingencies,* provides the basic guidance described above on the accounting for and reporting of loss contingencies, including credit losses. Statement 5 requires that a creditor evaluate the collectibility of both the contractual interest and the principal of all receivables when assessing the need for a loss accrual. An estimated loss from a loss contingency should be accrued by a charge to income if both of the following conditions are met:

- Information prior to issuance of the financial statements indicates that it is probable that an asset has been impaired or a liability has been incurred at the date of the financial statements.
- The amount of the loss can be reasonably estimated.[2]

Whether the amount of loss can be reasonably estimated will normally depend on, among other things, the loss experience of the creditor, information about the ability of individual debtors to pay, and appraisal of the collateral in light of the current economic environment. A creditor that has no experience of its own may refer to the experience of other enterprises in the same business. In all cases, Statement 5 requires a reasonable basis for quantifying the amount of loss.[3]

Allowance for Individually Impaired Loans, including Troubled Debt Restructurings

FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan,* addresses the accounting by creditors for impairment of certain loans. It applies to all creditors and all loans, uncollateralized as well as collateralized, except (1) large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment, (2) loans that are measured at fair value or at the lower of cost or fair value, (3) leases as defined by FASB Statement No. 13, *Accounting for Leases,* and (4) debt securities as defined by FASB Statement No. 115, *Accounting for Certain Investments in Debt and Equity Securities*.[4] If a loan is not considered impaired under Statement 114, then it is included in the allowance for collective impairment calculated in accordance with Statement 5. Statement 114 also applies to all loans that are restructured in a troubled debt restructuring involving a modification of terms.

[2] Statement 5, paragraph 8.
[3] EITF Topic No. D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio,* answer 6.
[4] Statement 114, paragraph 6.

Under Statement 114, a loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. As referenced in this Statement and in Statement 5, all amounts due according to the contractual terms means both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement.[5] Determining when a loan is impaired is based on management's judgment in applying its normal loan review procedures. Loans that are determined to be impaired are not included in the collective provision assessment under Statement 5.

Under Statement 114, the amount of the required allowance for loan losses is measured based on the present value of expected future cash flows discounted at the loan's effective interest rate or, as a practical expedient, at the loan's observable market price or the fair value of the collateral, if the loan is collateral dependent. Measurement methods are selected on a loan-by-loan basis. The estimate of future cash flows should be a creditor's best estimate based on reasonable and supportable assumptions and projections. All available evidence, including estimated costs to sell collateral, if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan, should be considered in developing those estimates. The weight given to the evidence should be commensurate with the extent to which the evidence can be verified objectively. The likelihood of the possible outcomes should be considered in determining the best estimate of expected future cash flows.[6]

When the present value of expected future cash flows or, alternatively, the observable market price of the loan or the fair value of the collateral is less than the recorded investment in the loan (including accrued interest, net deferred loan fees or costs, and unamortized premium or discount), a creditor should recognize an impairment by creating a valuation allowance with a corresponding charge to bad-debt expense. Subsequently, at each reporting period, management is required to recognize any changes in the measurement of impairment; however, the net carrying amount of the loan should never exceed the recorded investment in the loan.

If impaired loans have risk characteristics in common, a creditor may aggregate those loans and use historical statistics, such as average recovery period and average amount recovered, along with the composite effective interest rates, as a means of measuring those impaired loans.

Income Recognition on Impaired Loans

FASB Statement No. 118, *Accounting by Creditors for Impairment of a Loan—Income Recognition and Disclosures,* does not address how a creditor should recognize, measure, or display interest income on an impaired loan; however, Statement 118 requires that an entity disclose how it recognizes interest on impaired loans. Generally, regulatory guidelines establish the practice for designating loans as "nonaccrual." The federal banking agencies have adopted guidelines that banks generally should not accrue interest on any asset: (1) that is maintained on a cash basis because of deterioration of the borrower's financial condition, (2) for which full payment of principal and interest is not expected, or (3) upon which principal or interest has been in default for a period of 90 days or more unless the asset is both

5 Statement 114, paragraph 8.
6 Statement 114, paragraph 15.

well-secured and repayment of all amounts due is reasonably expected through collection efforts.

Loans Held for Sale

FASB Statement No. 65, *Accounting for Certain Mortgage Banking Activities,* and AICPA Statement of Position 01-6, *Accounting by Certain Entities (Including Entities with Trade Receivables) That Lend to or Finance the Activities of Others*, provide guidance for loans held for sale. Loans held for sale should be recorded at the lower of cost or fair value less cost to sell determined as of the balance sheet date. The amount by which cost exceeds fair value should be accounted for as a valuation allowance.

SEC Staff Guidance

SEC Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues*, requires that any recorded allowance must be supported by a consistently applied analysis of all available and relevant information, including both quantitative and qualitative factors, about circumstances that exist at the balance sheet date. The allowance for loan losses should be based on observable data, and changes in the allowance should be directionally consistent with changes in the observable data. All available observable data would include existing "environmental" factors, for example, existing industry, geographical, economic, and political factors that are relevant to the collectibility of the loan. If the reasonable estimate of the loss is a range, and some amount within that range appears to be a better amount than others within the range, then that amount should be accrued. If no amount within the range is a better estimate than any other amount, the minimum amount in that range should be accrued. SAB 102 describes in detail the elements needed by creditors to substantiate a systematic loan loss methodology for loan loss accounting, including estimating loan losses on a group of loans, management's process for identifying impaired loans, and estimating impairment on individual loans.

