

100 THAT
years COUNTS
1913-2013

The Revised (Proposed) Credit Impairment Model & the Impact on the ALLL

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AGENDA

- The Credit Impairment Journey
- Proposed Expected Credit Loss Model
- Impact to:
 - Debt Securities
 - Lenders & the ALLL
 - All Entities
- The IASB's Proposal...Briefly
- Highlights of Comment Letters on Proposal
- Recommendations from Moss Adams



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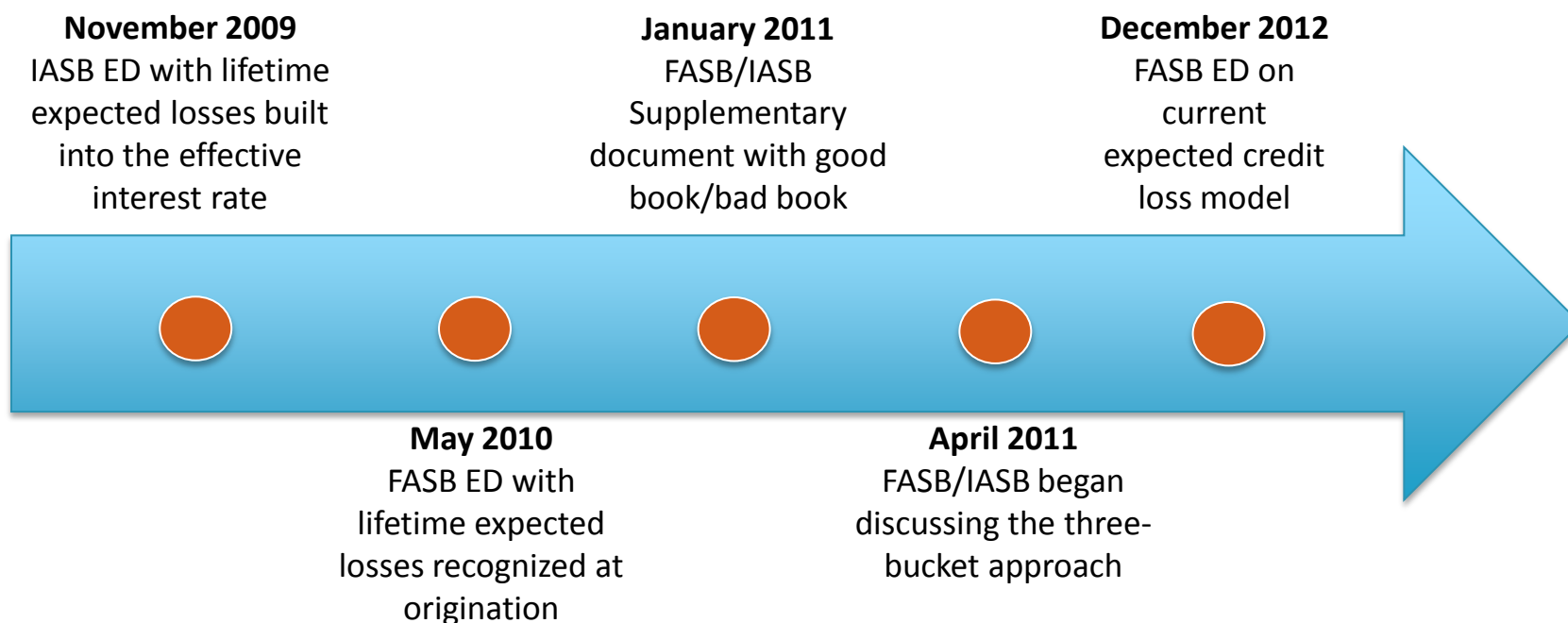
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THE CREDIT IMPAIRMENT JOURNEY

- The Financial Crisis Advisory Group was organized by FASB & IASB in October 2008
 - Objective: Consider how improvements in financial reporting could help enhance investor's confidence in financial markets
- Biggest weaknesses identified with existing practices:
 - Recognition of losses for loans and other financial instruments was not timely as it should have been
 - Multiple impairment approaches – complex!
- Group recommended that the Boards explore an alternative to incurred loss model that would use forward-looking information (more timely recognition of losses!)

