**MINUTES**

Financial Accounting Standards Board

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| **To:** | FASB Board Members | | |
| **From:** | Accounting for Financial Instruments Team | | |
| **Subject:** | August 22, 2012 FASB Board Meeting—Accounting for Financial Instruments: Impairment | **Date:** | August 29, 2012 |

*The Board meeting minutes are provided for the information and convenience of constituents who want to follow the Board's deliberations. All of the conclusions reported are tentative and may be changed at future Board meetings. Decisions become final only after a formal written ballot to issue an Accounting Standards Update or a Statement of Financial Accounting Concepts.*

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| Topic: | Accounting for Financial Instruments: Impairment |
| Basis for Discussion: | Memorandums 176 through 183 |
| Length of Discussion: | 8:00 a.m. to 10:28 a.m. EDT |

Attendance:

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| Board members present: | Seidman, Buck, Golden, Linsmeier, Siegel, and Smith |
| Board members absent: | Schroeder |
| Staff in charge of topic: | Kane |
| Other staff at Board table: | Stoklosa, McKinney, Shah, Tyson, and Rayfield |
| Outside participants: | Cooper, McConnell, Lloyd, Streckenbach, and Kapsis (IASB) |

**Type of Document and Timing Based on the Technical Plan:**

The Board met to discuss issues relating to the development of an Accounting Standards Update addressing the accounting for financial instruments. The Board's technical plan calls for an exposure document to be issued during the fourth quarter of 2012.

**Summary of Decisions Reached:**

At the August 22, 2012 Board meeting, the Financial Accounting Standards Board (FASB) made a number of key decisions on an alternative expected credit loss impairment model to address U.S. stakeholders' significant concerns about the understandability, operability, and auditability of the three-bucket credit impairment model under joint development with the IASB and whether it would reflect an appropriate measure of risk. This alternative model is referred to as the "Current Expected Credit Loss Model" (or the "CECL Model"). The CECL Model retains several key concepts that have been jointly deliberated and agreed upon with the IASB, including the main concept of expected credit loss and the current recognition of the effects of credit deterioration on collectability expectations. Unlike the three-bucket model, however, the CECL Model utilizes a single-measurement objective (that is, current estimate of expected credit losses) as opposed to the three-bucket model's dual-measurement approach, which requires a "transfer notion" to distinguish between financial assets that are required to use a credit impairment measurement objective of "12 months of expected credit losses" from those that use a credit impairment measurement objective of "lifetime expected credit losses." Following is a summary of the CECL Model resulting from the FASB's discussion.

Summary of the CECL Model

At each reporting date, an entity reflects a credit impairment allowance for its current estimate of the expected credit losses on financial assets held. The estimate of expected credit losses is neither a "worst case" scenario nor a "best case" scenario, but rather reflects management's current estimate of the contractual cash flows that the entity does not expect to collect. Certain approaches based on probability of default expectations, loss rates, and discounted expected cash flows would be consistent with this principle. Under the CECL Model, the credit deterioration (or improvement) reflected in the income statement will include changes in the estimate of expected credit losses resulting from, but not limited to, changes in the credit risk of assets held by the entity, changes in historical loss experience for assets like those held at the reporting date, changes in conditions since the previous reporting date, and changes in reasonable and supportable forecasts about the future. As a result, the balance sheet reflects the current estimate of expected credit losses at the reporting date and the income statement reflects the effects of credit deterioration (or improvement) that has taken place during the period.

Operationally, the FASB expects that expected credit loss estimates will often be measured for pools of similar asset types using the credit risk ratings determined by the entity as of the balance sheet date. As a result, entities may leverage their existing internal credit risk management tools and systems to implement the CECL Model. For example, if a pool of commercial mortgages held at the end of a reporting period is evaluated by an entity as a "Pass Category 2" loan, the entity might begin its estimate with its historical loss experience appropriate for that category, which would typically be quite low, and then adjust the historical loss experience for current conditions, and reasonable and supportable forecasts about the future. If credit conditions change during the next period such that a portion of the commercial mortgages is now categorized as "Pass Category 4," the entity would begin to develop its current expected credit loss estimate for those loans based on historical loss experience appropriate for that category, thereby increasing its current estimate of expected credit loss. If credit conditions continue to deteriorate and at the third reporting period some of the commercial mortgages are rated "Special Mention," the entity would likely begin its current expected credit loss estimate for the loans rated "Special Mention" with historical loss experience appropriate for that category and then adjust that historical loss experience as described above.

As risk increases in the various rating categories, the current estimate of expected credit loss would increase. Illustrated through use of a numerical example, for a pool of "Pass Category 2" commercial mortgages (which may include newly originated mortgages), 40 basis points[1] may represent the current expected loss, whereas a 7 percent loss might be expected for commercial mortgage loans that have deteriorated to a "Special Mention" risk rating. Any changes in the allowance—both increases and decreases—would be recognized immediately in net income.

