FASB Credit Losses

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Respondent information

Type of entity or individual:

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Questions and responses

1. Do you agree with the scope of financial assets that are included in this proposed Update? If not, which other financial assets do you believe should be included or excluded? Why?

   Yes, the scope is appropriate, but the proposal has significant consequences for long-duration retail loans and smaller lenders.

2. The proposed amendments would remove the initial recognition threshold that currently exists in U.S. GAAP and, instead, view credit losses as an issue of "measurement" as opposed to an issue of "recognition" because the credit losses relate to cash flows that are already recognized on the balance sheet. Do you believe that removing the initial recognition threshold that currently exists in U.S. GAAP so that credit losses are recognized earlier provides more decision-useful information?

   Yes, moving to a measurement approach is a necessary step if we are to avoid entering recessions under-reserved and exiting recessions over-reserved.

3. As a result of the proposed amendments, the net amortized cost on the balance sheet (that is, net of the allowance for expected credit losses) would reflect the present value of future cash flows expected to be collected, discounted at the effective interest rate. Do you agree that the net amortized cost (which reflects the present value of cash flows expected to be collected) results in more decision-useful information than currently exists under U.S. GAAP?

4.   The Board has twice considered credit loss models that would permit an entity not to recognize certain expected credit losses. In the January 2011 Supplementary Document, the Board considered a model that would permit an entity not to recognize some credit losses expected to occur beyond the foreseeable future. In the recent discussions on the three-bucket impairment model, the Board considered a model that would permit an entity only to recognize lifetime credit losses for loss events expected to occur beyond the 12-month horizon. Instead, the proposed amendments would require that at each reporting date an entity recognize an allowance for all expected credit losses. Do you believe that recognizing all expected credit losses provides more decision-useful information than recognizing only some of the expected credit losses? If not, how would you determine which expected credit losses should not be recognized (for example, 12 months or similar, foreseeable future horizon, initial recognition threshold, and so forth)?

The models required to estimate lifetime losses could also be used to estimate losses for a shorter period of time. The requirement to reserve against lifetime losses for long-duration assets like mortgages and auto loans appears to be onerous. More appropriate would be to consider a horizon sufficient to adjust loss reserves. If 12 months is too short to increase reserves in anticipation of future losses, then perhaps increase to 24 months.

Regardless of the forecast horizon, accurate modeling of long-duration loans will require the same models incorporating product lifecycles and the macroeconomic environment, so this is not a question of implementation difficulty or visibility, but of maintaining the financial viability of these loan types.

5.   The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets' remaining contractual cash flows. Do you believe that expected credit losses based on this information provides decision-useful information?

Every other area of large lenders already uses model-based decision-making. The proposal would bring the accounting standards in line with what is already needed for portfolio forecasting, stress testing, and Basel II. Even loan pricing should be based upon models such as these. A forward-looking, model-based approach should be considered non-negotiable if a lender's accounting is to align with its business management.

Smaller lenders such as credit unions, community banks, and finance companies are increasingly being asked to conduct forecasts, stress tests, concentration risk, and interest rate risk assessments. Although most smaller lenders have not yet implemented such models, the need is clear. This proposal will require significant new effort by these smaller lenders, but effort that they will need to expend in the near future regardless. This seems to be the right time to make such a proposal in order to keep these efforts aligned.

6.   For purchased credit impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be amortized and recognized as interest income over the life of the asset. To achieve this result, upon acquisition the initial estimate of expected credit losses would be recognized as an adjustment that increases the cost basis of the asset. Apart from this requirement, purchased credit impairment assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you believe that using the same approach to recognize changes in the credit impairment allowance for purchased credit-impaired assets and non-purchased-credit impaired assets provides decision-useful information? Do you believe that this is an improvement from the current model used for purchased credit-impaired assets?

Using an equivalent approach to assess future losses on both PCI and portfolio loans make sense, but can only be achieved if the seller provides sufficient history on those loans. At present, sellers rarely provide enough historical information for anything more than a guess at future losses. To estimate lifetime losses will require the transfer of significantly more historical information. The current standard of providing the most recent bureau score is far from adequate.

