FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Memorandum

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Project **Accounting for Financial Instruments: Impairment (AFIIMP)**

Topic **Feedback Summary**

Background

1. On December 20, 2012, the Financial Accounting Standards Board (FASB) issued proposed Accounting Standards Update, *Financial Instruments—Credit Losses (Subtopic 825-15)* (the proposed Update). The proposed Update aims to address the weakness that was identified in current U.S. generally accepted accounting principles (GAAP) by the Financial Crisis Advisory Group[1] (FCAG) regarding the delayed recognition of credit losses by requiring the timely recognition of *all* expected credit losses (as opposed to maintaining a threshold that must be met before *all* expected credit losses are recognized or permitting recognition of only *some* expected credit losses). The comment period for the proposed Update ended on May 31, 2013.

2. During the comment period, the Board and staff sought to educate stakeholders about the proposal through participation in various educational conferences and

[1] The Financial Crisis Advisory Group (FCAG) was created in October 2008 by the FASB and the IASB, as part of a joint approach to dealing with the reporting issues arising from the global financial crisis. The FCAG was asked to consider how improvements in financial reporting could help enhance investors' confidence in financial markets.

conference calls, by publishing a Frequently Asked Questions document[2] regarding the proposal, and by hosting a FASB Podcast regarding the proposal.

3. Consistent with the FASB's mission to improve financial reporting in a manner that *provides decision-useful information to investors and other users* of financial statements, the Board and staff developed a multi-faceted approach for obtaining feedback on the proposed Update. Specifically:

   a. To understand whether the proposed Update would achieve the Board's mission to improve financial reporting for the benefit of users, the Board and staff sought input from investors and other users of financial statements.

   b. To understand the operationality and cost of applying the proposed Update, the Board and staff sought input from preparers, auditors, and other parties involved in the financial statement preparation process.

4. Feedback was obtained in the following ways:

   a. **Investor Meetings** - The Board and staff received input from approximately 70 analysts and investors by meeting with them to discuss their views on how best to improve financial reporting of credit losses for the benefit of investors. A number of these meetings were conducted jointly with the staff and individual Board members from the IASB.

   b. **Field Visits** - The Board and staff conducted 17 field visits with preparers (including multi-national and domestic, financial and non-financial, and public and private institutions) to gather feedback on the operationality of the proposed Update. The IASB staff participated in nearly all of the field visits.

   c. **Comment Letters** – The Board and staff received comment letters from a variety of preparers and other interested parties detailed as follows:

[2] Available on the FASB website at the following address: http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176162305167

Type of Respondent	No. of Responses
Preparers	254
Professional Organizations	64
Public Accounting Firms	19
Individuals	13
Regulators & Gov't Agencies	6
Users	6
Total Comment Letters	**362**

Executive summary

5. As to whether constituents prefer the model articulated in the proposed Update, the staff and Board found a striking difference in the views of (a) investors and other users (for whom the Board seeks to improve financial reporting) and (b) preparers. Specifically:

   a. By a nearly 3-1 margin, investors and other users prefer a model that recognizes *all* expected credit losses (as opposed to maintaining a threshold that must be met before *all* expected credit losses are recognized or permitting recognition of only *some* expected credit losses).

   b. Most preparers prefer a model that either recognizes only *some* of the expected credit losses or maintains a threshold that must be met before *all* expected credit losses are recognized. In addition, financial institutions raised significant concerns on the potential impact on regulatory capital.

6. As to whether the model articulated in the proposed Update is operational, the staff and Board found that once preparers understood what the Board was expecting with regard to estimating expected credit losses, nearly all preparers participating in the field visits and outreach sessions indicated that the measurement of lifetime expected credit losses was operational. However:

a. Many preparers (including a large number of comment letter respondents) are under the impression that an entity would be expected to forecast economic conditions over the remaining life of the assets in the portfolio (which would be operationally challenging and yield potentially unreliable results). While this was not the Board's intention, both the staff and Board can appreciate how constituents arrived at that misunderstanding given the language in the proposed Update. This misunderstanding was clarified with those preparers participating in field visits and outreach sessions.

b. Preparers noted the incremental cost and effort to move to a "life of loan" expected credit loss model, and again expressed a preference for either a model that either recognizes only *some* of the expected credit losses or maintains a threshold that must be met before *all* expected credit losses are recognized.

7. The following paragraphs provide executive summaries of the feedback received from investors and preparers on the main objectives and core principles of the proposed Update. The appendices to this memo then provide more detailed summaries of the feedback received from investor outreach and comment letters and field visits.

Executive summary of investor views

8. Consistent with the feedback received on the May 2010 proposed Accounting Standards Update, *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities* (the May 2010 Exposure Draft), investors have significant concerns with the delayed loss recognition and the adequacy of reserves. Investors understand that there is significant subjectivity in management's credit loss estimates, and seek more information about the underlying assumptions and information used to develop loss estimates.

a. **Timing (and amount) of loss recognition** – By a nearly 3-1 margin, the majority of investors we consulted commented that all expected credit losses

should be recognized at origination. Most of the investors said that they view the allowance as representing capital set aside to absorb future expected losses and in this regard reserve adequacy is of paramount importance. They see no point in recognizing expected credit losses only if the default events are expected within a specific time frame. They also do not like the idea of triggers for recognizing all expected losses, which they asserted add another layer of subjectivity onto an already subjective estimate.

b. **Information set to be considered in estimating loss** - Almost all investors agreed that past, current and reasonable and supportable forecasts should be used to develop the loss estimate.

c. **Approach for purchased credit-impaired assets** – Investors nearly unanimously agreed that a gross presentation of the asset and the allowance for PCI will reduce complexity and enable better analysis. Many commented that they would also like the changes to be applied to all loans acquired in a business combination.

d. **Approach for financial assets at FV-OCI** – Investors had mixed views on application of the model to debt securities and assets measured at fair value through other comprehensive income (FV-OCI). Many investors are supportive of a single model for credit impairment and felt this would be a significant improvement over existing other-than-temporary impairment (OTTI) rules for securities. Others questioned whether there was even a need to have a separate model for recognizing credit losses through net income in light of the FV-OCI objective for the asset, which they believed was sufficiently transparent in the financial statements.

e. **Nonaccrual** – Investors support the approach that regulated banks utilize for non-accrual and were supportive of broadening that approach to all entities.

f. **Disclosures** – Investors would like to see more robust disclosures on credit losses. In addition to the proposed asset rollforward disclosures, investors said they would like to be able to better analyze the expected and actual performance of assets by vintage over time and management's ability to

forecast expected losses. Many favored a rollforward of expected credit losses disaggregated by portfolio segment showing the sources of changes in the reserve (originations, estimate revisions, purchases or sales, for example).