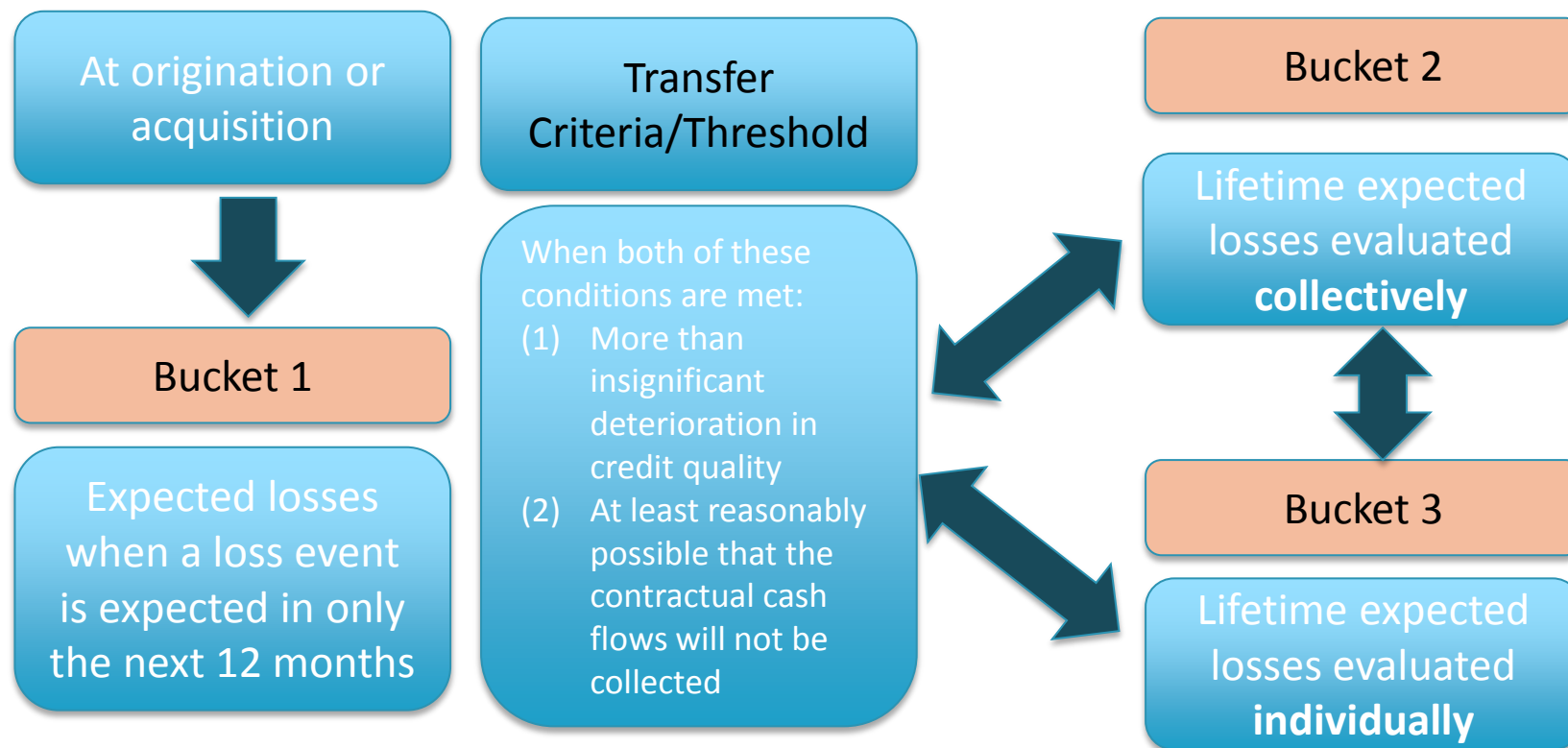
THE CREDIT IMPAIRMENT JOURNEY

- FASB & IASB have actually been exploring approaches to account for the impairment of financial assets for a number of years



