PROPOSED NEW ACCOUNTING STANDARD

Major Impact on Allowance for Loan and Lease Losses

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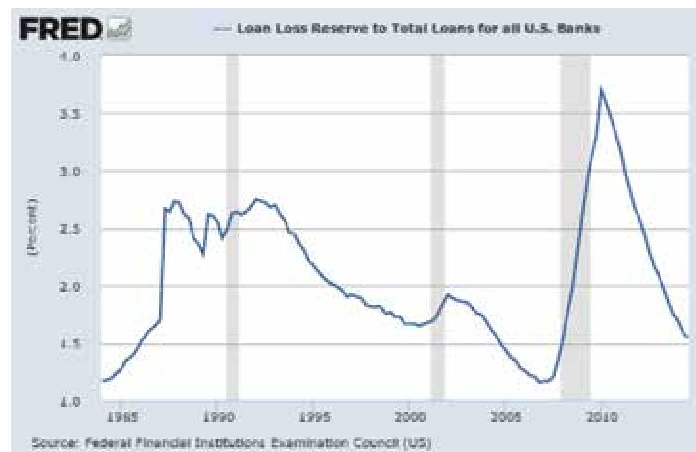
Introduction

The Financial Accounting Standards Board (FASB) began a joint project with the International Accounting Standards Board (IASB) to revise and improve accounting standards for financial instruments and credit losses as part of its convergence project. In the aftermath of the global financial crisis, it was evident that improvements were necessary for accounting of financial instruments and their associated credit losses. The existing credit impairment approach typically delays recognition until a credit loss is probable or has been incurred. This results in what commonly has been referred to as "too little, too late." As illustrated below, loan loss reserves compared to total loans have spiked following the most recent U.S. recessions (which are represented by the shaded areas).

The Boards established the Financial Crisis Advisory Group (FCAG) to study the impact that existing accounting standards had on the financial crisis, and to provide recommendations on ways to improve financial reporting to enhance investors' confidence in financial markets. FCAG identified two major weaknesses in existing financial reporting, which included:

- The delayed recognition of losses associated with loans, structured credit products, and other financial instruments by banks, insurance companies, and other financial institutions.
- The extraordinary complexity of accounting standards for financial instruments, including multiple approaches to recognizing asset impairment.

In January 2011, FASB and IASB published *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities – Impairment*. This document sought to address issues identified in the existing impairment methodologies. Based on comments received, FASB elected to move away from IASB's "three-bucket approach" methodology to credit impairment.



FASB released an exposure draft of a Proposed Accounting Standards Update (PASU) December 20, 2012, *Financial Instruments – Credit Losses (Subtopic 825-15) (the Proposal)*. FASB has indicated that a final standard is anticipated by the fourth quarter of 2015. The objective of the PASU, per FASB, was to provide financial statement users with more decision-useful information about the expected credit losses on financial assets held by a reporting entity. The objective is thought to be achieved by replacing the existing impairment approach, which reflects incurred credit events, with an approach that recognizes expected credit risks and by requiring consideration of a broader range of reasonable and supportable information to inform credit loss estimates. The PASU would also reduce complexity by replacing the various existing impairment methodologies utilized in U.S. Generally Accepted Accounting Principles (GAAP) with a consistent measurement approach for all financial assets.

Overview of the New Approach

PROPOSED APPROACH

At first glance, the proposed approach does not appear to be overly complex. The Proposal covers all debt instruments, which are defined as receivable or payable, that represent 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. Thus, this would include loans, debt securities, trade receivables, reinsurance receivables, lease receivables, and loan commitments. Further, credit losses are a current estimate of all contractual cash flows not expected to be collected over the contractual life of the asset.

