Absa Group Limited

Clarifying accounting credit provisioning

Cape Town
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Member of the BARCLAYS Group

ABSA

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IAS 39 principles
When should you provide?

- Entity should assess at the end of each reporting period whether there is **objective evidence** that a financial asset or group of assets is impaired
  - Fairly detailed description is provided in IAS
- Evidence occurred **after the recognition of the asset** (loss event)
  - Even though we know a certain % of customers will default in each tranche of new business, we can't provide for such business from day 1
- Loss event has an impact on the **estimated future cash** flows associated with the asset or group of assets that can be reliably estimated
  - Estimated cash flows include the effect of non-payers

IAS 39 principles
Objective evidence of impairment

Includes **observable data** that comes to the attention of the holder of the asset about the following loss events:

- Significant financial difficulty of the issuer or obligor
  - Could be anything such as unemployment, sickness, natural disasters, debt counselling. Often data tracking stats and proving a causal worsening in cash flows represent challenges
- A breach of contract such as a default or delinquency in the interest or principal payments
  - Most commonly used. Data is clear and simple. Clear link between delinquency and reduced cash flows
- The lender granting to the borrower a concession that the lender would not otherwise consider
  - Repayment plans are often used in Retail banking to assist customers with their payments. Restructure at prime -5% which is not available for new deals will constitute a loss event

IAS 39 principles
Objective evidence of impairment

- It becoming probable that the lender will enter bankruptcy or other financial reorganisation
  - Debt counselling would fall under this category
- The disappearance of an active market for that financial asset as a result of financial difficulties
  - Would relate more to a wholesale environment (EXAMPLE)
- Indicating that there is a measurable decrease in the estimated future cash flows from an asset or a group of assets since the recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including: adverse changes in the payment status of the borrowers in the group; or national or local economic conditions that correlate with the defaults on the assets in the group
  - Gets complicated in an environment where macro variables run in opposite directions, such as unemployment increasing, but interest rates decreasing
  - IBNR (AC133) is being replaced with 'Unidentified Impairment'

IAS 39 principles
Calculation

Measurement of impairment

- Amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of all future cash flows discounted at the financial asset's original effective interest rate
  - Carrying value – Watch out for suspended interest. Could cause double counting.
  - All future cash flows – Including post write-off recoveries!

IAS 39 principles
Calculation

Effective interest rate

- Fees paid and other premiums or discounts paid or received over the life of the loan are included in the calculation of the effective interest rate
  - Pre NCA micro loans : Huge up front admin fee, but low interest rates resulting in high Total Cost of Credit
  - Effective interest rate interpreted to imply contractual rate. The contractual rate will result in a zero impairment should expected cash flows happen without any bad debt
- Floating rate financial assets: re-estimation of cash flows required to reflect the movement in market interest rates which will alter the effective interest rate of the asset
  - Interpreted to mean that the cash flows earned in 2008 can not be discounted at 2009 interest rates resulting in a lower impairment

Calculations in practice
Basics

- You need detailed historical data:
  - Life time data
  - Cash flow information
  - Post write-off recovery information
  - Debt Counselling
- Formulas:
  - DCF% : Discounted instalments / Exposure at observation
  - PD * LGD
  - PD * LGD + (1-PD) * DCF%

Calculations in practice
General / Specific provisions

- General / Specific is a misnomer?
  - In Retail banking each accounts gets an impairment calculated which is then aggregated
  - In wholesale banking each account is still evaluated and a largely subjective impairment allocated. Impossible in Retail due to volumes
  - IAS instructs to impair once a loss event has been identified
  - AC 133 made provision for IBNR (Incurred, But Not Realised) for current accounts;
  - IAS allows for a measureable decrease in cash flows for a group of customers. Cash flow information
- UI Formulas:
  - Introduces the concept of Emergence Period
  - What is the lag between an event and the accounts moving into delinquency (to be based on known events such as bankruptcy, death, unemployment)
  - PD * LGD * Emergence Factor

<table>
<tr><th></th><th>Current</th><th>1-30 days</th><th>60 days</th><th>90 days</th><th>120 days</th><th>180 days</th><th>Legal</th></tr>
<tr><td>IAS</td><td>Unidentified</td><td colspan="6">Identified</td></tr>
<tr><td>Disclosure 1</td><td>General</td><td colspan="6">Specific</td></tr>
<tr><td>Disclosure 2</td><td colspan="3">General</td><td colspan="4">Specific</td></tr>
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Calculations in practice
Issues for consideration

- Point in Time calculations:
  - As provisions are made for future losses – the intention is to predict the medium term future
  - As a result, calculations are based on as recent information as possible
  - To avoid undue volatility, an average is used – 12 months / longer?
  - However, historical data always lags. Will PDs and LGDs based on 2008 data be applicable to June 2009 balance sheets?
  - Certainly some need to complement historical information with forward looking models based on macro-economical changes as well as changes in credit policies and processes (esp collections)
- Definition of Default:
  - Integral part of any impairment calculation
  - Always some subjective measure included (transfer to Legal) which is process and human dependant
  - Shouldn't change the number: an early definition increases the PD, but reduces the LGD
  - Not necessarily aligned to Basel
  - SA banks disclose 90 days. Basel = 90 days. Not necessarily aligned to processes in the bank – reduces the value of the term 'default' in operational MI