The key difference between the CECL Model and the previous three-bucket model is that under the CECL Model, the basic estimation objective is consistent from period to period, so there is no need to describe a "transfer notion" that determines the measurement objective in each period. As the example above illustrates, the estimates are updated every period for current information about the financial assets for which credit impairment is being measured using all supportable internally and externally available information considered relevant in making the forward-looking estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The estimates are never limited to losses expected over a specific period of time (whereas the "bucket one" estimate in the three-bucket model is limited to 12 months). As previously noted, after origination, expected credit losses for the loans in the earlier, higher-quality credit

[1] In this example, 40 basis points represents losses expected on a pool of newly originated commercial mortgage loans expressed as a percentage of the pool's recorded investment. It does not imply that each loan will experience a 40 basis point loss. Rather, the entire contractual cash flows will be collected for a majority of the loans in the pool. A small percentage of loans will experience significant credit losses (well in excess of 40 basis points), but these loans are not yet individually identifiable.

grades would typically be much less than expected credit losses for more severely rated loans that have significantly deteriorated in credit quality. Consistent with current accounting requirements, interest income would generally be recognized on the basis of contractual cash flows.[2] However, for purchased financial assets that have experienced significant deterioration in credit quality since origination, the discount embedded in the purchase price that is attributable to expected credit losses (that is, non-accretable yield[3]) would never be included in interest income. In all other regards, these assets would follow the same approach described above (that is, upon acquisition and at each reporting date an entity would recognize a credit impairment allowance for its current estimate of the contractual cash flows that the entity does not expect to collect). As a result, under this approach the allowance for originated financial assets[4] and purchased credit impaired financial assets would be measured consistently. However, balance sheet and income statement amounts for originated and purchased credit impaired financial assets would be presented separately. Furthermore, users will continue to be provided transparency into current credit risk assessments and the effects of credit deterioration (or improvement) on collectability expectations through the credit quality and risk disclosures that already require that an entity provide quantitative and qualitative information (by class of financial receivable) about credit quality, including the amount of recorded investment by credit quality indicator.

It should be noted that the CECL Model has been developed in the context of all financial assets. However, future discussions may affect the tentative decisions made during the development of the CECL Model. For example, discussions about how to apply the CECL Model to debt instruments measured at fair value with changes reported in other comprehensive income (FV-OCI) and debt securities have not been completed.

In summary, the CECL Model retains several key expected loss concepts that have been jointly deliberated and agreed upon with the IASB. The FASB believes that the CECL Model will improve the understandability and simplify the implementation of the expected credit loss principle.

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[2] The FASB plans to consider whether to retain a nonaccrual principle in the CECL Model in the near future.

[3] The non-accretable yield represents the discount inherent in the purchase price that is attributable to expected credit losses that exist at the date of purchase. Consistent with current U.S. GAAP and the approach under the three-bucket impairment model, the CECL Model would never recognize that credit-related discount as “interest income.” Rather, if (subsequent to the date of purchase) there was a decrease in the expected credit losses below that expected at the date of purchase, such a change would be recognized as a reduction in “impairment expense” in that period.

[4] Originated financial assets include purchased financial assets that have not experienced significant deterioration in credit quality since origination.

*Technical Decisions Reached in Developing the CECL Model*

This section provides details of the technical decisions reached in developing the CECL Model summarized above.

*Information Set to Consider*

The Board discussed the information set to be considered in assessing and/or measuring credit impairment. Consistent with its previous decision on the three-bucket impairment model, the Board decided that an estimate of expected credit losses should be based on all supportable internally and externally available information considered relevant in making the forward-looking estimate, including information about past events, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The information used should include qualitative and quantitative factors specific to the creditor, general economic conditions, and an evaluation of both the current point in the credit cycle and the forecasted direction of the credit cycle (for example, as evidenced by changes in issuer or industry-wide underwriting standards). An entity need only consider information that is reasonably available without undue cost and effort. The Board acknowledged that measuring expected credit losses requires judgment and estimates, and the eventual outcomes may differ from those estimates.

Seven Board members voted in favor of this decision.

*Decoupled Interest Approach*

Consistent with current accounting requirements, and consistent with the Board's previous decision on the three-bucket impairment model, the Board decided that interest income would generally be recognized on the basis of contractual cash flows for financial assets that do not qualify as purchased credit-impaired (PCI). [The FASB plans to consider whether to retain a nonaccrual principle in the CECL Model in the near future.]

Seven Board members voted in favor of this decision.

*Measurement Objective and Recognition Threshold*

The Board decided that the model should utilize a measurement objective of "expected credit losses" and that there should not be an initial recognition threshold that must be met before an entity recognizes a credit impairment. Expected credit losses are defined as the estimate of contractual cash flows not expected to be collected. Furthermore, the Board acknowledges that estimating expected credit losses over longer periods of time requires a significant amount of judgment and that as the forecast horizon increases, the degree of detail necessary in estimating expected credit losses decreases.

Seven Board members voted in favor of this decision.

