

Technical Line

FASB – Proposed guidance

Boards receive mixed feedback on credit impairment proposals

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What you need to know

- ▶ Constituents commenting on the joint credit impairment approach proposed by the FASB and IASB support convergence but say the approach is complex and more guidance would be necessary in several areas.
- ▶ The feedback on the joint approach is divided; views differ by geography.
- ▶ Many constituents urged the Boards to comprehensively field-test the model and seek comment on a final approach, even if that delays issuance of final guidance.
- ▶ Some US banks proposed an alternative approach.

Overview and background

The Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) (collectively, the Boards) jointly issued the Supplementary Document (SD) in January 2011, proposing a new model for determining when credit losses should be recognized on certain loans and other financial assets.¹

Under the proposal, assets would be split into a “good book” and a “bad book,” based on a company’s internal credit risk management policies. For the good book, expected credit losses would be recognized on a time-proportional basis but would be subject to a floor for losses expected in the foreseeable future. The full amount of expected loss would be recognized immediately for assets in the bad book.

The joint approach, if finalized, would mark a big change from current practice under both US GAAP and IFRS. It combines key elements of the Boards’ separate approaches (on which they also sought comments) and differs from what the Boards had separately proposed earlier. Comments on the SD were due by 1 April 2011.

The FASB has indicated that it will seek public comment on any amendments to the Codification involving impairment before finalizing a new standard. The FASB expects to issue its final guidance in the third quarter of 2011.

Key areas of comment

In their comment letters to the Boards, most constituents emphasized the need for a converged solution to accounting for credit impairment. However, they said the Boards' convergence priorities should not affect the quality of the final standard.

Constituents said the joint approach addresses many of their concerns with the original proposals. Particularly, FASB constituents like the ability to consider the best available and supportable information (i.e., past, present and forecast) when estimating expected losses, as well as the elimination of the requirement to recognize lifetime expected credit losses up front. IASB constituents like the decoupling of the calculation of interest income and the allocation of credit losses.

Constituents also believe that the impairment model for originated loans and purchased loans should be the same.

Given the far-reaching implications and the complexity of the proposals in the SD, many constituents complained that the comment period was too short and coincided with year-end financial reporting deadlines.

General feedback on the joint approach

Constituents noted that the joint approach is a conceptual compromise and is not consistent with the separate and different objectives of the Boards. Some (mostly non-US financial institutions) questioned how the addition of a floor for the good book is consistent with the time-proportional approach. Others (mostly US financial institutions) questioned the need for the time-proportional approach, given that recognizing losses expected in the foreseeable future addresses the concern regarding the adequacy of the allowance.

Preparers generally said the joint approach would be operationally complex, because it requires two separate impairment calculations for the good book (i.e., the time-proportional amount and the floor). Preparers also noted that the joint approach is significantly different from the existing impairment approaches under US GAAP and IFRS, which will require significant changes to systems and processes. To address the challenges posed by a new impairment approach and still address the weaknesses of the current standard, some US banks proposed an alternative discussed later in this publication.

If the Boards pursue the joint approach, preparers said, the Boards should provide additional guidance on defining the foreseeable future period and determining when an asset should be transferred from the good book to the bad book (and vice versa). Preparers also suggested that the Boards address the operational complexity presented by the approach.

Although the Boards haven't yet discussed how the joint approach would apply to debt securities, some preparers pointed out the difficulty of doing so. The credit risk of debt instruments is generally managed on an instrument-by-instrument basis, rather than the portfolio basis used for loans, they noted. Some US constituents suggested that the FASB continue to permit the application of the existing impairment guidance for debt securities.²

Constituents think that the joint approach is operationally complex, as it requires two separate impairment calculations.

Some preparers also said the joint model would not be appropriate for certain instruments, including trade receivables, revolving credit card receivables, insurance portfolios and highly rated instruments.

Most preparers noted that the joint approach would be as operational for closed portfolios as it is for open portfolios. The proposal addressed only open portfolios, to which financial assets are added and removed over time.

Users of financial statements generally expressed a preference for an expected-loss approach that ensures timely recognition of credit losses coupled with appropriate and adequate disclosures about loss estimates. Users also emphasized the importance of comparability of information between companies. Some users said the time-proportional element (i.e., the age-based ratio) of the joint approach may mask information about expected credit losses in the short term that are most relevant from the users' perspective. Other users said they could not comment on the joint approach because the FASB has not yet deliberated disclosure requirements.

Auditors said a lack of clarity in the guidance on the foreseeable future period and determining when an asset should be transferred from the good book to the bad book (and vice versa) would raise auditing challenges. Auditors said additional guidance is necessary in these areas to improve comparability between companies. Some said additional audit guidance would be necessary, particularly on auditing loss estimates for the foreseeable future.