Executive summary of preparer views

9. A majority of preparers do not support the proposed Update. Most preparers prefer a model that either recognizes only *some* of the expected credit losses or maintains a threshold that must be met before *all* expected credit losses are recognized. In addition, financial institutions raised significant concerns on the potential impact on regulatory capital.

    a. **Timing (and amount) of loss recognition -** As to the core question of operability, when provided clarifications on the Board's expectation on how an entity would estimate expected credit losses, nearly all preparers participating in the field visits and outreach sessions indicated that the measurement of lifetime expected credit losses was operational (albeit at an incremental cost). Having said that, the majority of preparers do not agree with the proposed Update because they believe it will result in (1) understating the net asset value of a financial asset measured at amortized cost on "Day 1" (by recognizing expected credit losses that are already reflected in the purchase price or transaction price at initial recognition) and (2) failing to "match" the timing of recognition of credit loss expense with the timing of recognition of compensation for expected credit losses (in the form of interest income). In addition, financial institutions raised significant concerns on the potential impact on regulatory capital.

    b. **Information set to be considered in estimating loss** – Nearly all preparers agreed that past, current and reasonable and supportable forecasts should be used to develop the loss estimate.

    c. **Approach for purchased credit-impaired assets** – Preparers generally supported the approach for PCI assets. Many respondents preferred the proposed approach because it eliminated many of the operational challenges

that exist as a result of applying Subtopic 310-30 (formerly SOP 03-3), primarily concerning the asymmetrical treatment of favorable and unfavorable changes in expected cash flows. Similar to some of the investor feedback, some preparers indicated that the scope of the PCI approach should be expanded to apply to all purchased assets, regardless of the level of deterioration experienced since origination.

d. **Approach for financial assets at FV-OCI –** Preparers generally disagreed with the approach for financial assets measured at FV-OCI. While a small minority agreed with the proposal's approach, those disagreeing with the approach did so for a number of reasons. Some preferred to maintain the existing OTTI model for debt securities while others recommended modifying the practical expedient. Others believe the Board should consider excluding U.S. treasury securities (and other similar debt instruments).

e. **Nonaccrual –** While investors supported the approach to introduce into U.S. GAAP the regulatory instructions on the nonaccrual of interest income, preparer reaction to the proposed approach was generally mixed. Some preparers believe that nonaccrual guidance should not be added to U.S. GAAP while others preferred including such a principle but recommended certain revisions to the proposed requirements.

Appendix A
Investor Outreach Feedback Summary

Population of investors consulted during outreach

A1. Since the issuance of the proposed Update, the FASB staff has received feedback on the proposal from more than 70 investors and other users of financial statements employed by more than 45 firms through face-to-face meetings and teleconferences with individual investors and groups of investors. Meetings typically lasted 60–90 minutes. Furthermore, almost every meeting included one or more Board member(s) and some of the meetings were conducted jointly with the IASB Staff and some IASB Board Members.

A2. The investors who spoke directly with Board members and staff as part of this outreach effort are employed by various organizations and represent a variety of perspectives. The investors who participated in consultations with the FASB represented their own views and not the views of their employers. Many of the participants have corporate policies that do not allow them to identify themselves or their firms publicly. Approximately 51 percent (36 of 71) of the investors consulted were buy-side analysts focused on financial institutions. The remainder included sell-side analysts specializing in either bank/insurance-related sectors (22), ratings agencies analysts (9), or accounting analysts (4).

A3. The investor feedback received specifically on the proposed Update is in addition to feedback received from more than 200 investors leading up to and following the May 2010 Exposure Draft. The staff believes that its continued focus on financial institution investors helps ensure that the feedback to the Board is as relevant and reliable as possible because the feedback comes from investors who actually analyze credit losses and the Alliance for Loan and Lease Losses. That is, they are the primary users affected by this issue and are the investors for whom the Board seeks to improve financial reporting in this area. Investor feedback has generally remained consistent over time, with a few recurring themes, including a focus on

more timely recognition of expected credit losses, reserve adequacy at any given point in time to cover future expected losses, obtaining more information about underlying assumptions and information used to develop loss estimates, and the importance of global convergence.

Investors' objectives with regard to credit losses

A4. Investors remain concerned about the delayed recognition of losses associated with the current accounting framework and the adequacy of reserve estimates. Investors consulted noted that they spend vast amounts of time analyzing the allowance for credit losses, in conjunction with information about the credit quality of the portfolio. Investors highlighted the systematic under-reserving that is inherent in today's model caused by only reserving for some of the expected losses. They often referred to frustration with accounting "restrictions," such as the evidence required to meet the probability threshold for recognition of losses and the inability for management to use forward looking expectations to recognize expected credit losses. They highlighted that their analyses today aim to adjust the reported amounts for the analyst's forecast of all the credit losses that ultimately will come through the portfolio (i.e., what we might refer to as "all expected credit losses"). They do this to determine whether there is potential near-term or long-term earnings risk and/or capital risk and to analyze whether an entity's risk-based pricing model is appropriate.

A5. Investors consulted understand that there is significant subjectivity in management's credit loss estimates. The level of attention paid to credit loss estimates gives both buy-side and sell-side analysts confidence that market forces help to control subjectivity or, at the very least, make it more transparent. In other words, when an entity's reserves are significantly out of line with its peers, investors question why that is and typically adjust their earnings and valuation models to reflect what they believe are more appropriate expectations. Investors seek transparency into the credit risk of the underlying assets and the assumptions used by management to establish credit reserve estimates. Furthermore, information about how credit loss

estimates have changed from prior periods (at an adequately disaggregated level) helps investors make their own assessments/adjustments of all credit losses expected to come through the portfolio. Ultimately, no matter what number is reported as an "allowance for credit losses," investors will make their own assumptions about the near-term and lifetime expected credit loss.

