FASB Financial Instruments Project

Proposed Accounting Standards Update

Financial Instruments – Credit Losses

(Subtopic 825-15)

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Financial Instruments – Credit Losses

FASB issued for comment on December 20, 2012, a proposal for changing how credit losses are recognized and measured for certain financial assets, principally loans. FASB's comment deadline is May 31, 2013.

The proposal is intended to change accounting principles to address criticisms that the current impairment model delays the recognition of credit losses on loans (and securities) and results in loan loss allowances that are "too little, too late."

The proposal is referred to by FASB as the "current expected credit loss" (or CECL) model.

Aspects of CECL to be Covered

1. Recognition
2. Measurement
3. Scope
4. Nonaccrual and Charge-offs
5. Effective Date
6. International Convergence

Recognition

Credit losses would be recognized using an expected loss model. That is, an estimate of the amount of contractual cash flows that are not expected to be collected on a financial asset or group of financial assets held at the reporting date.

Unlike current U.S. generally accepted accounting principles (GAAP), there would no longer be a "triggering event" for measuring the credit loss inherent in a financial instrument.

The proposed change would mean that virtually any credit deterioration would affect a bank's financial performance and financial position, rather than requiring credit deterioration to build to the point where an incurred loss is probable before the deterioration affects the reported financial results.

Recognition

The FASB's proposal requires periodic estimates of the lifetime expected credit losses for all financial assets that are within its scope, which would be recognized as allowances for expected credit losses.

Changes from one period's estimate of the allowance for expected credit losses to the next (after considering charge-offs and recoveries) would be reported in earnings, including on those assets measured at FV-OCI.

The FASB's model differs from the "three-bucket" expected loss approach it had been developing jointly with the IASB until August 2012. The IASB has since proposed to require allowances based on periodic estimates of (i) lifetime expected credit losses for all assets on which credit risk has increased significantly since initial recognition and (ii) expected credit losses resulting from default events on assets that are possible within the next 12 months.

Measurement

The CECL model broadens the range of information that should be incorporated into the measurement of credit losses. Under current GAAP, banks estimate credit losses based on information about past events and current conditions. Under the CECL model, "reasonable and supportable" forecasts that affect expected collections on financial instruments also should be considered.

The CECL model does not prescribe a method for measuring credit losses; rather, it allows any reasonable approach, so long as it reflects both the possibility that a credit loss results and the possibility that no credit loss results.

FASB also intends for the accounting model to draw heavily from an institution's credit risk management process.

It is likely that many banks, particularly community banks, currently do not have readily available the types of data that would be needed to implement the proposed CECL model.

Measurement

Key differences from current GAAP include:

- Removal of the “loss is probable” requirement before credit loss is measured.
- Consideration of reasonable and supportable forecasts affecting collectibility in addition to information about past events and current conditions when estimating credit loss.
- Estimate of expected credit losses is not a best-case or worst-case scenario.

Scope

The proposal would apply to financial assets measured at (i) amortized cost and (ii) fair value with changes in fair value during the reporting period reported in Other Comprehensive Income (FV-OCI).

In practical terms, that means (i) loans and debt securities that are held to maturity and (ii) debt securities that are designated as available for sale.

The CECL model would replace five discrete impairment models that currently apply to certain financial instruments depending on legal form and, for securities, the degree of credit risk.

Scope

Debt securities:

- Other-than-temporary impairment (OTTI) would be superseded
- A practical expedient could be used for qualifying securities
- Securities could be pooled as well as evaluated individually
- Allowance rather than adjustment to amortized cost for OTTI loss recognized in earnings

Troubled debt restructurings

- Retains the designation

Purchased-Credit-Impaired (PCI) loans

- Broadens the scope of loans and debt securities that qualify as PCI
- Creates a day-1 allowance for impairment, unlike current practice
- Permits estimated increases in expected cash flow to be reflected in income immediately

Nonaccrual and Charge-offs

The proposal would set standards for putting debt instruments on nonaccrual when collectibility is in doubt and for the charge-off of uncollectible financial assets.

GAAP would define:

- "Collateral dependent" (differently from current GAAP)
- Nonaccrual
- Cash-basis and cost-recovery income recognition
- Write-off

The addition of these reporting conventions to GAAP would extend them to the financial sector outside of regulated banking institutions (and to holders of debt instruments outside the financial sector). Such a change would enhance comparability between banks and similar unregulated enterprises.

Effective Date

No date is set for the proposal to be applied in financial statements, but the effective date for any final standard is not likely to be before January 1, 2015.

Open issues include whether early adoption of a final standard should be permitted and whether non-public companies should have additional time to adopt the final standard compared to public companies.

International Convergence

Until August 2012, the FASB and IASB were jointly developing an expected credit loss model referred to as the "three-bucket" approach.

Based on negative feedback received from stakeholders, the FASB decided to pursue the single measurement approach outlined here, rather than dual measurement under the "three-bucket" model.

The IASB did not agree that the feedback it received on the "three-bucket" approach indicated this model was fatally flawed. The IASB issued its "three-bucket" approach for comment in March 2013 with comments due July 5, 2013.