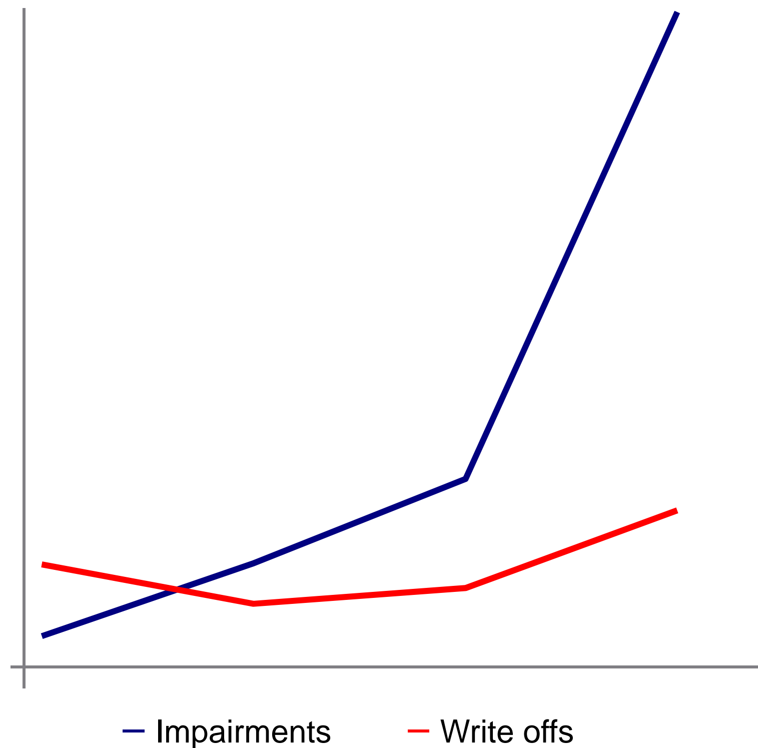
Calculations in practice
Issues for consideration

- LGDs :
  - The expected cash flows once an account has defaulted
  - Unsecured – Difference in balance from month – month adjusted for interest and fees
  - Card – additional purchases means that cash flows are calculated on a nett basis
  - Secured:
    - Actual cash flows adjusted for security values – often per LTV band
    - Security – physical / index adjusted
    - Discounting to point of default
  - Will depend on the default definition. Early default definition has a low LGD
- Outcome Periods:
  - Time between the loss event and an actual default
  - Most often the time it takes for a delinquent account to default
  - Basel = 12 months. This is not an IAS term
- Emergence:
  - Time that it takes for a perfectly current account to indicate signs of a loss event
  - Most often the time it takes for a current account to become delinquent (bucket 1)

Calculations in practice
An overview

	Formula	Key questions
Unidentified impairment	Balance * PD x LGD x emergence factor	• Appropriateness of loss events applied in the calculation of unidentified impairment
Identified impairment	Balance * PD x LGD	• Treatment of anomalies such as debt counselling • Coverage of outcome periods
Default	Balance x LGD	• Are recent changes in security values considered
General		• What assumptions have been made • Have overrides to the model taken place and if so, why • How have the parameters moved and why, i.e: – Data history – Formula change – Change in process

Backtesting



- When are you over / under provided?
- 1 year's write-offs ? Often used in the USA – huge lag for mortgages + discounting could double losses!
- Coverage ratios with other banks? Differences in write-off strategies cloud issues.
- Comparisons to Expected Loss? Fundamental differences
- Remains a combination of various factors

Impact of Economic Cycles

- IAS discourages over-the-tops, therefore impairments under IAS 39 will be volatile
- Different portfolios react differently
  - Homeloans have a longer lag due to loan terms (20 – 30 years) and the work out in Legal takes 12 to 18 months
  - Micro loans have and 18 month terms and takes < 6 months to be worked out in Legal
  - Mortgage portfolios can continue to take pain long after interest rates start to decrease – [house prices, longer terms]
- 0-1 roll rates are very sensitive to interest rate movements, so expect to see a reduction in UI
- Later roll rates and legal work-out have a profound lag. Expect continued high Specific Impairments / II

Expected Loss vs Impairments

Requirement	EL	Impairments
Loss Event	Expected	Objective evidence of a default event (1 cent or 1 day in arrears)
Exposure Definition	Exposure at default (EAD) (i.e. the aggregate of all utilised and unutilised facilities after applying the relevant Credit Conversion Factor)	Utilised (drawn) balance
PD	Through the cycle	Point in time
Default point (where a 100% PD is applied)	90 days in arrears	Incurred loss event
LGD	Downturn (based on the market value of security)	Actual/expected realisation of security