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Memorandum

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

Topic **Clarification of Expected Credit Losses**

Purpose of This Memorandum

1. As discussed in the feedback summary (Memo 232) on the proposed Accounting Standards Update, *Financial Instruments—Credit Losses* (Subtopic 825-15) (the proposed Update), a number of issues were raised during outreach and in comment letters about the Board’s intent regarding the term *expected credit losses*. While many of these issues were clarified through the Staff FAQ document¹ issued in March 2013 (FAQ document), other issues were raised during field visits or in comment letter feedback. This memo comprises the following clarifications on expected credit losses that the staff believes the Board needs to consider as it further develops an expected credit loss model:

¹ Frequently Asked Questions - Proposed Accounting Standards Update, *Financial Instruments—Credit Losses* (March 25, 2013)

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- (a) Whether an entity is required to forecast economic conditions over the entire life of a loan in order to estimate “expected credit losses”
- (b) How the term *all contractual cash flows* should be interpreted within the definition of expected credit loss
- (c) Clarification of the measurement principle regarding the use of multiple scenarios
- (d) Clarification of whether certain loss rate type approaches “implicitly” satisfy the time value of money measurement principle
- (e) Application guidance for how to assess current conditions and how to develop forecasts about the future
- (f) How the Board expects auditors to opine on the estimate of expected credit losses.

A. Whether an entity is required to forecast economic conditions over the entire life of a loan in order to estimate *expected credit losses*

- 2. Based on feedback received during the exposure period, it is clear that there is a broad misunderstanding that the proposed Update would require an entity to forecast economic conditions over the entire life of a loan to estimate expected credit losses. This misconception led to constituents raising concerns 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. However, the staff believes that it was not the Board’s intention to require an entity to forecast economic conditions over the life of an asset.
- 3. Under the proposed Update, to develop a current estimate of expected credit losses, the historical loss experience would need to be updated 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). An entity's ability or inability to obtain or develop reasonable and supportable forecasts of future conditions over the entire life of the loan would only affect the entity's analysis of whether (and how) the historical loss experience *is adjusted* for what is currently expected. Furthermore, an entity's ability to obtain or develop reasonable and supportable forecasts of future conditions over the entire life of the loan does *not* override the need to consider historical loss experience for similar assets of similar credit risk as the foundation of the estimate of expected credit losses.

4. To that end, the staff believes that the Board's original intention was not to require management to forecast economic conditions over the life of the asset; rather, management would only be 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). For the periods beyond those that are able to be reasonably and supportably forecasted, the staff believes that the Board never intended to prescribe or prohibit specific approaches or assumptions in how management develops its expectation about the future.

Staff analysis and recommendation

5. The staff believes that a final standard on expected credit losses that requires a lifetime loss estimate must (a) clarify that an entity is not required to forecast economic conditions over the life of the asset and (b) require an entity to revert to an unadjusted historical average loss experience for the periods beyond those that are reasonably and supportably forecasted. While final wording would be subject to the Board's approval, the staff recommends that the following clarifications be made in the final standard:

In developing an estimate of expected credit losses, an entity is not expected to forecast economic conditions over the life of an asset. Rather, for future periods beyond which the entity is able to make or obtain reasonable and supportable

forecasts of expected credit losses, the entity is expected to revert to unadjusted historical averages.

6. The staff also would recommend clarifying that an entity would be required to disclose the period of time for which it makes reasonable and supportable forecasts and the approach utilized for reverting to unadjusted historical averages.
7. The staff understands that this would eliminate the option included in question #13 of the FAQ document, which allowed an entity to assume that economic conditions will remain stable for future periods beyond which the entity is able to make or obtain reasonable and supportable forecasts (that is, freeze the furthest reasonable and supportable forecast and utilizing that forecast for the remaining future periods). Given the feedback received, and upon further contemplation, the staff believes that such an approach can easily lend itself to manipulation and create artificial volatility because it amplifies the furthest out (and likely the most unreliable) reasonable and supportable condition, whereas a “reversion to the mean” approach relies on historical averages for periods beyond those that are reasonably and supportably forecasted.

Question 1 for the Board

1. Does the Board agree with the staff’s recommendation on how to clarify whether an entity is required to forecast economic conditions over the entire life of a loan in order to estimate “expected credit losses”?