Threshold and timing for recognition of losses

Majority views

A6. Almost all investors we consulted support a change from an "incurred loss" model to an "expected loss" model, although they acknowledge that the term *expected loss* can mean different things to different people. Similarly, almost all investors we consulted support removal of the "probable" threshold for loss recognition. They noted that this threshold has artificially delayed loss recognition.

A7. The majority of investors we consulted (52 of 71) commented that all expected credit losses should be recognized at origination. Most of the investors said that they view the allowance as representing capital set aside to absorb future expected losses and in this regard reserve adequacy is of paramount importance. They see no point in recognizing expected credit losses only if the default events are expected within a specific time frame. They also do not like the idea of triggers for recognizing all expected losses, which they asserted add another layer of subjectivity onto an already subjective estimate.

> Having a trigger event is awful accounting. We have seen that. The application is inconsistent. How much deterioration is enough to warrant the full loss? I don't like the subjectivity in that. Will it actually cause banks to take more risk in the securities portfolio because they can hide behind the fact that a lot of the risk was already "priced in." [U.S. largecap bank analyst (long-only)]

> Reserves should be built as volume grows, not just as things deteriorate. [U.S. large and midcap bank analyst (hedge fund)]

A8. In the investor meetings, the FASB staff noted that when forecasting losses on "good assets" there may be some future time horizon beyond which it is very difficult to

accurately forecast the timing and amount of losses or the future economic conditions that may exist beyond a certain point. Given this circumstance, the staff indicated that the Board is faced with deciding to either (a) have preparers establish no reserve on good loans for periods beyond this "foreseeable future" or (b) have preparers revert to historical averages for periods beyond the foreseeable future. Most investors we consulted agreed with the Board's decision to have preparers revert to historical averages for periods beyond the foreseeable future, noting that a historical average would be more informative than an uneconomic assumption of zero credit losses. Several investors reiterated their comments that a time-based trigger (such as foreseeable future) would add another layer of subjectivity onto an already subjective estimate.

> You shouldn't assume zero losses in the future just because they are hard to predict. Most banks have a lot of history that should help them. [Global large and midcap bank analyst (long only)]

> Booking anything other than lifetime losses introduces timing subjectivity. [U.S. mid and largecap bank analyst (sellside)]

Minority views

A9. Some investors (18 of 71) said that they think it is inappropriate to recognize all expected credit losses up front. This view exists across all investor perspectives: buyside analysts (seven), sellside analysts (five), credit analysts (three), and accounting analysts (three).

A10. Each user had their own reasons for preferring not to recognize all expected credit losses at origination. Some of the reasons mentioned included:

a. It does not appropriately "match" credit losses against interest income.
b. It will result in too much reserves being recognized too soon.
c. It will require/allow forecasting beyond two years, which could result in unreliable (potentially cookie jar) estimates and volatile revisions.
d. It will cause a major capital hit.

A11. Most of these users either preferred an incurred loss model that would allow more leeway in when a loss would be recognized (for example, by eliminating the

probable threshold or allowing for a general reserve) or they would like an expected loss model that recognizes losses expected over the foreseeable future, which was typically defined as more than 12 months but less than 36 months. Many struggled to articulate exactly when losses should be recognized. A few stated that the current incurred loss model used today is appropriate.

The information set to be used in reserving for expected credit losses

Majority views

A12. Most investors we consulted agree that historical information about credit losses, coupled with information about current conditions and reasonable and supportable forecasts, should be used to develop the reserve for expected credit losses. They expressed concern that restricting the inputs into the credit reserve estimate limits the usefulness of the reserve estimate because it restrains management's ability to fully reserve for expected credit losses. Therefore, they noted that management should be required to incorporate both historical loss experience for similar assets and supportable forecasts in their estimate of expected credit losses.

A13. Investors understand that there is subjectivity in this approach and noted that adequate disclosure is critical. Furthermore, some investors noted that they may not support a lifetime expected loss/supportable forecast approach if adequate disclosure about the inputs and assumptions used to measure expected credit losses is not provided in such a manner that an investor could reasonably apply its own view of the future to forecast the entity's expected credit losses.

Minority views

A14. Some investors consulted (generally many of the 18 that do not like the recognition of lifetime expected losses) stated that forecasts should not be allowed beyond the foreseeable future because these forecasts are not reliable. These investors noted that the use of historical experience as a proxy for future expectations in the absence of reliable information was not helpful.

> Volatility in loan losses have been noteworthy. In the recent crisis, the loan losses were the highest since the Depression. Banks will struggle with what is the right loss rate. It is hard for me to imagine a bank being able to book a lifetime loss rate that is less than the recent rate it has been experiencing. I am concerned that auditors will force the bank to heavily weight the most recent information. Still, it doesn't make sense to wait to take some of the losses. [U.S. largecap bank analyst (long only)]

The approach for purchased credit-impaired assets

A15. Nearly all investors consulted asserted that the same approach to credit losses should be utilized for purchased credit-impaired (PCI) and non-PCI assets. Similarly, nearly all investors consulted stated that a gross presentation of the asset and the allowance for PCI assets will reduce complexity and enable better analyses.

A16. Many investors commented that they also would like the changes to be applied to healthy loans acquired in a business combination.

> The acquisition of non-PCI loans should not be different from other loan accounting. The current accounting is confusing to investors and it inhibits healthy M&A activity. [US mid to largecap banking analyst (buyside)]

The approach for financial assets measured at FV-OCI

A17. The investors we consulted expressed mixed reaction to the approach for financial assets measured at fair value through other comprehensive income (FV-OCI). Consistent with the discussion above regarding Investors' Objectives, most investors we consulted view this project as addressing the delayed recognition of credit losses *on the balance sheet*. For debt securities measured at FV-OCI, investors were less concerned about current financial reporting because the assets use fair value as the primary balance sheet measure, which investors generally view as appropriate for debt securities.

A18. Given this background, some investors we consulted support a single model for credit loss recognition for all financial assets and felt this would be an improvement

over existing other-than-temporary-impairment (OTTI) rules for securities because current OTTI rules can result in the delayed recognition of credit losses. Other investors we consulted suggested that, given a measurement objective of FV-OCI, there is no need to separately recognize credit losses through net income and they are satisfied with the transparency of marking all changes in fair value (including those because of management's assessment of the changes in credit risk) through OCI. Still others are satisfied by the existing OTTI rules and see no need to change them.

Nonaccrual

A19. Investors we consulted support the approach that regulated banks currently utilize for nonaccrual of interest income and support broadening that approach to all entities.

