Accounting for Financial Instruments – Credit losses

December 11, 2014

FINANCIAL ACCOUNTING STANDARDS BOARD

Introduction

Financial Crisis Advisory Group (FCAG)

- Formed in 2008 by FASB and IASB

Recommendation

- Explore alternative to ‘incurred loss model’
- Reduce complexity by having a single impairment model
- Utilize more forward-looking information

Current Response

- Proposals that result in more timely recognition of credit losses
  - FASB model – recognize all (lifetime) expected credit losses
  - IASB model – recognize some (12 months) expected credit losses until significant deterioration threshold is met, then recognize lifetime expected credit losses

FASB Model - Current Expected Credit Loss (CECL)

Expected credit loss model reflecting more forward-looking information (lifetime expected losses)

At each reporting date, an organization recognizes a credit impairment allowance equal to the estimate of all contractual cash flows not expected to be collected over the life of the financial asset

- Reflects management expectations based on past events, current conditions, and reasonable and supportable forecasts.
- Includes changes in the estimate of expected credit losses resulting from, but not limited to:
  - Changes in credit risk of assets held by an entity
  - Changes in conditions since previous reporting date
  - Changes in reasonable & supportable forecasts about the future

Provides enhanced disclosures compared to current GAAP

Available-for-Sale Debt Securities

AFS debt securities were excluded from the CECL model during Redeliberations

Would apply modified impairment guidance in Topic 320

- An allowance approach would be used for recognizing impairment losses, which would allow for credit loss reversals
- Requirement to consider the length of time that fair value of the security has been below amortized cost would be eliminated
- When estimating whether a credit loss exists, an entity would no longer be required to consider recoveries or additional declines in fair value after the balance sheet date

Summary of the Board's Decisions

Loans		Debt Securities	
Held for Investment	CECL	**Held to Maturity**	CECL*
Held for Sale	Lower of cost or market	**Available for Sale**	New credit loss model*
		Trading	FV-NI

* Under both the CECL model and the new credit loss model for AFS debt securities, losses will be reflected for the difference between the debt security's amortized cost basis and its fair value (LOCOM) when identified for sale

New credit loss model for AFS debt securities – The Board decided that the "other-than-temporary" concept should no longer exist

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AFI Impairment: Model Change

Current U.S. GAAP vs. "Current Expected Credit Loss" (CECL)

	US GAAP Today	Proposal (CECL)
When a Loss is Recognized	When a loss is "probable," or "incurred" (+ four other models)	No recognition threshold, updated at each reporting date
How Much of a Loss is Recognized	Difference between the recorded investment and the present value of expected future cash flows, discounted at loan's original effective interest rate	Current estimate of cash flows not expected to be collected
What Information Set is Used in Determining a Loss	Past events & current conditions	Past events & current conditions Reasonable & supportable expectations about future

High Level Feedback—U.S. Stakeholders

- Strong (3-1 margin) user support for FASB proposal
- Preparers generally do not support recognition of full life time losses on day 1
  - Concern with projecting losses beyond a reasonably foreseeable time period
  - Concern that CECL does not reflect economics of lending
- Strong support for PCI model

Redeliberations

Clarifications to measurement principle
- Elimination of multiple outcomes approach
- Collective evaluation when similar risk characteristics exist
- Periods beyond reasonable and supportable forecasts – revert to historical average
- Collateral-based practical expedients
- ECL for contractual term, considering prepayments but not extensions, renewals, modifications unless TDR expected.
- Consider relevant internal and external information
- Not required to recognize credit loss when amount of loss would be zero.

- **In-Scope**
  - Financial guarantees
  - NFP programmatic loans
  - Reinsurance receivables
- **Out of scope**
  - 401(k) loans
  - Insurance policy loan receivables
  - Pledges receivable
  - Common control related party receivables
  - AFS debt securities

Disclosures
- Discussions continue on AFS debt securities and roll forward disclosures
- Retained disclosures for nonaccrual and write-off policies
- Collateralized financial asset disclosures would apply only to collateral dependent financial assets
- Affirmed disclosure requirements for past-due financial assets

Other topics discussed
- Nonaccrual – no changes from existing guidance
- TDR- will be continued
- Acquired loans – PCI only applies to loans with significant deterioration
- Held for sale – valuation allowance

Upcoming Discussions: Continued disclosure discussion, transition, cost/complexity

Impairment: Project Timeline