Regulators supported the Boards' convergence efforts but had mixed views on the joint model. Some non-US regulators said the concept of a floor had merit, but they generally preferred the time-proportional component of the joint model.

US banking regulators continue to prefer a forward-looking impairment model that would result in recognition of losses earlier than the current incurred loss model under US GAAP. These regulators emphasized the need for a model that entities of all sizes can implement and expressed concerns that smaller financial institutions might have trouble implementing the time-proportional approach. These regulators stressed the importance of field-testing the model and suggested that the Boards consider a practical expedient that in certain circumstances would require only one calculation of expected losses (e.g., situations in which the time-proportional amount of remaining lifetime expected losses would be less than the floor). These regulators noted that the floor is a critical component of the joint model and that they would not support a model without one.

Foreseeable future

Constituents mainly focused on the length of the foreseeable future period, and views were mixed. Many constituents agreed that there should not be a bright-line definition and that the decision should be left to management's discretion with appropriate disclosures. However, some supported setting a bright line of, say, 12 months. Doing so would enhance comparability of information between companies, they said.

Consistent with the SD, some constituents said the type of assets in the portfolio would be a factor in determining the length of the foreseeable future period. The availability of inputs relating to asset type, origination criteria, geographic concentration and borrower demographics would vary across portfolios and would

Many preparers think that the allowance for the foreseeable future period would exceed the time-proportional amount in many situations.

affect the forecasts. Constituents also noted that the length of the foreseeable future also depends on the economic environment. It is easier for companies to make long-term forecasts in stable economic environments than in periods of economic stress or uncertainty.

Some preparers noted that the amount of expected losses for a period exceeding 18 to 24 months would be generally higher than the time-proportional amount.

The US banking regulators believe that the foreseeable future period would vary by asset type and would be longer than 12 months for many asset classes (e.g., for loan portfolios, they said this period would generally be 24 to 36 months). These regulators prefer not to create a bright-line rule and said they would object to limiting this period to 12 months. They also emphasized the importance of robust disclosures in this area.

Foreign regulators generally said the concept of the floor is appealing, but they do not want the floor to be the core of the joint model. They would rather limit the foreseeable future to a well-defined period (e.g., 12 months), which would result in greater use of the time-proportional component of the joint approach.

Good book – bad book

Generally, preparers viewed the requirement to distinguish between the good book and the bad book to be consistent with how financial institutions manage risk internally in their lending businesses.

However, preparers said that the criteria to distinguish between the good book and the bad book are not clearly defined, which may lead to diversity in practice about what goes in the bad book. They thought that the guidance provided in the SD dealt with the extreme ends of the continuum of how companies manage financial assets and did not adequately address situations between the two extremes. Preparers suggested that the Boards provide additional guidance and examples in the final standard to promote consistency.

Some preparers noted that there are different stages of credit-risk management of a loan based on degrees of uncertainty about collection. These preparers cautioned the Boards that any lack of clarity in the guidance may result in delays in bad book classification of an asset, causing a delay in recognition of credit losses even when the loss conditions were present much earlier. Other US preparers suggested that the criteria for bad book loans should be similar to the current US GAAP³ concept of an impaired loan, which is well defined and understood in the banking industry.

Users said the distinction between a good book and a bad book could provide useful information if the criteria are clearly defined. They requested that the Boards provide general guidelines to ensure consistent application.

The US banking regulators agree with the principles-based requirements to differentiate between a good book and a bad book. However, to enhance comparability, regulators recommended that the Boards provide further clarification about minimum expectations for the characteristics of the assets in the bad book. Regulators also believe that the criteria to identify a bad-book loan should be broad and that the application of these criteria should result in the inclusion of assets in the bad book that show signs of credit deterioration, even if there are no specific performance issues.

Constituents suggested that the Boards to provide additional guidance regarding when an asset should be transferred to the bad book.

Foreign regulators generally liked the idea of the good book and bad book split and indicated that existing international banking regulatory reporting guidance (e.g., Basel requirements) could be leveraged.

Estimating losses

Generally, constituents supported the idea of incorporating all available and supportable information (i.e., past, present and future) for coming up with robust loss estimates and making the estimation process a more forward-looking exercise rather than one that considers only historical information.

Some preparers said management should be permitted to use its judgment when estimating credit losses. Knowing the risk inherent in its assets, management may have its own views about the effects of changes in underwriting standards, loan covenant terms, expected deterioration or improvements in economic conditions, adjustment for imprecision and uncertainty of estimates.

Preparers emphasized that estimating losses can be a complex exercise that can be affected by variety of factors, such as the characteristics of assets, the availability of information, the tenor of the portfolio and the sophistication of estimation techniques, among others. These preparers suggested that the Boards continue to allow loss estimates to be based on management's best estimate and not require probability-weighted expected outcomes, which could be operationally very complex.

Allocation of losses

Constituents had mixed views on whether companies should be able to choose discounted or undiscounted estimates for the time-proportional calculation. Constituents were also divided on the flexibility provided in the proposal for choosing a discount rate if a discounting method was used.

A number of preparers said they would prefer to use a straight-line undiscounted calculation for the time-proportional allowance. These preparers said an undiscounted approach is easier to compute and explain to users and would provide a level of consistency in application and comparability between entities.

Preparers who prefer the use of discounting cited the incorporation of the time value of money as an important feature in allocating expected losses. These preparers generally said discounting using the effective interest rate is conceptually the most theoretically sound method and is well understood by users.

Users generally said allowing companies to choose between the discounted or undiscounted method and allowing them to choose a discount rate would hamper comparability between entities.

US banking regulators said they would not support discounting for good-book open portfolios due to concerns about complexity. Foreign regulators would prefer a model in which discounting is applied when relevant (e.g., bad-book assets), resulting in the reporting of more reliable information. Foreign regulators also preferred using an effective interest rate for the purposes of discounting.

Other views

Constituents suggested that the Boards re-expose the final proposal after they have redeliberated all significant aspects of the model and considered the feedback on the SD.

An alternative proposed by the US banking industry

A number of US-based banks (both large and small) proposed an alternative model for the Boards to consider. This model is a more forward-looking variation on current practice under US GAAP. The banks' model would consider management's best estimate of losses inherent in the loan portfolio, taking into account all relevant current and historical information as well as expected events and conditions.

The two components of the proposal are:

- ▶ A base component that represents the best estimate of expected inherent losses in the portfolio that are reasonably predictable
- ▶ An additional credit risk adjustment (CRA) that is estimated considering macro-level factors (e.g., the effect of lower underwriting standards, uncertainty regarding current economic conditions) that are expected to emerge as the credit cycle progresses. The CRA would address the inherent limitations of the forecasting process and the cyclical nature of macroeconomic conditions.

The banks said their proposed model would be less complex than the joint approach and would address the cyclical behavior of financial instruments by taking a broader view of the credit cycle.

Feedback on the FASB's approach

Most US constituents supported the FASB's approach, which would require an entity to immediately recognize all credit losses expected to occur in the foreseeable future period (i.e., the floor in the joint approach).

US constituents generally believe that it is less burdensome to forecast, with reasonable accuracy, events and conditions over a shorter time horizon. They also questioned the incremental benefit of the time-proportional calculation when in many scenarios (e.g., when the foreseeable future period is more than 18 to 24 months) they expect the floor amount to be higher than the time-proportional amount.

Some constituents believe that applying the FASB's approach may not require a split between a good book and a bad book because expected losses for bad-book assets would mostly occur in the foreseeable future and, therefore, would be recognized immediately. These constituents said eliminating the requirement to split assets into a good book and a bad book could reduce operational complexity.

US banking regulators support the FASB's approach because they say the time-proportional approach would result in deferring recognition of loan losses beyond current practice.

Feedback on the IASB's approach

Most foreign constituents supported the IASB's approach, which would require recognition of losses on a time-proportional basis over the life of the portfolio. In their view, the IASB's approach appropriately reflects the economics of lending

While the US constituents prefer the FASB's approach, others generally prefer the IASB's approach.

transactions by aligning interest income with credit-loss expense. These constituents object to the floor, which they say would exceed the time-proportional amount in many cases and would be inconsistent with the IASB's objective.

Our views

With widely divergent views between US and foreign constituents, the Boards may struggle to achieve convergence. Based on the feedback received, if the Boards decide to pursue the joint model, they will need to address concerns about operationality, particularly the requirement to do two separate impairment calculations.

What's next

The Boards plan to jointly deliberate the feedback on the SD. They will also discuss aspects of impairment accounting not covered in the SD. The IASB has not indicated whether it will re-expose an impairment model once redeliberations are complete. However, given the IASB's desire to issue final guidance by 30 June 2011, it is not clear whether re-exposure would be possible. The FASB plans to expose the proposed amendments to the Codification before finalizing its guidance in the third quarter of 2011.

Endnotes:

- ¹ FASB and IASB Supplementary Document, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the SD), 31 January 2011
- ² FASB Staff Position No. 115-2 and FAS 124-2, *Recognition and Presentation of Other-Than-Temporary Impairments* (subsequently codified in ASC 320 and ASC 325-40)
- ³ ASC 310-10, *Receivables* (formerly FAS 114 – *Accounting by Creditors for Impairment of a Loan – an amendment of FASB Statements No. 5 and 15*)

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