Disclosures

A20. Regardless of the credit loss recognition model used, investors consulted would like to see more robust disclosures on the credit loss reserve. This would include a more detailed explanation of the inputs into the estimate (which is included in the proposed Update), a rollforward of the entity's portfolio disaggregated at the portfolio segment level (which is included in the proposed Update), and also a rollforward of the reserve for expected credit losses disaggregated at the portfolio segment level, including originations, estimate revisions, purchases, sales, and repayments. This reserve rollforward was not included in the proposed Update, but investors consulted consistently suggested that such a rollforward would enable them to better analyze the expected/actual performance of assets over time and also better assess management's ability to reliably forecast expected losses.

A21. Ultimately, investors are trying to figure out the total expected loss, how those expectations change over time, and the reasons for the change (for example, changes

in business mix, unexpected changes in the economy, forecasting error) as well as how actual losses develop over time and to what vintage they relate.

Early adoption

A22. Some investors we consulted support early adoption because they noted that many entities will begin to "soft adopt" the proposal as soon it is issued. Others, however, noted that early adoption would be a "mess" and would result in investors "pricing in" the estimates of the early adopters to those who had not early adopted, which would essentially force entities to adopt the proposal before they are ready. Some suggested that we should consider delaying the effective date for smaller institutions.

Appendix B
Comment Letter and Field Visit Feedback Summary

International convergence

B1. In general, respondents support the overall objective of the FASB and the IASB to develop a single, converged standard on the accounting for expected credit losses. Because they believe that convergence is critical to the success of the global capital markets, they are concerned with the differences between the Boards' respective proposals. They believe that if the Boards cannot develop a converged solution and instead move forward with variants of each Board's respective proposed model (a) certain financial institutions (specifically those that prepare financial statements under U.S. GAAP) will be at a regulatory capital disadvantage compared to those institutions preparing financial statements under IFRS, (b) investors would be affected when analyzing and comparing financial statements of financial institutions prepared under U.S. GAAP against those prepared under IFRS, and (c) financial statement preparers would face significant operational challenges when preparing financial statements under both U.S. GAAP and IFRS.

B2. While many respondents support the Board's efforts on convergence to date, many respondents also point out the remaining differences between the two proposals on expected credit losses and as a result, urge the Board to continue to work with the IASB on ways to minimize those differences. Those respondents believe that international convergence is fundamental to global capital markets and anything less than full convergence on the recognition of credit losses on financial instruments would be detrimental to the competitiveness of global capital markets.

B3. Specifically, if the final standards are not converged, respondents expressed concern that comparability across financial institutions would suffer. This would not only affect investors when analyzing and comparing financial statements of financial institutions prepared under U.S. GAAP against those prepared under IFRS, but would also present significant operational challenges to entities that prepare financial statements under both U.S. GAAP and IFRS (for example,

implementation of multiple accounting standards and possibly maintaining dual accounting systems). Some also suggested that the significant differences between the two proposals would put U.S. financial institutions at a competitive disadvantage because of the impact of the allowance for credit losses on regulatory capital. However, there were some respondents who cautioned the Board on its efforts on convergence. While they appreciate the concept of convergence, they recommended that the Board concentrate on developing a final standard on credit losses that is an improvement to current accounting standards and utilizes existing U.S. GAAP as the starting point, as opposed to starting with a so-called "clean sheet of paper."

General premise of moving to an expected credit loss model

B4. A majority of respondents agreed with the Financial Crisis Advisory Group's[3] (FCAG) recommendation to the FASB and the IASB to develop an expected loss model by removing recognition thresholds and allowing the use of forward-looking information. They believe that the move to an expected loss model addresses the delayed recognition of credit losses and is in direct response to lessons learned from the recent global financial crisis about the weaknesses existing in U.S. GAAP (for example, that loan loss allowances under existing GAAP were inadequate to absorb losses incurred during the financial crisis in part because of existing accounting standards).

B5. Some respondents, however, did not support the FCAG's recommendation to move away from an event-driven, incurred loss model. They suggested that FCAG's recommendation to the Boards to develop an expected loss model was a "knee-jerk" reaction to the recent financial crisis and would not have prevented the crisis. In addition, they believe that an expected loss model (which does not require an event to trigger the recognition of a loss) is not consistent with the FASB's

[3] The Financial Crisis Advisory Group (FCAG) was created in October 2008 by the FASB and the IASB, as part of a joint approach to dealing with the reporting issues arising from the global financial crisis. The FCAG was asked to consider how improvements in financial reporting could help enhance investors' confidence in financial markets.

Conceptual Framework and would be inconsistent with other loss recognition guidance in U.S. GAAP. As a result, some respondents believe that a credit loss model should require loss recognition only after meeting an incurred loss threshold or trigger point. This would allow financial statement users to better discern changes in the allowance balance that relate to specific credit loss events that occurred as opposed to more subjective expectations of future credit losses (see paragraph 26 for further discussion of feedback on recognition).

Measurement

Misunderstandings and operational concerns

B6. When developing a current estimate of expected credit losses, the proposed Update requires an entity to update its historical loss experience for the entity's current assessment of existing conditions and reasonable and supportable forecasts about the future (and their implications for the entity's current estimate of expected credit losses). Many respondents stated in their comment letters that forecasting and "predicting" economic conditions over the *remaining life* of an asset would be operationally challenging (if not impossible) and would result in providing information to users that is both inaccurate and unreliable. In addition, some of these respondents also believe that the proposed Update requires an entity to specifically identify the amount of cash flows that will not be recovered and in which period the entity believes those losses will occur.

B7. Respondents were also concerned with management's estimate of expected credit losses being subjected to audit (and regulatory) scrutiny. Respondents expressed concerns that they would be subjected to additional scrutiny from auditors and regulators if they do not currently possess sufficient, reliable data to update historical loss experience for current conditions and reasonable and supportable forecast about the future.

B8. While conducting field visits with preparers, the staff heard similar feedback regarding a life of loan expected credit loss estimate, in particular the concerns on

the inability to forecast and predict economic conditions over the entire remaining life of the asset.

B9. Neither the Board nor the FASB staff expected that an entity would be required to develop a forecast of economic conditions over the remaining life of an asset. However, both the Board and the staff can appreciate how constituents arrived at that misunderstanding given the language in the proposed Update. During field visits, educational outreach sessions, and through the Frequently Asked Questions document published in March 2013, the Board and staff sought to clarify this misunderstanding by clarifying its original expectation on how an entity would estimate expected credit losses. Specifically, the Board and staff explained the following:

a. That an entity is not expected to forecast and predict economic conditions over the entire *life* of the asset; rather, it is only expected to update historical loss experience for current conditions and reasonable and supportable forecasts about the future (with the forecasts being made over a shorter, more reliable period of time).

b. That for the periods beyond those that are able to be reasonably and supportably forecasted, entities could revert to a historical average loss experience or freeze the furthest reasonable and supportable forecast.

When provided these clarifications, nearly all preparers participating in the field visits and outreach sessions indicated that the measurement of lifetime expected credit losses was operational (albeit at an incremental cost).

Reversion to the mean

B10. Of those respondents who understood the Board's intentions regarding reasonable and supportable forecasts and their effect on an entity's historical experience, some respondents believe that reverting to unadjusted historical averages for future periods beyond which an entity is able to make or obtain reasonable and supportable forecasts provides users with information that is misleading because historical credit loss experience may not be a good predictor of credit losses in the

future. They prefer that for the periods beyond those that are able to be forecasted, entities should not revert to historical average loss experience but rather recognize zero expected losses.

Multiple possible outcomes and fully or over-collateralized assets

B11. The proposed Update would require that an estimate of expected credit losses always reflect both the possibility that a credit loss results and the possibility that no credit loss results. As a result, an entity is prohibited from estimating expected credit losses based solely on the most likely outcome.

B12. Some respondents expressed concern that this requirement will lead to the recognition of an expected credit loss on financial assets that are either fully or over-collateralized. Said differently, respondents indicated that although the probability of default may not be zero, the loss given default would be zero (or very close to zero) because of the collateral protecting against such a loss. Respondents suggested that the proposed Update be revised to either (a) exclude from its scope financial assets that are either fully or over-collateralized or (b) be revised to describe how fully or over-collateralized financial assets implicitly satisfy the requirement to reflect both the possibility that a credit loss results and the possibility that no credit loss results.

Time value of money

B13. The proposed Update would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. It proposed that methods implicitly reflect the time value of money by developing loss statistics on the basis of the ratio of the amortized cost amount written off. Such methods may include loss-rate methods, roll-rate methods, probability-of-default methods, and a provision matrix method using loss factors.

B14. Many respondents prefer that any final standard not make specific reference to a time value of money principle. Some respondents were confused as to the Board’s intention with the time value of money measurement principle and whether a

discounted cash flow technique (DCF) would always be required. Other respondents highlighted that various loss rate methods and probability of default methods will not necessarily reconcile perfectly to a DCF. Finally, some respondents have a different view as to what it means to "implicitly" reflect the time value of money and do not agree with the Board that loss rate approaches "implicitly" reflect time value of money since they may not provide the identical result as a DCF technique.

B15. While not disagreeing that loss rate or PD/LGD approaches should be acceptable, a number of preparers suggested that it would be simpler (and would less likely be subjected to audit scrutiny) to merely articulate which approaches satisfy the time value of money principle. Doing so would avoid external interpretation differences with the "implicit" time value of money assumption language in the proposed Update.

Operational concerns specific to credit unions and other small institutions

B16. Feedback from credit unions and other smaller and less complex entities indicated that they would incur significant incremental costs associated with operationalizing a life of loan estimate of expected credit losses, even after understanding the Board's intent regarding the updating for reasonable and supportable forecasts about the future. Many of these entities currently utilize annual loss rates (i.e., the net amount written off in a 12-month period divided by the average amortized cost) when developing their current allowance for loan losses. These entities typically do not have access to historical life-of-loan credit loss data.

B17. Under the proposed Update, the methodology of using an annualized loss rate would not be allowed and would therefore require these entities to develop systems to track and calculate historical loss experience that is not currently tracked today. Furthermore, these entities do not currently have the resources to adjust the newly-determined historical loss experience for current conditions and reasonable and supportable forecasts. As a result, some of these entities suggested that the Board consider whether (a) the proposed Update should apply to these entities or (b) there

are other reasonable and acceptable methods that could be used as a proxy that will satisfy the objectives of the proposal.

Operational concerns specific to credit card balances

B18. Respondents indicated that applying the measurement principle of the proposed Update to a credit card balance will be operationally difficult because of the inherent complexities in determining the life of a credit card's funded and unfunded balance.

B19. Respondents indicated that the historical data needed to develop an expected loss estimate on a credit card balance would require an entity to first develop an average loan life for the credit card balance. They suggested that developing an average loan life for a credit card balance is inherently more difficult than determining one for a traditional loan product because the average loan life will depend on whether a credit cardholder pays in full each month (referred to as a "transactor") or pays less than their full balance and therefore carries a balance each period (referred to as a "revolver"). While historical information on the average life of a credit card balance may exist on either category of cardholder, respondents indicated that whether a cardholder is a transactor or a revolver is largely influenced by current economic conditions and is therefore subject to change (for example, a borrower could migrate from being a transactor to a revolver during times of economic stress). These changes can significantly affect the historical average life of a credit card balance and add to the complexity associated with estimating expected credit losses on a credit card balance.

Recognition

Conceptual concerns

B20. The majority of comment letter respondents objected to the proposed Update because they believe it will result in (1) understating the net asset value of a financial asset measured at amortized cost on "Day 1" (by recognizing expected

credit losses that are already reflected in the purchase price or transaction price at initial recognition) and (2) failing to "match" the timing of recognition of credit loss expense with the timing of recognition of compensation for expected credit losses (in the form of interest income).

a. *Understates net asset value on Day 1*- Respondents believe that the proposed Update will result in an understatement of the financial asset at initial recognition of the financial instrument and would not be reflective of the economics of a lending transaction. They suggest that the immediate recognition of losses will result in a financial instrument being measured and recorded at an amount that is less than fair value at the time of origination, which is inconsistent with the economics of a lending transaction that is based on market terms (that is, credit risk was already contemplated in the price of the financial instrument at the time of the transaction). In addition, some preparers expressed concern that upfront recognition of lifetime expected credit losses may hinder an investor's ability to understand and analyze the extent of change in credit loss expectations since origination (or acquisition) because of the size of the upfront losses being recorded, particularly in growing portfolios.
b. *Does not "match" the timing of recognition of credit losses with interest income* – Respondents acknowledge that it may be difficult if not impossible to perfectly match the timing of the recognition of credit losses with the timing of the recognition of the compensation for expected credit losses (a subcomponent of interest income). However, many respondents disagreed with recognition of expected credit losses upon the asset's origination (or acquisition) without regard to the timing of the interest income related to that asset. Preparers are concerned that such a mismatch in the timing of the recognition of credit losses and interest income will confuse investors and other financial statement users regarding the preparer's ability to effectively manage its lending activities and credit risk management practices.

Capital concerns

B21. Financial institutions raised significant concerns on the proposed Update's potential effect on regulatory capital. Some suggested that the proposed Update's requirement to record a life of loan estimate of expected credit losses on "Day 1" may have a counterintuitive and uneconomic effect of reducing an entity's motivation to extend credit. Said differently, financial institutions may be hesitant and unwilling to lend because the extension of credit will reduce the entity's capital position. This effect would be amplified when an entity is growing, as an entity would be required to provide for greater levels of reserves as its portfolio increases in size.

B22. Furthermore, credit unions expressed significant concern over the proposal because of specific effects on the credit union industry. Credit unions frequently view themselves as different from other regulated financial institutions because their regulator is their only real financial statement user, as their members rarely utilize their financial statements. In addition, capital requirements for credit unions[4] are set by Congress which differs from capital requirements[5] set for other regulated financial institutions that are delegated to the regulatory agencies. For credit unions, capital level limits are measured only by the ratio of net worth to total assets, which would be negatively affected by the likely increase in reserves needed under the proposed Update. Unlike other financial institutions, however, credit unions generally do not have access to additional capital raising activities.

The approach for financial assets measured at FV-OCI

B23. The Board decided that financial assets that are measured at fair value through other comprehensive income (FV-OCI), including debt securities, should utilize the same credit loss recognition model as financial assets that are measured at amortized cost. However, the Board recognized that expected credit losses for financial assets measured at FV-OCI may more frequently be measured on an

[4] 12 U.S. Code (U.S.C.) § 1790d
[5] 12 U.S.C. § 1831o

individual asset basis because the business model involves selling individual assets. Therefore, in an effort to minimize the cost of compliance when expected credit losses are insignificant, the proposed Update states that if an entity meets two conditions, then it may apply the practical expedient and would not be required to apply the model to the FV-OCI financial asset being evaluated. The two conditions are (1) the fair value of the financial asset is greater than or equal to its amortized cost and (2) credit losses on the financial asset are expected to be insignificant.

B24. Preparers generally disagreed with the approach for financial assets measured at FV-OCI. While a small minority agreed with the proposal's approach, those disagreeing with the approach did so for a number of reasons. Some preferred to maintain the existing other-than-temporary impairment (OTTI) model for debt securities while others recommended modifying the practical expedient. Others believe the Board should consider excluding U.S. treasury securities (and other similar debt instruments).

a. *Maintain the existing OTTI model for debt securities* – Respondents acknowledge the Board's intention of trying to develop a single impairment model that could be applied to all financial assets measured at amortized cost and FV-OCI. However, some respondents believe that the existing OTTI model in Subtopic 320-10 is well understood by investors and is applied consistently by preparers. Some suggested that applying the credit losses model in the proposed Update would result in less decision-useful information as compared to the information resulting from applying the OTTI model. They point out that the OTTI model was improved in light of the recent financial crisis and that users benefited from having more timely insight into the recognition of credit losses for securities. In addition, they believe that having a different impairment model for debt securities is justified because debt securities are managed differently than other debt instruments.

b. Some respondents also questioned the proposed Update's requirement to evaluate at least two possible outcomes regarding debt securities that are measured at FV-OCI, particularly given the lack of historical experience

that a loss will occur with certain commonly-held instruments (for example, AAA-rated securities or U.S. Treasury security frequently held by financial institutions). The proposed Update would require an entity to assign a loss to all securities measured at FV-OCI, even if historical experience may suggest that a loss has never been experienced those securities.

c. *<u>Modify the proposed Update's practical expedient</u>* –Some respondents prefer that the practical expedient be revised to indicate that if an entity meets either of the two currently proposed criteria then the entity may apply the practical expedient and therefore not apply the credit losses model to the financial asset being evaluated. Other respondents suggested that practical expedient be revised to remove the requirement that the fair value of the financial asset be greater than (or equal to) its amortized cost because this condition is generally more a reflection of interest rate risk than credit risk.

d. *<u>Exclude from the scope U.S. treasury securities (and other similar debt instruments)</u>* – Some respondents questioned the relevance, faithful representation, and whether the benefits exceed the costs of recognizing credit losses on certain government-issued (or government-guaranteed) debt instruments wherein the credit risk is exceedingly low. Accordingly, respondents suggested that the Board consider a practical expedient for these types of instruments that is based largely on qualitative factors versus the currently proposed practical expedient that is based on quantitative factors exclusively.

B25. Some respondents indicated that the proposed Update was unclear on how to account for, upon transition, previously recorded impairments (credit or non-credit related) that were accounted for under existing U.S. GAAP. Some respondents suggested that the Board should consider whether an entity would reverse the previously recorded impairment charge (that was recognized as a direct write-down of the asset) and effectively increase the cost basis such that the original effective yield of the instrument is restored.

Purchased credit-impaired assets

B26. Under the proposed Update, the discount embedded in the purchase price that is attributable to expected credit losses would not be recognized as interest income for PCI financial assets. Rather, an entity would recognize the amortized cost of the PCI asset, at acquisition, as equal to the sum of the purchase price and the associated expected credit loss at the date of acquisition. The difference between amortized cost and the par amount of the debt is recognized as a noncredit discount or premium. By doing so, the asset is accreted from this amortized cost to the contractual cash flows without ever recognizing as interest income the purchase discount attributable to expected credit losses at acquisition. Subsequent changes in the estimate of expected credit losses would be recognized immediately as an adjustment to credit loss expense.

B27. Preparers generally supported the approach for PCI assets. Many respondents preferred the proposed approach because it eliminated many of the operational challenges that exist as a result of applying Subtopic 310-30 (formerly SOP 03-3), primarily concerning the asymmetrical treatment of favorable and unfavorable changes in expected cash flows.

B28. Similar to some of the investor feedback, some preparers indicated that the scope of the PCI approach should be expanded to apply to all purchased assets, regardless of the level of deterioration experienced since origination. Those respondents believe that economically there is no difference between PCI and non-PCI assets because in both cases, the expectation of credit losses is contemplated in the purchase price of the assets. Further, those respondents suggested that a single credit loss measurement model for all purchased financial assets, regardless of deterioration, will eliminate implementation complexity and provide users with consistent, transparent and decision-useful information including relevant credit loss provision metrics and interest income reflective of the rate of return implicit in the purchased asset.

B29. Many respondents indicated that the proposal does not provide adequate transition guidance for PCI assets. Those respondents recommended that the Board address whether and how preparers would evaluate existing PCI assets currently accounted

for under Subtopic 310-30. For example, the Board should specifically address whether preparers need to reassess the existing population of PCI assets using the new definition of a PCI asset and whether preparers would need to adjust the current split between accretable and nonaccretable yields for existing PCI assets. Given that the unit of account is not specified for PCI assets under the proposed Update, some respondents also suggested that the Board provide application guidance or a practical expedient as to how an entity may allocate the non-credit discount/premium to the cost basis of individual assets in the portfolio of purchased assets.

B30. In addition, respondents indicated that the interaction between the accounting for a PCI asset and the nonaccrual guidance in the proposals is unclear (see paragraph 48 for further discussion).

Troubled debt restructurings

B31. The proposed Update would require that a loan restructured in a troubled debt restructuring (TDR) not be accounted for as a new loan because a TDR is part of a creditor's ongoing effort to recover its investment in the original loan. Instead, under the proposed Update, the cost basis of the modified asset shall be adjusted (with a corresponding adjustment to the allowance for expected credit losses) so that the effective interest rate on the modified asset continues to be the original effective rate, given the new series of contractual cash flows. The basis adjustment (that is, the adjustment to the amortized cost basis of the financial asset) would be determined as the amortized cost basis before modification less the present value of the new series of contractual cash flows (discounted at the original effective interest rate).

B32. In general, views on the proposed Update's requirements relating to TDRs were mixed. Conceptually, some respondents believe that the distinction between TDRs and nontroubled debt restructurings continues to be relevant while others disagree with that view. Operationally, some believe the proposed guidance should be clarified with respect to whether (1) the basis adjustment could ever increase the

cost basis of the asset and (2) expected prepayment can be considered when determining the basis adjustment under the proposed Update.

TDR classification continues to be relevant

B33. Some respondents believe that the understanding of whether a modification is a TDR continues to be relevant. They agree with the Board's view that the economic concession granted by a creditor in a TDR reflects the creditor's effort to maximize its recovery of the original contractual cash flows in a debt instrument. As a result, they support the requirement to adjust the cost basis of the asset to reflect the fact that the modified debt instrument following a TDR is a continuation of the original debt instrument.

TDR classification is no longer relevant

B34. Some respondents believe that the evaluation of whether a modification is a TDR is no longer relevant because of the single impairment model of the proposed Update. They suggested that a model that requires separate identification and accounting for a TDR is inconsistent with the Board's objective of developing a single credit impairment model for all financial assets. Additionally, some believe that requiring a cost basis adjustment to reflect the asset's original effective interest rate (EIR) mixes the accounting for credit losses and yield recognition and that yield recognition guidance is not an objective of the proposed Update. Respondents also indicated that the costs associated with identifying and accounting for modified debt instruments as TDRs do not outweigh the benefits resulting from a TDR distinction. As a result, these respondents do not support the proposed Update's requirement to have entities adjust the cost basis of the modified asset in order to reflect the original instrument's EIR.

B35. To the extent that the Board reconsiders the requirement to identify and account for TDRs, respondents also stated that preparers should be required to provide decision-useful information about troubled borrowers and their related restructurings and modifications. Therefore, they recommended that the Board

consider enhancing existing TDR disclosures to provide greater transparency about troubled borrowers and the nature of the restructurings and modifications.

Cost basis adjustment

B36. The proposed Update requires that when an entity executes a troubled debt restructuring, the cost basis of the asset should be adjusted so that the EIR (post-troubled debt restructuring) is the same as the original EIR, given the new series of contractual cash flows. The basis adjustment would be calculated as the amortized cost basis before modification less the present value of the modified contractual cash flows (discounted at the original EIR). Some respondents stated that there may be situations in which the cost basis of a financial instrument may need to be adjusted upward (for example, if the lender increases the interest rate and extends the term of the loan). They suggested that the proposed Update is unclear on whether an entity would be permitted to increase the cost basis of an asset and recommended that the Board clarify whether this would be allowed.

Consideration of prepayments

B37. Under the proposed Update, when an entity executes a troubled debt restructuring, the cost basis of the asset should be adjusted so that the effective interest rate (post-troubled debt restructuring) is the same as the original effective interest rate, given the new series of contractual cash flows. Some respondents inquired as to whether the Board intended to override the existing guidance on application of the interest method for prepayable loans. Specifically, paragraph 310-20-35-26 (formerly part of Statement 91) states, in part:

a. Except as stated in the following sentence, the calculation of the constant effective yield necessary to apply the interest method shall use the payment terms required by the loan contract, and prepayments of principal shall not be anticipated to shorten the loan term. ***If the entity holds a large number of similar loans for which prepayments are probable and the timing and amount of prepayments can be reasonably estimated, the entity may***

consider estimates of future principal prepayments in the calculation of the constant effective yield necessary to apply the interest method. (emphasis added)

B38. Further to this question, respondents highlighted that if the charge-off amount must be based solely on contractual cash flows, such an approach would tend to overstate the economic loss the entity believes it is incurring by modifying the loan terms, since such an approach would charge-off amounts of foregone interest that are never expected to be foregone (because prepayments are expected). However, if the Board intends to allow an entity to forecast prepayments when it determines the charge-off amount for a TDR, then it will introduce the possibility that the EIR for the asset will not be constant over time. Specifically, under existing guidance that does not introduce basis-adjustments, a mortgage's EIR is generally the stated rate such that prepayments do not impact the asset's current period yield. If prepayments are considered under the new model, however, the EIR will only be constant at the original EIR if the adjustment is calculated based on (and amortized over) the contractual life. If the amount is calculated based on (and amortized over) the expected life, then the yield will revert to the modified contractual rate if prepayments are slower than expected at the time of modification.