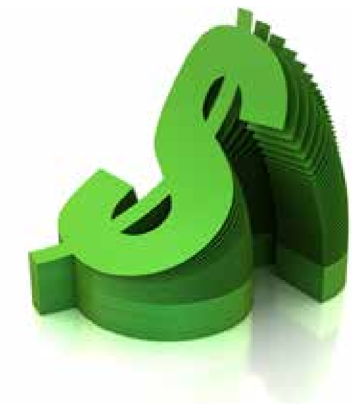
EXISTING IMPAIRMENT APPROACH

The existing impairment approach is based on the “probable” threshold. Currently, GAAP requires that an event be probable before a loss can be recognized. FASB Accounting Standards Codification (ASC) 450 *Contingencies* is often the guidance that is followed to determine the credit losses necessary for recognition on a loan portfolio. The general practice is to analyze historic net loss rates by loan type, and adjust this quantitative factor for various qualitative factors. Loans that have been identified individually as having characteristics of impairment generally have been accounted for based on FASB ASC 310 *Receivables*.

PROPOSED EXPECTED LOSS APPROACH

The proposed expected loss approach disregards the “probable” threshold, and requires additional information be considered when estimating credit losses over the contractual term of each asset. Past events such as historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts of future events or circumstances will be considered in making the estimate. An entity would not be permitted to establish expected credit losses solely on the basis of the most likely or worst-case outcomes. Expectations are that an allowance for credit losses would be recognized for most financial assets, unless they meet certain criteria established in the Proposal.

Overview of the New Model



FINANCIAL ASSETS

Financial assets measured at fair value with changes in value reflected through other comprehensive income (the most common of which would be available-for-sale debt securities) would still reflect changes in the fair value of the asset on the balance sheet, but deteriorations or improvements in credit risk would be reflected through the income statement. However, the PASU includes an exception that would permit entities to elect not to recognize expected credit losses on these types of assets if:

- The fair value of the financial asset is greater than or equal to the amortized cost basis.
- Expected credit losses on the financial statements are insignificant.

PROPOSED EXPECTED LOSS APPROACH

The proposed approach also adds consideration of the time value of money into the estimate. The Proposal states, "an estimate of expected credit losses shall 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 shall be the financial asset's effective interest rate." The effective interest rate is defined as the rate of return implicit in the debt instrument; *i.e.*, the contractual interest rate adjusted for any net deferred loan fees or costs, premium or discount, existing at origination or acquisition of the debt instrument. If an entity bases a credit loss for a collateral-dependent financial asset on the fair value of the collateral, the fair value would be considered equivalent to the present value.

Other Additions

Historically, guidance on defining and accounting for nonaccrual assets has been driven by regulatory bodies; however, the Proposal provides details on accounting for assets for which no accrual of interest shall be made. The Proposal states that an entity shall cease its accrual of interest income only if the entity's expectations about cash flows expected to be collected indicate that the overall yield on the financial asset will be negative. However, any previously recognized interest income shall not be reversed.

GAAP does not currently offer guidance on when to write off (or charge off) financial assets; but the Proposal has provided guidance on when a write-off should occur. The Proposal states that an entity should directly reduce the cost basis in a financial asset (or portion of a financial asset) in the period in which the entity determines that it has no reasonable expectation of future recovery. A reversal of a previous write-off should only occur when consideration is received in satisfaction of some or all contractually required payments previously written off.

Preparing for Final Update

Until FASB issues a final version of the ASU, entities should not make significant changes in their financial assets and credit loss models. However, given the increased level of information that will be needed in the estimation process, entities should be considering how and what information will be needed to produce “reasonable and supportable forecasts that affect the expected collectability of the financial assets’ contractual cash flows.” This additional factor into the credit impairment model is the most significant change from the current guidance, and will likely require various assumptions and estimates.

Entities should also consider the capital implications of the proposed model. While not the stated objective, it is likely that an increase in credit allowances will occur as a result of the transition (assuming the final rule is consistent with that proposed model). At the 2013 AICPA Banking Conference, the Office of the Comptroller of the Currency’s Thomas Curry stated his support for FASB’s proposed changes, and indicated that he would expect adoption of the new model to result in a 30 - 50% increase in banks’ reserves for loan losses.

For further details on how the proposed rules related to the allowance for loan and lease losses may impact your institution, contact:

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