*Measurement of Expected Credit Losses*

Consistent with the Board's previous decision on the three-bucket impairment model, the Board decided that an entity's estimate of expected credit losses should reflect the time value of money. To the extent that an entity estimates expected credit losses using a discounted cash flow model, the Board decided that the discount rate utilized should be the financial asset's effective interest rate.

In applying this principle, the Board indicated that because the amortized cost basis of a financial asset represents the principal and interest cash flows discounted at the original effective interest rate, measurement approaches that estimate expected credit losses based on historical charge-off rates are acceptable methods of estimating expected credit losses in a manner that reflects the time value of money. Similarly, the Board decided that as a practical expedient, measurement approaches for collateral-dependent financial assets that estimate expected credit losses by comparing the cost basis with the fair value of collateral are acceptable methods of estimating expected credit losses in a manner that reflects the time value of money.

Seven Board members voted in favor of this decision.

Consistent with the Board's previous decision on the three-bucket impairment model, the Board also decided that an entity's estimate of expected credit losses should, at a minimum, contemplate at least two possible outcomes, including (1) an outcome in which a credit loss results and (2) an outcome in which no credit loss results. As a result, an entity would be prohibited from estimating expected credit losses on the basis of the most likely outcome for an individual financial asset.

In applying this principle, the Board indicated that some measurement methods (such as a loss-rate method, a probability of default method, and a provision matrix method using loss factors) rely on an extensive population of actual loss data as an input when estimating credit losses and, therefore, inherently satisfy this requirement because the population of actual loss data reflects items within that population that ultimately resulted in a loss and those that resulted in no loss. Similarly, the use of the fair value of collateral in estimating credit losses for collateral dependent loans inherently satisfies this requirement because the fair value of collateral reflects several potential outcomes on a market-weighted basis.

Seven Board members voted in favor of this decision.

*Purchased Credit-Impaired Assets*

The Board decided to define PCI assets as acquired individual assets (or acquired groups of financial assets with shared risk characteristics at the date of acquisition) that have experienced a significant deterioration in credit quality since origination, based on the assessment of the buyer.

Six Board members voted in favor of this decision.

The Board decided that these assets should follow the same approach as originated assets for purposes of credit impairment (that is, upon acquisition and at each reporting date an entity would recognize a credit impairment allowance for its current estimate of future contractual cash flows that the entity does not expect to collect). Changes in the credit impairment allowance (favorable or unfavorable) would be recognized immediately.

When recognizing interest income on PCI assets, the discount embedded in the purchase price that is attributable to expected credit losses (that is, nonaccretable yield) would not be recognized in interest income. One way an entity might practically follow this approach and integrate it into existing systems would be to deem the amortized cost of the PCI asset, at acquisition, to equal the sum of (1) the purchase price and (2) the associated impairment allowance at the date of acquisition. By doing so, the asset could then be accreted from the PCI amortized cost to the contractual cash flows (that is, par) without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition.

Furthermore, the Board decided that balance sheet and income statement amounts for PCI should be presented separately from similar amounts for non-PCI assets.

Seven Board members voted in favor of this decision.

*Recognition of the Difference between Fair Value and Net Amortized Cost for Debt Instruments Classified and Measured at Amortized Cost and FV-OCI*

For financial assets measured at *amortized cost*, the Board has previously decided that impairment for financial assets subsequently identified for sale should be recognized in earnings in an amount equal to the entire difference between the instrument's amortized cost basis and its fair value.

For financial assets measured at *FV-OCI*, the Board decided that any unrealized loss resulting from the difference between (1) the fair value of a financial instrument and (2) the net carrying amount of the financial instrument (that is, the amortized cost less any impairment allowance) should only be recognized in earnings when the entity actually sells the financial instrument.

Seven Board members voted in favor of this decision.

*Recognition of Credit Impairment as an Allowance*

For debt instruments classified at either amortized cost or FV-OCI (including debt securities), the Board decided that the estimate of expected credit losses should be recognized as an allowance (that is, a contra-asset) rather than as a cost-basis adjustment to the asset.

Seven Board members voted in favor of this decision.

*Presentation for Financial Assets Measured at FV-OCI*

The Board decided that, at a minimum, an entity should present on the balance sheet both (1) the fair value and (2) the amortized cost (net of allowance for credit losses) for financial assets classified and measured at FV-OCI. If they are not presented on the balance sheet, the notes to the financial statements should include a full reconciliation of the difference between the fair value and amortized cost for such assets, including (a) amortized cost, (b) the allowance for credit losses, (c) the accumulated amount needed to reconcile amortized cost less allowance to fair value, and (d) fair value.

Seven Board members voted in favor of this decision.

*Application of the CECL Model to Debt Securities and Debt Instruments Measured at FV-OCI*

The Board discussed the application of the model to debt securities and debt instruments measured at FV-OCI but did not make any decisions (other than those described above). In the near future, the Board intends to discuss how the CECL Model would apply to debt securities and debt instruments measured at FV-OCI.