Overview of IFRS Accounting

Basic Principle

An entity shall assess at each balance sheet date whether there is objective evidence that a financial asset or group of financial assets is impaired and, if so, shall recognize the impairment based on the excess of the carrying amount of the loan over the present value of the estimated future cash flows discounted at the loan's original effective rate.

Allowance for Collective Impairment

International Accounting Standard 39, *Financial Instruments: Recognition and Measurement,* requires the recognition of impairment in respect to losses that have been "incurred but not reported." An entity first assesses whether objective evidence of impairment exists individually for financial assets that are individually significant, and individually or collectively for financial assets that are not individually significant. If an entity determines that no objective evidence of impairment exists for an individually assessed financial asset, whether significant or not, it includes the asset in a group of financial assets with similar credit risk characteristics and collectively assesses them for impairment. Individually assessed assets for which an impairment loss is or continues to be recognized are not included in a collective assessment of impairment. The objective of the collective assessment for impairment is to identify losses that have been incurred, but not yet identified, on an individual basis. When performing a collective assessment of impairment, an entity groups assets by similar credit risk characteristics that are indicative of the debtor's ability to pay all amounts according to the contractual terms. Paragraph AG88 of IAS 39 describes this process:

- Impairment losses recognized on a group basis represent an interim step pending the identification of impairment losses on individual assets in the group of financial assets that are collectively assessed for impairment. As soon as information is available that specifically identifies losses on individually impaired assets in a group, those assets are removed from the group.

If there is objective evidence that an impairment loss on loans and receivables carried at amortized cost has been incurred, an entity measures the amount of the loss as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition).[7] Formula-based approaches or statistical methods may be used to determine impairment losses in a group of financial assets (e.g., for smaller balance loans).

Allowance for Individually Impaired Loans

A financial asset or a group of financial assets 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 has an effect on the estimated future cash flows of the financial asset or group of financial assets that can be reasonably estimated. It may not be possible to identify a single, discrete event that caused the impairment. Rather, the combined effect of several events may have caused the impairment. Losses expected as a result of future events, no matter how likely, are not recognized. Objective evidence that a financial asset or group of assets is impaired includes, but is not limited to, observable data that come to the attention of the holder of the asset about the following loss events:[8]

- Significant financial difficulty of the issuer or obligor;
- A breach of contract, such as a default or delinquency in interest or principal payments;
- The lender, for economic or legal reasons relating to the financial difficulty, granting to the borrower a concession that the lender would not otherwise consider;
- It becoming probable that the borrower will enter bankruptcy or other financial reorganization;
- The disappearance of an active market for that financial asset because of financial difficulties; or

[7] IAS 39, paragraph 63.
[8] IAS 39, paragraph 59.

- Observable data indicating a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:
    i. An adverse change in the payment status of borrowers in the group (e.g. an increased number of delayed payments or an increased number of credit card borrowers who have reached their credit limit and are paying the minimum monthly amount); or
    ii. National or local economic conditions that correlate with defaults on the assets in the group (e.g., an increase in the unemployment rate in the geographical area of the borrowers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for loan assets to oil producers, or adverse changes in industry conditions that affect the borrowers in the group).

At each balance sheet date, an entity shall assess whether there is any objective evidence that a financial asset or group of financial assets is impaired. If there is objective evidence that an impairment loss on loans and receivables carried at amortized cost has been incurred, the entity shall measure the amount of the loss as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective interest rate (i.e., the effective interest rate computed at initial recognition).[9] Contractual cash flows and historical loss experience provide the basis for estimating expected cash flows. Historical loss rates are adjusted on the basis of relevant observable data that reflect current economic conditions. The carrying amount of a loan receivable shall be reduced either directly or through use of an allowance account. The entity shall recognize the amount of the loss in profit or loss.

The process for estimating the amount of an impairment loss may result in either a single amount or a range of possible amounts. In the latter case, the entity recognizes an impairment loss equal to the best estimate within the range taking into account all relevant information available before the financial statements are issued about conditions existing at the balance sheet date. Where there is a continuous range of possible outcomes, and each point in that range is as likely as any other, the midpoint of that range is used.[10]

If, in a subsequent period, the amount of the impairment loss decreases and the decrease can be related objectively to an event occurring after the impairment was recognized (such as an improvement in the debtor's credit rating), the previously recognized impairment loss shall be reversed through income either directly or by adjusting an allowance account. The reversal shall not result in a carrying amount of the financial asset that exceeds what the amortized cost would have been had the impairment not been recognized at the date the impairment is reversed.

[9] IAS 39, paragraph 63.

[10] International Accounting Standard 37, *Provisions, Contingent Liabilities and Contingent Assets*, paragraph 39.