7.   As a practical expedient, the proposed amendments would allow an entity not to recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost amount of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. The proposed amendments would require an entity to disclose the amortized cost basis of assets that apply this practical expedient each period. Do you believe that the practical expedient for some financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income is reasonable? Why or why not?

8.   The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this approach provides decision-useful information?

9.   The proposed amendments would require that an estimate of expected credit losses be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets' remaining contractual cash flows. Do you foresee any significant operability or auditing concerns or constraints in basing the estimate of expected credit losses on such information?

To avoid future portfolio failures, loss reserves will need to be based upon real models, not rough intuitive estimates. Like any other model within the financial institution, those models will need to be validated and audited. That is standard practice everywhere else that models are used and should not be viewed as an abnormal requirement here.

10.   The Board expects that many entities initially will base their estimates on historical loss data for particular types of assets and then will update that historical data to reflect current conditions and reasonable and supportable forecasts of the future. Do entities currently have access to historical loss data and to data to update that historical information to reflect current conditions and reasonable and supportable forecasts of the future? If so, how would this data be utilized in implementing the proposed amendments? If not, is another form of data currently available that may allow the entity to achieve the objective of the proposed amendments until it has access to historical loss data or to specific data that reflects current conditions and reasonable and supportable forecasts?

For any asset with a significant lifecycle, rough adjustments to historical averages has failed in every major crisis around the world, including the US Mortgage Crisis where roll rate models proved woefully inadequate. To create a usable forward-looking estimate, historic data must be analyzed with sufficiently robust models. These models exist and are in use at leading institutions. Using lesser averaging techniques always fails in the face of lending cycles, credit cycles, and economic cycles. (e.g. J. Breeden, RMA Journal, "Consumer Risk Appetite: How Comsumer Demand Drives Credit Quality", March, 2012.)

Creating a viable forward-looking model requires two to three years of performance history on loans of all vintages to estimate lifecycles, credit risk, and simple extrapolations of the macroeconomic environment. To approximate correlations to macroeconomic history requires at least one full economic cycle, such as having data back to roughly 2004 in the current context.

For those without sufficient historical in-house data, credit bureaus are beginning to provide longer performance history by vintage suitable for calibrating the needed models.

11.   The proposed amendments would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. This proposal would prohibit an entity from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode). As described in the Implementation Guidance and Illustrations Section of Subtopic 825-15, the Board believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability or auditing concerns or constraints in having the estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results?

Modeling the probability of loss versus no-loss is standard practice throughout the models used in lending institutions.

12.   The proposed amendments would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off because of credit loss and the amortized cost basis of the asset and by applying the loss statistic to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors. Do you foresee any significant operability or auditing concerns or constraints with the proposal that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly? If time value of money should not be contemplated, how would such an approach reconcile with the objective of the amortized cost framework?

If losses are to be computed over the remaining lifetime of the loan, in cases of 30-year mortgage or 7-year auto loans a discounted cash-flow approach is essential to avoid trying to hold full reserves against possible losses 30 years into the future.

13.   For purchased credit-impaired financial assets, the proposed amendments would require that the discount embedded in the purchase price that is attributable to expected credit losses at the date of acquisition not be recognized as interest income. Apart from this proposal, purchased credit-impaired assets would follow the same approach as non-purchased-credit-impaired assets. That is, the allowance for credit losses would always be based on management's current estimate of the contractual cash flows that the entity does not expect to collect. Changes in the allowance for expected credit losses (favorable or unfavorable) would be recognized immediately for both purchased credit-impaired and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you foresee any significant operability or auditing concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition?

14.   As a practical expedient, the proposed amendments would allow an entity not to recognize expected credit losses for financial assets measured at fair value with qualifying changes in fair value recognized in other comprehensive income when both (a) the fair value of the individual financial asset is greater than (or equal to) the amortized cost basis of the financial asset and (b) the expected credit losses on the individual financial asset are insignificant. Do you foresee any significant operability or auditing concerns or constraints in determining whether an entity has met the criteria to apply the practical expedient or in applying it?