THREE-BUCKET MODEL

- Boards jointly developed a three-bucket model for impairment based on “expected” losses (April 2012)



EXPECTED CREDIT LOSS MODEL BUILDING BLOCK CONCEPTS: SCOPE & EXISTING GAAP

- Proposal would apply to financial assets including:
 - Debt instruments at amortized cost (AC) or fair value through other comprehensive income (FV-OCI)
 - Loans
 - Debt securities
 - Receivables (“trade” not historically included)
 - Lease receivables recognized by lessors
 - Loan commitments

Current impairment models in existence/use

Loans and receivables
ASC 310-10 and ASC 450-20

Certain acquired loans and securities
ASC 310-30

Debt securities
ASC 320-10

Certain beneficial interests
ASC 325-40

EXPECTED CREDIT LOSS MODEL BUILDING BLOCK CONCEPTS: THE PROPOSAL

- Each reporting period, entities would record their current estimate of expected credit losses
- Estimating the contractual cash flows not expected to be collected would include the following elements:

Time value of money

Information
about past
events

+

Information
about
current
conditions

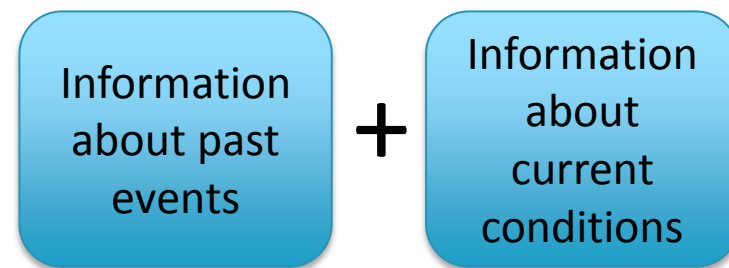
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Reasonable
and
supportable
forecasts

Must consider at least two possible outcomes, one of which
reflects a possible credit loss

EXPECTED CREDIT LOSS MODEL BUILDING BLOCK CONCEPTS: EXISTING RELEVANT INFORMATION

- Information used in today's models would continue to be appropriate:



- Current evaluation of borrowers (or issuer's) creditworthiness
 - Historical/forecasted operating results
 - Liquidity and leverage (DSC & DTI)
 - Credit scores/quality (e.g., FICO scores, risk or credit rating)
 - Pending litigation impacting entity
- Credit enhancements (e.g., guarantees, collateral)

EXPECTED CREDIT LOSS MODEL BUILDING BLOCK CONCEPTS: EXISTING RELEVANT INFORMATION + THE PROPOSAL

- Reasonable and supportable economic forecasts might include consideration of economic indicators
 - Business confidence metrics - GDP
 - Factory orders
 - Inflation rates
 - Vacancy rates
 - Unemployment rates
- Entities would evaluate both the current point in, and the forecasted direction of the economic cycle
- FASB acknowledges forecasting over longer periods of time would be challenging – “static” forecast allowed
- What about national vs. regional data?
- What constitutes “reasonable and supportable”?

Reasonable
and
supportable
forecasts

EXPECTED CREDIT LOSS MODEL BUILDING BLOCK CONCEPTS: THE PROPOSAL

- An entity would have flexibility in approach it chooses to incorporate forecasts into the estimate of expected credit losses
 - Directly adjusting each individual historical loss rate (often referred to as “allocating the unallocated” when the unallocated is your qualitative reserve)
 - Calculation a base component and layering on a credit risk adjustment (e.g. qualitative adjustment)

EXPECTED CREDIT LOSS MODEL BUILDING BLOCK CONCEPTS: TIME VALUE OF MONEY + THE PROPOSAL

- Estimates of expected credit losses would have to reflect the time value of money, explicitly or implicitly
- Discounted cash flow (DCF) models explicitly reflect the time value of money – contractual cash flows not expected to be collected would be discounted using the instrument’s original effective interest rate (EIR)
- Other estimation methods may implicitly capture time value – e.g., historical loss statistics developed using the amounts written off

