

FASB Credit Losses

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Respondent information

Type of entity or individual:

Preparer

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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?

We realize that this inclusion is not new to the proposal; however, we fail to see the theoretical logic of including loan commitments in the consideration of credit losses. How can an expense (for credit loss provision) and an allowance against outstanding loans (contra-asset) be recognized in a period in which the loan has not actually been extended? These certainly are commitments, but until the loan is actually drawn down, what is there to reserve for?

Consider the following illustration of this requirement to book an allowance for loan commitments: Assume a new credit union opens its doors on Day 1 and commits \$3,000,000 in credit card loans. If a provision amount at an estimated 3% of commitments is recorded, a \$90,000 allowance is expensed and recognized. If on that first day, \$50,000 is spent on the cards, the result is a \$(40,000) net loan balance. How does that make sense?

Consider in an extreme case that this credit union closes its doors at the opening of Day 2. The maximum loss exposure is \$50,000 because that is the total of the loans extended. The resulting entry would be to unwind at least \$40,000 of the provision back to income.

To avoid understating loan balances and overstating credit loss expense, loan commitments need to be excluded from the scope of this proposal.

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?

N/A

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?

N/A

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)?

N/A

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?

N/A

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?

N/A

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?

N/A

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?

N/A

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?

i. We currently take into account historical loss experience adjusted through qualitative and environmental factors to reflect current conditions. We take a very limited forward-looking view to ascertain the likelihood of foreclosure on identified loans. So, the major change will be in building reasonable and supportable forecasts on a recurring basis. This proposed guidance is very vague regarding implementation, and there are no best practices as no one is currently doing this.

From an audit standpoint, the vaguer the guidance and the more "prophetic" institutions become in projecting credit losses, the less ground there is for auditors to take a stand on what is reasonable. We concede that the proposed language calls for "reasonable and supportable," but even that is vague. Essentially, we run the risk of moving into a realm where there is no sense-check left because we have left common sense behind.

ii. From an operating standpoint, the implementation of the proposed guidance could have a significant impact on the answer to the following theoretical lending question: if an institution could make an "A" loan with essentially no risk of loss, or a "C" or "D" loan, which would they make?

In the current environment, they could make either one because while the C/D paper has higher risk of loss, that risk is offset through a higher risk-based rate. Under the proposed guidance, there would be no provision recorded for expected losses on the "A" loan, where the expected lifetime loss for the "C/D" loan would have to be recorded up front. However, the institution is not allowed to book the corresponding higher interest income up front, resulting in a mismatch in expense (expected loan losses) and income (higher earnings on a riskier loan). As such, the institution would gravitate toward the "A" paper

This proposal could have the unintended consequence of making it harder for people of "modest means", or those whose credit has taken a temporary turn for the worse, to have access to funds. Financial institutions might shy away from booking lower quality loans if it means recognizing lifetime losses up front, effectively shutting off access to capital at a time when such people most need it.

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?

See response to Q9. We currently have sufficient historical data and update to reflect current conditions. However, we likely cannot use this data to build reasonable and supportable future forecasts. We do not currently incorporate forecasts and this data is not currently available.

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?

i. See response to Q2. Assuming we continue to rely on historical data adjusted for qualitative and environmental factors, including both loans with losses and those without, we would implicitly consider both outcomes. The additional impact would be minimal.

ii. See response to Q9. The same auditing concerns are echoed here.

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?

We already use methods that reflect the time value of money: explicitly with discounted cash flow models and implicitly with our FAS 5 loss ratio analyses by portfolio segment.

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?

Not expected to have material impact.

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?

Not sure that this is helpful as written – you still have to calculate. So in the end, not sure that you have really saved any time or effort.

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?

Due to system limitations, we already have to manually back off accrued interest for loans on non-accrual status. It appears that as a result of the application of this proposed guidance, more loans would meet the non-accrual criteria, which would result in increased (and arguably unnecessary) administrative burden.

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?

The distinction between troubled debt restructurings and nontroubled debt restructurings is not relevant to us. We are concerned with whether our loans are collectible, not whether the borrower is experiencing financial difficulty or 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?

Regardless of disclosure provided, due to the vagueness in the proposed guidance, there will be wide diversity of practice. As a result, instead of aiding in clarifying the financial position of a financial institution, their position will be further muddled when compared against peers.

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

See response to Q9. The same disclosure concerns are echoed here.

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?

Again, due to the vagueness in the proposed guidance, any illustrations are helpful. However, the key will not necessarily be determining how to “calculate” the future portion, rather, finding what to use to provide appropriate estimates of expected charge-offs.

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

They appear reasonable for what would be required.

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

We agree that early adoption should not be permitted. If it is permitted, comparability is non-existent.

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?

No, the effective date should not be the same for both public and nonpublic entities. In some cases, due to limited resources, the burden on nonpublic companies would be excessive in attempting to comply with the proposed guidance.

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

They appear reasonable for what would be required.

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?

The earliest implementation would be feasible is two years. This would provide the necessary time to determine what reasonable and supportable forecasts of the future would be, calculate the cumulative effect and work through tracking concerns within the system.

Additional comments-updt. Please provide any additional comments on the proposed Update:

Additional comments-process. Please provide any comments on the electronic feedback process:
