ASAF Meeting April, 2013

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Project Objectives

- **Timely Recognition of Credit Losses**
  - Address concerns with existing standards and practice: delayed recognition of losses under the incurred loss approach
  - PV of cash flows an entity expects to collect is consistent with measurement objective for assets held for collection (under C&M proposals)
- **Separate Presentation of Interest Income and Credit Losses**
  - Rate of return includes the compensation that a lender receives for taking on the credit risk inherent in the debt instrument
  - Investors want separate presentation of credit losses from interest income (often referred to as a “decoupled” approach for interest income and credit loss recognition)
  - Using effective rate as discount rate (in a DCF approach) isolates credit loss and does not introduce noise related to market changes

Comparing the Models . . . *FASB v IASB*

Similarities between Proposals . . .

- **Covers all financial assets subject to credit risk**
  - Except those reported at FV through net income/P&L
- **Both models based on “expected” credit losses**
  - Not “incurred” losses
  - Not “most likely outcome”
- **Same information used to estimate expected credit losses for Stage 2 and 3 Assets (which are “lifetime” estimates after deterioration has occurred)**
- **Time value of money is considered**
- **Enhanced disclosures are provided**

Basics of FASB Model

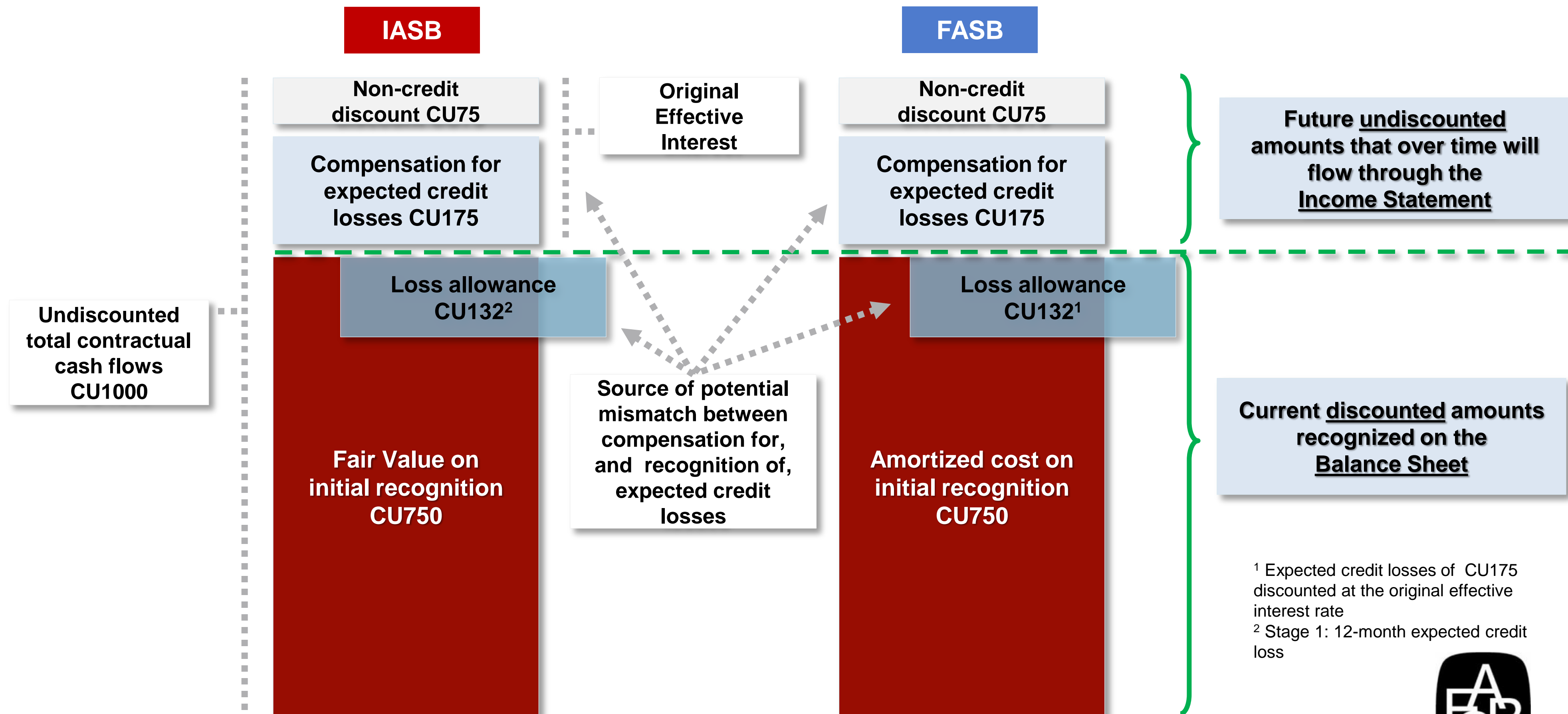
- Every reporting period, **expected credit losses** would be re-estimated; favorable and unfavorable changes would be reported in earnings
- Current estimate of expected credit losses based on the current **risk ratings** of the assets, **historical loss experience** for assets with similar risk ratings and remaining lives, **adjusted for changes** in current circumstances, and reasonable and supportable expectations about the future
  – Key difference between models: For "Stage One Assets," FASB estimate is not limited to what is expected (probability of default) in next 12 months
- Expected losses are inherent in groups of similar assets; the inability to identify *which* asset will deteriorate should not interfere with timely recognition of losses that are expected in the individual assets held
- FASB used term "full" rather than "lifetime" to avoid suggesting that projections through the remaining life are necessary. Rather, we expect estimates will start with historical information, and be adjusted using available information that indicates that current expectations differ from past experience

The “Day 1” Issue

- Some believe that the FASB model recognizes losses prematurely and in excessive amounts
  - Present in current GAAP, IASB, and FASB models; it’s a matter of degree and timing
  - Clearly a **transition** issue for longer-term assets; try to separate from ongoing effects
- FASB rationale
  - Measurement objective is consistent between C&M and Impairment for assets held for collection
  - Based on historical data, losses are often foreseeable beyond 12 months; IASB’s Stage One requires recognition of lifetime expected credit losses associated with the probability of a loss occurring in the next 12 months
  - Removing any threshold for recognition reduces management's discretion as to when expected losses should be recognized, improves understandability, operability, and auditability of approach
- FASB concern about “proportionate approach” for Stage One Assets
  - Most credit losses emerge early in life; waiting for significant deterioration for some assets delays timely loss recognition and introduces non-comparability
  - Not recognizing the probability of a loss occurring beyond 12 months leads to under-reserving of assets, followed by a “catch-up” when the deterioration occurs
  - The measure of Stage One Assets is inconsistent with amortized cost

Is there Double Counting?

Lower Quality, Shorter Duration (e.g., credit card receivables)



[1] Expected credit losses of CU175 discounted at the original effective interest rate
[2] Stage 1: 12-month expected credit loss

Is there Double Counting?

Lower Quality, Longer Duration (e.g., commercial loans)

	IASB		FASB	
	Non-credit discount CU75	Original Effective Interest	Non-credit discount CU75	Future undiscounted amounts that over time will flow through the Income Statement
	Compensation for expected credit losses CU175		Compensation for expected credit losses CU175	
Undiscounted total contractual cash flows CU1000	Loss allowance CU40[2]	Source of potential mismatch between compensation for, and recognition of, expected credit losses	Loss allowance CU132[1]	Current discounted amounts recognized on the Balance Sheet
	Fair Value on initial recognition CU750		Amortized cost on initial recognition CU750	

[1] Expected credit losses of CU175 discounted at the original effective interest rate

[2] Stage 1: 12-month expected credit loss

FASB Model – Debt Securities and Financial Assets Measured at FV-OCI

- Securities and non-securities follow the same approach
- However, as a **practical expedient**, an entity may elect not to recognize expected credit losses for financial assets classified at FV-OCI when both of the following conditions are met:
  - FV of the financial asset is greater than the amortized cost basis
  - Expected credit losses on the financial asset are insignificant
- Practical expedient for **high-quality assets**; cost-benefit consideration

Purchased Credit Impaired (PCI) Assets

- Common issue for **business combinations** and portfolio transfers; current GAAP is complex and confusing
- FASB proposal follows same approach to estimating expected credit losses as originated and non-PCI assets
  - The allowance would be based on management's current estimate of the contractual cash flows that the entity does not expect to collect
  - Changes in credit impairment allowance (favorable or unfavorable) recognized immediately as bad debt expense
- **Initial** estimate of expected credit losses is recognized as an adjustment to the cost basis of the asset (an allowance) and would **not** be recognized as interest income

FASB Model – The Result

- For investors:
  - Balance sheet reflects management's current estimate of expected credit losses at the reporting date
    - Allowance can be **easily understood** since it is based on a single measurement objective; asset is carried at PV of expected cash flows
  - Income statement reflects **changes** in expected credit losses during the period
    - No "cliff effect" resulting from a change in measurement objective for the credit impairment allowance
  - Interest income measured **separately** from credit losses; however, **accrual ceases** when collection is not probable
    - Consistent with investor's suggestions following the May 2010 Exposure Draft
  - **Disclosures** provide insight into the credit quality of financial assets at each reporting date and **illustrate credit deterioration** occurring during the reporting period

FASB Model – The Result (continued)

- For preparers:
  - A model that **leverages existing** internal credit risk management **tools and systems**; however, the **inputs** to the measure **will change**
  - A consistent measurement approach throughout the portfolio with **no barriers or thresholds for recognition**
  - An approach for PCI assets that is
    - less complex and costly to implement
    - easier to explain to investors