Time value of money

EXPECTED CREDIT LOSS MODEL THE PROPOSAL AND AT LEAST TWO POSSIBLE OUTCOMES

- Estimate should reflect the possibility of both a credit loss and of no loss
- A probability-weighted calculation that considers more than two outcomes would not be required nor prohibited
- Use of a “most-likely outcome” or “best estimate” (i.e., statistical mode) would not be permitted
- Measurement methods that use an extensive population of historical data implicitly capture multiple outcomes if the data includes items that ultimately resulted in a loss

At least two outcomes, one of which reflects a possible credit loss

EXPECTED CREDIT LOSS MODEL AT LEAST TWO POSSIBLE OUTCOMES – AN EXAMPLE

- Company A purchases a BBB-rated three-year bond with a par value of \$500,000 and a coupon of 2% and determines the following possible outcomes
 - 95% likelihood that all contractual cash flows will be collected
 - 5% chance that not all of the contractual cash flows will be collected
- Under current US GAAP, Company A concludes based on its best estimate that it will collect all contractual cash flows
- Under the proposal, Company A would recognize an allowance for expected credit losses

EXPECTED CREDIT LOSS MODEL – AUDIENCE POLLING QUESTION/DISCUSSION

Which of the proposed building blocks do you believe would be the most challenging to apply?

- A. Reasonable and supportable forecasts
- B. Time value of money
- C. At least two possible outcomes
- D. All of the above
- E. None of the above

INTEREST INCOME – THE PROPOSAL

- Generally would be based on an asset’s effective interest rate and the gross amortized cost amount
- An entity would stop accruing interest when it is no longer probable that it will collect “substantially all” principal or interest

Collection of substantially all principal not probable

Collection of substantially all interest not probable
(principle collection probable)

Cost-recovery method

Cash-basis method

- Cash receipts would reduce the carrying amount of the asset
- When carrying amount is reduced to zero, cash receipts would be recognized as recoveries with excess recognized as interest income

- Cash receipts would be recognized as interest income when received
- Cash receipts in excess of interest that would have been recognized (absent the nonaccrual principle) would reduce the carrying amount

OTHER ASPECTS OF THE PROPOSAL

- Unit of measurement guidance would be removed
 - Current practices may not change (e.g. individual, pools of assets)
- Credit losses would be presented through an allowance account – new concept for debt securities (OTTI)
- Certain concepts remain largely unchanged
 - Write-offs and recoveries (recoveries against allowance – credit to bad debt provision)
 - Modifications and troubled debt restructurings (instead of allowance – direct write-down on TDRs)

ACCOUNTING FOR PURCHASED CREDIT-IMPAIRED (PCI) ASSETS IN THE PROPOSAL

- PCI concept would apply to loans and debt securities
- PCI assets would be acquired financial assets that have experienced a significant deterioration in credit quality since origination compared to today's "probable" threshold
- Accounting would generally follow the same approach as originated assets with the following exceptions
 - The allowance for expected credit losses embedded in the purchase price and recorded at acquisition would not flow through the income statement
 - Adjusted cost basis would be the purchase price plus the allowance for credit losses
- Changes in the credit impairment allowance would be recognized in income immediately

PURCHASED CREDIT-IMPAIRED (PCI) ASSETS EXAMPLE

- Company B acquires a debt instrument with the following
 - Par amount of \$100,000
 - Purchase price of \$80,000 (the instrument has experienced deterioration in credit quality since origination)
 - Expected credit loss embedded in the \$20,000 discount to par is determined to be \$15,000
- Journal entry at purchase

| | | |
|--------------------------------------|---------|--------|
| Debt instrument (par amount) | 100,000 | |
| Debt instrument (noncredit discount) | | 5,000 |
| Allowance for expected credit losses | | 15,000 |
| Cash | | 80,000 |

- Non-credit discount of \$5,000 would be accreted into interest income over the life of the instrument under ASC 310-20
- Allowance of \$15,000 would be re-measured each reporting period

