CUNA REGULATORY ADVOCACY

CUNA REGULATORY COMMENT CALL

January 25, 2013

FASB Proposal on Credit Losses for Financial Instruments

SUMMARY

- The Financial Accounting Standards Board (FASB) issued a proposed accounting standards update regarding financial reporting of expected credit losses on loans and other financial assets held by financial institutions, including credit unions.
- The proposed model would utilize a single “expected loss” measurement for the recognition of credit losses, which would replace the multiple existing impairment models in U.S. generally accepted accounting principles that generally use an “incurred loss” approach. Under the proposal, the reporting entity would be required to estimate the cash flows that it does not expect to collect, using all available information, including historical experience and forecasts about the future.
- FASB is accepting comments through May 31, 2013; please send your comments to CUNA by May 10. (On March 28, FASB extended the comment deadline to May 31 from April 30.)

Field Visit Volunteers: FASB is soliciting entities that would be willing to participate with the staff, on a confidential basis, in a field visit to discuss the provisions of this proposal. The purpose of field visits is to assess the operability and the costs and benefits of the proposed guidance. Entities interested in volunteering can contact Steve Kane.

DESCRIPTION OF FASB PROPOSAL

Overview of Proposal

The proposal sets forth a “current expected credit loss” (CECL) model that would replace the multiple impairment models that currently exist for debt instruments in U.S. generally accepted accounting principles (GAAP). Under the CECL model, the allowance for expected credit losses would reflect management’s current estimate of the contractual cash flows that the reporting entity does not expect to collect, based on its assessment of credit risk as of the reporting date.

As proposed, the CECL model considers more forward-looking information than is permitted under current GAAP. When credit losses are measured under current GAAP, an entity generally only considers past events and current conditions in measuring the incurred loss. The proposal would broaden the information an entity is required to consider in developing its credit loss estimate to include relevant information about past events, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets’ remaining contractual cash flows.

For each reporting period, a reporting entity, including credit unions, would estimate expected credit losses on its financial assets. That estimate would be neither a “worst case” nor a “best case” scenario, but rather would reflect management’s current estimate of the contractual cash flows that the entity does not expect to collect. The organization could not avoid recognizing a loss simply because it has not hit a probability threshold that it will collect all of the cash flows.

Using the CECL model, the credit deterioration (or improvement) reflected in the income statement would include changes in the estimate of expected credit losses resulting from: (1) changes in the credit risk of the entity’s assets; (2) changes in conditions since the previous reporting date; and (3) changes in reasonable and supportable forecasts about the future. The balance sheet would reflect the current estimate of expected credit losses at the reporting date and the income statement would reflect the effects of credit deterioration (or improvement) that has taken place during the period.

Scope and Scope Exceptions

The proposed CECL model would apply to all reporting entities, including credit unions. Further, the proposed guidance would apply to all debt instruments[1] carried at either amortized cost or at fair value with changes in other comprehensive income (OCI), commonly referred to as FV-OCI. In addition, the proposal would cover debt securities, trade receivables, reinsurance receivables, lease receivables, and loan commitments.

Recognition

At each reporting date, an entity would be required to recognize an allowance for expected credit losses[2] on financial assets within the scope of this proposal.

Practical Expedient

The proposal provides for a practical expedient that would permit an entity to not recognize expected credit losses for financial assets measured at FV-OCI if the following conditions are met as of the reporting date:

- The asset's fair value equals or exceeds the asset's amortized cost; and
- Expected credit losses on the asset are insignificant.

Estimation of Expected Credit Losses

Under the proposal, an estimate of expected credit losses would be based on relevant internally and externally available information, which includes information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts and their implications for expected credit losses. The information used would include quantitative and qualitative factors specific to borrowers and the economic environment in which the reporting entity operates. Those factors include the current evaluation of borrowers' creditworthiness and an evaluation of both the current point in, and the forecasted direction of, the economic cycle (for example, as evidenced by changes in lender-specific or industry-wide underwriting standards). Therefore, a further adjustment would need to be made, as necessary, to reflect current information that may indicate current expectations about loss that is not reflected in the historical experience. Although an entity would be required to estimate credit losses over the entire contractual term of the financial assets, as the forecast horizon increases, the degree of judgment involved in estimating expected credit losses increases because the availability of detailed estimates for periods far in the future decreases. An entity would need to consider information that is available without undue cost and effort that is relevant to the estimated collectibility of contractual cash flows.