15.   The proposed amendments would require that an entity place a financial asset on nonaccrual status when it is not probable that the entity will receive substantially all of the principal or substantially all of the principal or substantially all of the interest. In such circumstances, the entity would be required to apply either the cost-recovery method or the cash-basis method, as described in paragraph 825-15-25-10. Do you believe that this proposal will change current practice? Do you foresee any significant operability or auditing concerns with this proposed amendment?

16.   Under existing U.S. GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a troubled debt restructuring. As described in paragraphs BC45–BC47 of the basis for conclusions, the Board continues to believe that the economic concession granted by a creditor in a troubled debt restructuring reflects the creditor's effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, unlike certain other modifications that do not qualify as troubled debt restructurings, the Board views the modified debt instrument that follows a troubled debt restructuring as a continuation of the original debt instrument. Do you believe that the distinction between troubled debt restructurings and nontroubled debt restructurings continues to be relevant? Why or why not?

17.   Do you believe the disclosure proposals in this proposed Update would provide decision-useful information? If not, what disclosures do you believe should (or should not) be required and why?

18.   Do you foresee any significant operability or auditing concerns or constraints in complying with the disclosure proposals in the proposed Update?

19.   Do you believe that the implementation guidance and illustrative examples included in this proposed Update are sufficient? If not, what additional guidance or examples are needed?

The examples provided can be misleading at times. Any retail loan with a duration greater than 90 days will show a strong lifecycle effect, so roll rate models will be inappropriate except for pay-day and tax refund loans. The reason being that lifetime loss forecasts must be able to capture the lifecycle effects from any age of the loan through the projected duration of that loan. For all but the shortest retail loans, only the vintage approach will apply.

The vintage-based example provided is overly simplistic. It illustrates annual analysis of annual vintages. That may be acceptable as an output of a model, but any model that captures macroeconomic impacts on loan losses will need at least quarterly and preferably monthly granularity. (For an in-depth discussion of modeling retail loans with macroeconomic data, see J. Breeden (2010) "Reinventing Retail Lending Analytics", Riskbooks.)

Considering both the lifetime and forward-looking requirements together means that much more sophisticated models will be required than any of the provided examples. This is not an insurmountable requirement, as many of the largest banks already possess the makings of such models for meeting their stress testing requirements. However the examples should mention to which assets they apply, and it should be mentioned that none of them are satisfactory to meet the proposal's goals when considering card, auto, mortgage, home equity, or personal loans and lines extending beyond one year.

20.   Do you agree with the transition provision in this proposed Update? If not, why?

21.   Do you agree that early adoption should not be permitted? If not, why?

No, early adoption should be allowed. Creating the models necessary to meet these requirements is a significant undertaking that will take considerable time. If early adoption is not allowed, lenders are not incented to begin this work early. By waiting until near the end, many will run out of time and deploy substandard models, defeating the purpose. Lenders need to be incented to begin this work early and take the time required to make models of sufficient quality to be useful in the next crisis.

22.   Do you believe that the effective date should be the same for a public entity as it is for a nonpublic entity? If not, why?

23.   Do you believe that the transition provision in this proposed Update is operable? If not, why?

24.   How much time would be needed to implement the proposed guidance? What type of system and process changes would be necessary to implement the proposed guidance?

For retail loan portfolios, lenders should anticipate at least a year to gather the necessary data, build the models, test and validate them. Larger institutions will go faster, because they will have a head start from efforts to comply with Basel and stress testing requirements. Any institution not currently engaged in either Basel or stress testing will find that they must undertake significant effort in terms of data and analytics capabilities. A majority of smaller lenders will most likely need to turn to data and analytics vendors to provide solutions as in-house resources and expertise will be limited.

| Additional comments-updt. | Please provide any additional comments on the proposed Update: |
| Additional comments-process. | Please provide any comments on the electronic feedback process: |