Nonaccrual

B39. The proposed Update would require an entity to cease its accrual of interest income when it is not probable that the entity will receive substantially all of the principal or substantially all of the interest. Further, the proposed Update provided explicit guidance as to when a cash-basis approach should be used and when a cost-recovery approach should be used.

B40. While investors supported the approach to introduce into U.S. GAAP the regulatory instructions on the nonaccrual of interest income, preparer reaction to the proposed approach was generally mixed.

Do not add nonaccrual guidance in U.S. GAAP

B41. Some respondents believe that the concept of the nonaccrual of interest income recognition is widely understood and applied by regulated entities and is therefore not needed to be specifically defined in U.S. GAAP. They believe that including the specific nonaccrual principle and rules in the proposed Update may lead to additional application inconsistencies as there are wording differences between the proposed requirements and existing regulatory guidance.

Add nonaccrual guidance to U.S. GAAP but revise the proposed principle

B42. Some preparers believe that U.S. GAAP would be improved by the inclusion of the guidance on the nonaccrual of interest income as they believe a more consistent application of recording interest income will result. However, these respondents believe that certain revisions to the principle are needed.

a. *Differences between regulatory instructions and the proposed Update* – Regulatory instructions state that the accrual of interest income should cease when "payment of principal or interest is not expected". The proposed Update states that the accrual of interest income should cease when it is "not probable that the entity will receive substantially all" of the principal or interest. Some respondents suggested that the differences in the wording of the thresholds of when to cease the accrual of interest income may be interpreted and applied differently in practice. Accordingly, these respondents believe that the proposed Update should be revised to more consistently align the wording of the proposed nonaccrual principle with the regulatory guidance on when an entity must cease the accrual of interest.

b. *Application to credit cards*– Respondents indicated that financial institutions in the credit-card industry do not follow the nonaccrual guidance provided by regulatory instructions. Rather than placing a credit card balance on nonaccrual, many stated that the industry practice on uncollectible accrued finance charges and fees is to either reverse them against interest and fee income or by reserving for them through provision expense and allowance for

loan losses at the time of income accrual. Some suggested that the nonaccrual guidance in the proposed Update would require significant changes and will present many operational challenges to existing credit card income accrual systems. As a result, respondents suggested that the Board clarifies whether the nonaccrual principle should be applied to credit card balances and if so, to consider other practical ways of implementing such a principle that would minimize the associated operational challenges.

c. *Application to PCI assets* – Some respondents indicated that the proposed Update does not address how an entity would apply the nonaccrual principle to PCI assets. By definition, a PCI asset has experienced significant deterioration in credit quality from origination. Respondents indicated that a PCI asset, upon acquisition, would automatically be placed on nonaccrual status based on the proposed Update's requirement that if it is "not probable that the entity will receive substantially all" principal or interest. As a result, respondents recommend that the proposed Update be clarified to explicitly state whether the nonaccrual principle applies to PCI assets and if so, how an entity would apply the principle to PCI assets.

d. *Application to debt securities* – Respondents indicated that the proposed Update does not adequately provide guidance on how to apply the nonaccrual principle to debt securities and as a result, it is unclear when an entity is required to cease the accrual of interest on a debt security. For example, it is unclear how premiums or discounts would affect whether a debt security should be placed on nonaccrual. Respondents indicated that without application guidance of the nonaccrual principle on debt securities, differences will continue to exist between regulatory guidance and U.S. GAAP and application of the principle will be inconsistent and will result in a lack of comparability across entities.

e. *When to reinstate the accrual of interest income* – Some respondents stated that the proposed Update does not include guidance on when an entity would

be able to begin accruing interest income after it had already stopped accruing interest income. These respondents recommend that the Board clarifies whether an entity would be allowed to begin accruing interest after it had previously ceased recognizing interest. If the Board believes it is appropriate to accrue interest income after ceasing the recognition of interest income, these respondents suggest that the Board clarifies under what circumstance an entity would be able to begin accruing interest again.

f. *Principal vs. interest* – Some respondents stated that it is often unclear whether the cash collected after the ceasing of interest recognition represents payments of principal or interest. As a result, respondents indicated that the proposed Update does not provide sufficient guidance on how an entity would record cash collected that is not considered either principal or interest but rather is characterized simply as cash flows. Therefore, respondents suggested that the Board clarify how an entity is to record subsequent cash collections after it has already ceased the accrual of interest income, particularly when it is not possible to determine whether cash flows represent principal or interest.

g. *Transition* – Respondents indicated that there may be a potential reduction in the number of financial assets that are placed on nonaccrual because of the requirement that an entity cease the accrual of interest when it is probable that "substantially all" cash flows are not expected to be collected. The terms "substantially all" are an additional qualifier to the requirements in current regulatory guidance. Therefore, an entity that has previously ceased the recognition of interest income on a financial asset may no longer meet the additional qualifier of the proposed Update. As a result, the entity would be able to begin accruing interest income on that financial asset. Respondents suggested that the Board consider providing transition guidance on whether and how and entity would need to reassess existing financial assets that are on nonaccrual status against the new nonaccrual requirements upon transition.

Implementation of the proposed Update

B43. Many respondents indicated that implementing the requirements of the proposed Update could take a minimum of two years to complete. Preparers stated that they would need to develop systems to collect and analyze historical loss data to develop estimates of expected credit losses. In addition, preparers also indicated that sufficient time would be needed to test and validate the results of the modeling systems. They also noted that other system changes would likely be necessary to implement other required changes of the proposed Update, including at a minimum, (a) the nonaccrual of interest, (b) the adjustment of the cost basis of a modified asset in a TDR, (c) evaluating whether a debt instrument measured at FV-OCI meets the practical expedient and (d) new disclosures.

B44. To this end, some respondents recommended that the Board consider certain practical accommodations for smaller and/or less complex entities that will likely face resource constraints when implementing the requirements of the proposed Update. Respondents suggested that for these entities, there may be simpler and less costly estimation techniques, condensed disclosure requirements, and a more appropriate transition period that will still satisfy the proposed Update's overall recognition and measurement objectives. Accordingly, respondents recommended that the Board consider working with constituents (for example, the Private Company Council) in understanding the implementation challenges that these entities would likely encounter when implementing the requirements of the proposed Update.