An estimate of expected credit losses would reflect the time value of money either explicitly or implicitly. If an entity estimates expected credit losses using a discounted cash flow model, the discount rate utilized in that model would be the financial asset's effective interest rate.

In addition, an estimate of expected credit losses would be neither a worst-case nor a best-case scenario. Rather, an estimate would reflect both the possibility that a credit loss results and the possibility that no credit loss results. However, a probability-weighted calculation that considers the likelihood of more than two outcomes would not be required. As proposed, an entity would be prohibited from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode).

The estimate of expected credit losses would need to reflect how credit enhancements mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets.

[1] The proposal would define "debt instrument" as, "A receivable or payable that represents a contractual right to receive cash (or other consideration) or a contractual obligation to pay cash (or other consideration) on fixed or determinable dates, whether or not there is any stated provision for interest."
[2] Expected credit losses are a current estimate of all contractual cash flows not expected to be collected.

Recognizing Changes in the Allowance for Expected Credit Losses

An entity would need to recognize in the statement of financial performance (as a provision for credit loss) the amount of credit loss (or reversal) required to adjust the allowance for expected credit losses for the current period in the statement of financial position to that required under this proposal.

Interest Income

When recognizing interest income on purchased credit-impaired (PCI) financial assets within the scope of this proposal, an entity would not recognize as interest income the discount embedded in the purchase price that is attributable to the acquirer's assessment of expected credit losses at the date of acquisition. The allowance for expected credit losses for PCI financial assets would be an estimate of all contractual cash flows not expected to be collected. Changes in the allowance for expected credit losses would be recognized in the statement of financial performance (as a provision for credit losses) in the current period.

Under the proposal, an entity would cease accrual of interest income when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest.

- If it is not probable that the entity will receive payment of substantially all of the principal, the entity would recognize all cash receipts from the debt instrument as a reduction in the carrying amount of the asset. When the carrying amount has been reduced to zero, additional payments received would be recognized as recoveries of amounts previously written off (that is, recorded as an adjustment to the allowance for expected credit losses) with any excess recognized as interest income.
- If it is probable that the entity will receive payment of substantially all of the principal but it is not probable that the entity will receive payment of substantially all of the interest (which may be the case if the value of collateral exceeds the amortized cost basis), the entity would recognize interest income on the debt instrument when cash payments are received. Cash receipts that exceed the amount of interest income that would have been recognized in the period had the asset not been placed on nonaccrual status would be applied to reduce the carrying amount of the asset.

Troubled Debt Restructurings (TDR)

Under existing GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a TDR. As noted in the proposal, FASB continues to believe that the economic concession granted by a creditor in a TDR reflects the creditor's effort to maximize its recovery of the original contractual cash flows. As a result, unlike certain other modifications that do not qualify as TDRs, FASB views the modified debt instrument that follows a TDR as a continuation of the original debt instrument. The basis adjustment would be calculated as the amortized cost basis before modification less the present value of the modified contractual cash flows (discounted at the original effective interest rate). As a result, the effective interest rate (post-TDR) would be the same as the original effective interest rate, which is consistent with existing practice.

Subsequent Measurement

Under the proposal, an entity would be required to directly reduce the cost basis in a financial asset (or portion thereof) within the scope of this proposal in the period in which the entity determines that it has no reasonable expectation of future recovery. The allowance for expected credit losses would be reduced by the amount of the asset balance written-off (also referred to as "charged-off"). Recovery of a financial asset previously written-off would be recognized by adjusting the allowance for expected credit losses only when consideration is received.

Other Presentation Matters

For recognized financial assets within the scope of this proposal that are measured at amortized cost (other than PCI assets and loan commitments), an entity would present the estimate of expected credit losses on the statement of financial position as an allowance that reduces the amortized cost of the asset.

For recognized financial assets that are measured at FV-OCI (other than PCI assets and loan commitments), the estimate of expected credit losses would be a contra-asset that reduces the amortized cost of the asset. The net amortized cost amount for such assets (that is, net of the allowance for expected credit losses) would be included on the statement of financial position.

For recognized PCI assets that are not measured at fair value with all changes in fair value recognized in current net income, an entity would present the estimate of expected credit losses on the statement of financial position as an allowance that reduces the sum of the asset's purchase price and the expected credit losses on the asset at the time of acquisition.