IMPACT TO DEBT SECURITIES

- Other-than-temporary impairment (OTTI) would be replaced with expected credit loss model
- Proposal would eliminate the requirement to evaluate credit losses on a security-by-security basis
- Use of a best estimate or most likely outcome to estimate credit losses would no longer be allowed
- An entity would record an allowance instead of adjusting the security's cost basis
- Nonaccrual guidance would affect how interest income is recognized
 - Situations where it is not probable that entity will receive substantially all of the principal or interest

PROPOSAL'S PRACTICAL EXPEDIENT FOR FV-OCI DEBT SECURITIES

- Example – individual and pool analysis
 - Company Z has the following portfolio of debt securities and is considering how it might be affected by the proposal

Securities

US Treasury Bonds, AA-rated corporate bonds

- B-rated corporate bonds
- Commercial mortgage-backed securities (CMBS) (lower tranche)

Current approach

Generally, no OTTI

Estimate expected cash flows for individual securities (e.g., DCF analysis) with an OTTI and compare to recorded investment

Possible approaches under proposal

Group securities by similar risk characteristics and apply loss rates

Continue to measure credit losses for individual securities

PROPOSAL'S PRACTICAL EXPEDIENT FOR FV-OCI DEBT SECURITIES? MAYBE...

- Expected credit losses would not be required to be recognized for an individual asset classified as FV-OCI when both
 - Fair value is greater than or equal to its amortized costs
 - Expected credit losses are insignificant

Debt securities classified at FV-OCI

FV < cost

Record an allowance for expected credit losses

FV > or = cost

Do not record an allowance for expected credit losses

Debt securities with insignificant credit losses

All other debt securities

Record an allowance for expected credit losses

IMPACT TO LENDERS & THE ALLL

- The proposal does not provide unit of measurement guidance
- Measurement of credit losses for individual loans
 - Use of fair value would not be permitted as a practical expedient
 - Requirement to use collateral when foreclosure is probable would be removed
 - Proposal would change definition of collateral-dependent
 - A financial asset for which the repayment is expected to be provided **primarily or substantially** through the operation **(by the lender)** or sale of the collateral, based on an entity's assessment as of the reporting date

IMPACT TO LENDERS & THE ALLL (CONT.)

- Measurement of credit losses for pools of loans
 - Current models would likely need to change to account for movement from incurred to expected losses
 - Probability of default and loss given default
 - Roll rate
 - Vintage-based or closed pool
 - Loss rate
- Proposal would not require specific approaches, but would provide latitude for lenders to develop estimation techniques
 - Technique would have to be used consistently over time
 - Aim to faithfully estimate expected credit losses
- Calculation of expected losses would require additional data and changes to related processes and controls

IMPACT TO ALL ENTITIES

- Receivables would be subject to the proposal
 - Historical loss rates for aging buckets may need to be adjusted for economic forecasts
 - Allowances would be required for all receivables, including those
 - Classified as current
 - From significant customers that have always paid
- How an entity recognizes recoveries may need to change
 - Proposal would require an entity to credit the allowance for credit losses for recoveries
- Changes to accounting for debt securities

PROPOSAL'S NEW DISCLOSURES

- Extensive credit quality information about debt securities
 - Many disclosures currently required for loans by ASU 2010-20 would be required for other debt instruments
- Information about the factors that influence management's estimates of credit losses, including any changes and the reasons for those changes
 - Forecasts used would need to be disclosed
- Rollforward of debt instruments measured at Amortized Cost or FV-OCI
- Past due policies and information, including an aging analysis of the amortized cost

TRANSITION AND EFFECTIVE DATE OF PROPOSAL

- An entity would record a cumulative-effect adjustment to beginning retained earnings
- The proposal does not include an effective date
 - Early adoption would not be permitted
 - Preparers were asked to provide feedback on the amount of time needed to implement the proposal