Interest Recognition on Impaired Loans

Once a financial asset or a group of similar financial assets has been written down as a result of an impairment loss, the entity shall recognize interest income using the rate of interest used to discount the future cash flows for the purpose of measuring the impairment loss.[11]

Loans Held for Sale

IFRS does not have a specific concept of "loans held for sale" like GAAP, however, loans and receivables that the entity intends to sell immediately or in the near term are classified as held for trading with changes in fair value recognized through profit and loss.

Differences between US GAAP and IFRS

The major differences in the requirements of US GAAP and IFRS related to the allowance for loan losses are:

- When the estimate of the amount of a loan loss represents a range of amounts and no amount in the range is better than other amounts, IFRS requires recording the midpoint in the range, whereas US GAAP requires recording the low point in a range.
- US GAAP does not specify how a creditor should recognize, measure, or display interest income on an impaired loan, although the cost recovery method or a cash basis method or a combination of the two is provided as examples. Under IFRS, after an impairment loss has been recognized, interest income is recognized based on the rate used to discount the future cash flows when measuring the amount of the impairment loss.
- A troubled debt restructuring is defined under US GAAP but not under IFRS; however, under both IFRS and US GAAP impairments are recorded for loans where the lender, for economic or legal reasons relating to the borrower's financial difficulty, grants the borrower a concession that the lender would not otherwise consider.
- Loans held-for-sale are carried at lower of cost or fair value under US GAAP and at fair value under IFRS.
- Impairment on floating-rate loans could potentially be different because IFRS requires the current rate to be used to calculate impairment, whereas US GAAP allows the impairment to be calculated using either (1) the current rate at the date of the impairment, which remains fixed, or (2) a rate that changes with an index or other factors, for assessing the amount of the allowance at future dates.
- In principle, all loan accounting in IAS 39 is based on the present value of cash flows, discounted at the original effective rate. As a result, all IAS 39 loan loss computations should consider both the timing and the amount of expected cash flows, whether labeled as principal or interest. In contrast, the present value computations mandated by Statement 114 apply only to the loans that fall within its scope. Statement 5 does not address discounting.

[11] IAS 39, paragraph AG93.

Plans of the FASB and IASB

The International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB) have added a Financial Instruments project to their agenda that will:

- Reconsider the recognition and measurement of financial instruments
- Address issues related to impairment of financial instruments and hedge accounting
- Improve accounting for financial instruments
- Increase convergence of accounting for financial instruments.

Appendix B

Members of the Working Group on Provisioning

Co-Chairs	**Kathleen Casey** Commissioner Securities and Exchange Commission
	John Dugan Comptroller Office of the Comptroller of the Currency
Co-coordinators, Technical Team	**Kevin Bailey** Deputy Comptroller Office of the Comptroller of the Currency
	Paul Beswick Deputy Chief Accountant Securities and Exchange Commission
Australia	**Heidi Richards** General Manager, Industry Technical Services Australian Prudential Regulation Authority (APRA)
Germany	**Markus Grund** Senior Advisor Bundesanstalt für Finanzdienstleistungsaufsicht (BaFin)
Japan	**Yasushi Shiina** Director for International Banking Regulations, International Affairs Division & Supervisory Coordination Division Financial Services Agency
	Minoru Aosaki Deputy Director, Office of International Affairs Financial Services Agency
United Kingdom	**Richard Thorpe** Accounting Sector Leader Financial Services Authority
United States	**Charles Holm** Senior Advisor, Division of Banking Supervision & Regulation Federal Reserve Board
	Zane Blackburn Chief Accountant Office of the Comptroller of the Currency
	Kathy Murphy Deputy Chief Accountant Office of the Comptroller of the Currency
	Vance Price National Bank Examiner Office of the Comptroller of the Currency

	Rachel Mincin Associate Chief Accountant Securities and Exchange Commission
	Brian Fields Professional Accounting Fellow Securities and Exchange Commission
BCBS	**Klaas H.W. Knot** For the Chairman, BCBS (Division Director, Supervision Policy, Netherlands Bank)
	Stefan Walter Secretary General, BCBS
	Sylvie Matherat Chair, BCBS Accounting Task Force (ATF) (Director, Financial Stability, Bank of France)
	Arthur Lindo BCBS ATF (Associate Director and Chief Accountant – Supervision, Federal Reserve Board)
IMF	**Noel Sacasa** Senior Financial Sector Expert, Monetary and Capital Markets Department
IOSCO	**Steven Maijoor** For the Vice Chairman, IOSCO Technical Committee (Director, Authority for Financial Markets, Netherlands)
	Greg Tanzer Secretary General, IOSCO
	Allison Patti IOSCO SC1 (Professional Accounting Fellow, Securities and Exchange Commission)
IASB	**Tom Jones** Vice-Chairman
	Wayne Upton Director of International Affairs
FASB	**Lawrence Smith** Board member
PCAOB	**Mark Olson** Chairman
	Martin Baumann Director, Office of Research and Analysis
IFIAR	**Paul Boyle** Chairman (Chairman, Financial Reporting Council, UK)
FSF Secretariat	**Gerald A. Edwards, Jr.** Senior Advisor on Accounting and Auditing Policy