For loan commitments, an entity would present the estimate of expected credit losses on the statement of financial position as a liability.

Disclosures

An entity would need to disclose information related to credit risk and the recognition of credit losses as it relates to:

- Credit-quality information;
- Allowance for expected credit losses;
- Roll forward for certain debt instruments;
- Reconciliation between fair value and amortized cost for debt instruments measured as FV-OCI;
- Past-due status;
- Nonaccrual Status;
- PCI financial assets; and
- Collateralized financial assets.

The disclosure information would need to enable users of the financial statements to understand:

- The credit risk inherent in the portfolio and how management monitors the portfolio's credit quality;
- Management's estimate of expected credit losses; and
- Changes in the estimate of expected credit losses that have taken place during the period.

When disclosing information by portfolio segment or class of financial asset, an entity would determine how much detail it must provide to satisfy these disclosure requirements and how it disaggregates information into segments or classes for assets with different risk characteristics. An entity would need to strike a balance between obscuring important information as a result of too much aggregation and overburdening financial statements with excessive detail that does not help users understand the entity's financial assets and allowance for expected credit losses.

Transition and Effective Date

As proposed, the guidance would be adopted by a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period in which the guidance becomes effective.

FASB did not include a proposed effective date for the CECL model. However, FASB is seeking input on whether to permit early adoption for all entities, as well as a delayed effective date for nonpublic entities.

SPECIFIC QUESTIONS REGARDING THE PROPOSAL

Scope

1) Do you agree with the scope of financial assets that are included in the proposal? If not, which financial assets should be included or excluded?

Recognition and Measurement

2) The proposed amendments would remove the initial recognition threshold that currently exists in 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. Would this change, that will result in credit losses being recognized earlier, provide more decision-useful information?

---

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. Would this change result in more decision-useful information than under current GAAP?

---

4) The proposed amendments would require that at each reporting date an entity recognize an allowance for all expected credit losses. Would recognizing all expected credit losses provide 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 (e.g., 12 months or similar foreseeable future horizon, initial recognition threshold, and so forth)?

---

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 expected credit losses based on this information provide decision-useful information?

---

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 into 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-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 assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Would 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? Is this an improvement from the current model used for purchased credit-impaired assets?

---

7) As a practical expedient, the proposed amendments would allow an entity not to recognize expected credit losses for financial assets measured at FV-OCI 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. Is the practical expedient 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. Would this proposal change current practice? Do you foresee any significant operability concerns with this proposed amendment?

---

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 concerns or constraints in basing the estimate of expected credit losses on such information?

---

10) FASB 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?

---

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). FASB believes that many commonly used methods already implicitly satisfy this requirement. Do you foresee any significant operability 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?

---

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 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?

---

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 expected 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 assets and non-purchased-credit-impaired assets as bad-debt expense rather than yield. Do you foresee any significant operability concerns or constraints in determining the discount embedded in the purchase price that is attributable to credit at the date of acquisition?

---

14) Under existing GAAP, the accounting by a creditor for a modification to an existing debt instrument depends on whether the modification qualifies as a TDR. FASB continues to believe that the economic concession granted by a creditor in a TDR 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 TDRs, FASB views the modified debt instrument that follows a TDR as a continuation of the original debt instrument. Does the distinction between TDRs and non-TDRs continue to be relevant? Why or why not?

Disclosures

15) Would the proposed disclosure provisions provide decision-useful information? If not, what disclosures do you believe should (or should not) be required and why?

---

16) Do you foresee any significant operability concerns or constraints in complying with the proposed disclosure provisions?

Implementation Guidance and Illustrations

17) Are the implementation guidance and illustrative examples included in this proposal sufficient? If not, what additional guidance or examples are needed?

Transition and Effective Date

18) Do you agree with the proposed transition provision? Why or why not?

---

19) Should early adoption be permitted? Why or why not?

---

20) Should there be a delayed effective date for nonpublic entities? Why or why not?

---

21) 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?

Other Comments or Questions

22) Other comments or questions regarding the credit loss proposal.

Field Visit Volunteers: FASB is soliciting entities that would be willing to participate with the staff, on a confidential basis, in a field visit to discuss the provisions of this proposal. The purpose of field visits is to assess the operability and the costs and benefits of the proposed guidance. Entities interested in volunteering can contact Steve Kane.

Please send comments to Assistant General Counsel Luke Martone.
Click here for FASB's proposal.