IASB'S CREDIT LOSS PROPOSAL...BRIEFLY

- Their scope includes guarantees
- Core principles of an expected credit loss estimate would be similar to FASB's building blocks, however:
- On initial recognition, is there objective evidence of impairment?
 - YES: an entity would follow the credit-impaired approach
 - No allowance would be recorded on day one (credit risk embedded in discount)
 - Allowance at subsequent report dates would reflect changes in lifetime expected losses
- NO: is the simplified approach required/available and elected?
 - Yes, allowance would reflect lifetime expected losses
 - No, allowance would reflect 12 months of expected losses; the allowance would reflect lifetime expected losses FOR significant deterioration in credit quality

KEY TAKEAWAYS OF THE FASB'S PROPOSAL

- The FASB's Proposed Accounting Standards Update, *Financial Instruments – Credit Losses* would
 - Apply to all entities
 - Remove the existing “probable” threshold for recognizing credit losses in US GAAP, which allows for no ALLL in certain circumstances
 - Result in the recognition of an allowance for credit losses for almost every debt instrument, including highly rated debt securities and receivables from customers who always pay
 - Requires an entity to essentially “forecast” by considering forward-looking information when estimating credit losses
 - Significantly change how interest income is recognized on impaired debt securities (no OTTI; nonaccrual status); loans effectively not changed
 - Change the accounting for PCI assets (bifurcating discount for credit and non-credit)

HIGHLIGHTS OF COMMENT LETTERS ON PROPOSAL

Overall themes

- Generally acknowledge the Board's concern that the existing guidance resulted in financial entities recognizing loan losses too slowly during the financial crisis
- The proposed Update sounds good in theory
- Many existing concerns, recommendations and questions

HIGHLIGHTS OF COMMENT LETTERS ON PROPOSAL

Overall comment theme concerns

- Concerned with considering forecasts far into the future because the level of precision decreases
- Requirement for the entity to distinguish the period in which they expect a credit loss to occur would be an overly complex and challenging estimate
- Many challenges for smaller entities

HIGHLIGHTS OF COMMENT LETTERS ON PROPOSAL

Overall comment theme concerns (continued)

- Entities could arrive at very different conclusions about where in the cycle (relative to both short- and long-term cycles) the economy is at the reporting date
- Potential for inconsistent application in practice
 - Unclear how the conditions of “reasonable” and “supportable” should interact – it is not clear if meeting the “supportable” condition should make the forecast “reasonable”

HIGHLIGHTS OF COMMENT LETTERS ON PROPOSAL

Overall comment theme suggestions

- The Board and IASB should prioritize having a clear principle and a minimum of operational complexity over other considerations
- Field testing by the Board is critical as proposal needs to be operable for all groups (small, medium & large institutions)
- The Board should provide ample time for implementation as it will take a significant amount of effort for companies to make necessary changes to their information systems and internal controls (mixed reactions on whether early adoption is permitted or not).

HIGHLIGHTS OF COMMENT LETTERS ON PROPOSAL

Other miscellaneous comment themes

- Concerns about the auditability of the proposed guidance and its potential for inconsistent application in practice
 - Estimates of expected credit losses are most reliable and auditable when they are developed on the basis of past events; current conditions; and reasonable, supportable, and available forward-looking information about future economic circumstances
- Some are supportive of the Board removing the troubled debt restructuring distinction from the Codification and some think it should be retained

HIGHLIGHTS OF COMMENT LETTERS ON PROPOSAL

What Credit Union Organizations are Saying

- **NCUA** – small- and medium-sized credit unions may be unduly impacted through discouraging lending to low-income borrowers
- **CUNA** – strongly opposed to the proposal based on a number of concerns
- **Northwest CU Association** – concerned that matching principle is not met and that predictive modeling will be very difficult and costly

RECOMMENDATIONS FROM MOSS ADAMS

1. Quality of loan data inputs is key – inaccurate data is worthless...at best
2. Process for updating the data – if the data is outdated, it isn't much better
3. Alternative methods (database?) for aggregating key data may be necessary if your system isn't working for you
4. Think “Vintage” analysis
5. Sign up for MA Insights!

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