B. How the term *all contractual cash flows* should be interpreted within the definition of *expected credit loss*

8. The proposed Update defines *expected credit losses* as “an estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit.” During the exposure period, the staff received three main questions on the Board’s intent with the phrase *all contractual cash flows*; the staff believes that clarifications of these questions should be provided in the final standard on expected credit losses:

- (a) Does the expected credit loss estimate represent a “life of loan” estimate?
- (b) Should prepayments be taken into consideration in estimating expected credit losses?
- (c) Whether (and how) an entity considers renewals, extensions, modifications, and expansions?

Staff analysis and recommendation

- 9. Questions #7 and #8 of the FAQ document addressed the first two questions raised during the exposure period. The questions stated that the Board continues to believe that the term *all contractual cash flows* refer to cash flows over the entire contractual term of the financial asset (in effect, the life of the loan) but that an entity consider expected prepayments that shorten the expected life of a loan when estimating expected credit losses. The Board chose not to characterize the credit loss estimate as lifetime losses because that term suggested to stakeholders that projections would be necessary over the entire lifetime of an asset (regardless of prepayments), which would not be required under the proposed model.
- 10. As a result, the staff recommends that the Board include in its final standard on expected credit losses a discussion that indicates that the term *all contractual cash flows* refers to cash flows over the entire contractual term of the financial asset (i.e., the life of the loan) and that an entity would consider expected prepayments on an asset’s expected life when determining the estimate of expected credit losses.
- 11. Because of the staff’s view on expected prepayments, however, constituents have questioned whether an entity is required to consider renewals, extensions, and modifications when evaluating an expected life of a financial instrument. Some have suggested that it would be conceptually inconsistent to require an entity to consider the effect of prepayments while allowing it to ignore the effects of renewals, extensions, and modifications on an asset’s expected life.
- 12. The staff can appreciate constituents’ feedback regarding whether an entity is required to consider renewals, extensions, and modifications when estimating all

contractual cash flows. However, the phrase *all contractual cash flows* is generally limited to the current legal terms of the contractual arrangement between the borrower and the lender. Specifically, the estimate of expected credit losses seeks to quantify expected losses on credit that the lender has extended as of the balance sheet date (that is, in the form of either a recognized financial asset or the present legal obligation to extend credit). As a result, potential future credit losses that could result from the future renewal, modification, extension, or expansion of a credit facility beyond the current contractual terms would not be considered in estimating expected credit losses because the lender has not yet exposed itself to such credit losses (that is, at a future date the lender can choose to avoid such credit exposure by not renewing, modifying, extending, or expanding the credit facility).

13. However, the Board continues to believe that an economic concession granted by a lender in a troubled debt restructuring reflects the lender's effort to maximize its recovery on an existing credit, as opposed to extension of a new credit. Therefore, it is possible that a lender reasonably expects that it will grant an economic concession to an existing borrower as part of its efforts to maximize recovery of the existing credit that has been extended as of the balance sheet date. As a result, if a lender reasonably expects that it will execute a troubled debt restructuring with a borrower, the lender may utilize its estimate of expected cash flows (which may include interest payments made for years beyond the current contractual term) in estimating expected credit losses as of the balance sheet date. To do so provides the most representationally faithful depiction of the expected credit losses on credit that the lender has extended as of the balance sheet date. To prohibit such an approach would artificially require that a lender assume that a borrower will refinance externally (which may prove impossible and provide an unrealistic depiction of the actual economic credit loss expected by the lender).
14. As a result, the staff recommends that the Board clarify in its final standard on expected credit losses that an entity would not consider renewals, extensions, and modifications when estimating all contractual cash flows unless the entity

reasonably expects that it will execute a troubled debt restructuring with a borrower.

Questions 2 through 4 for the Board

2. Does the Board believe that the term *all contractual cash flows* refer to cash flows over the entire contractual term of the financial asset (that is, the life of the loan)?

3. Does the Board believe that an entity should consider expected prepayments on an asset's expected life when determining the estimate of expected credit losses?

4. Does the Board believe that an entity should not be required to consider extensions, renewals, and modifications when estimating all contractual cash flows unless the entity reasonably expects that it will execute a troubled debt restructuring with a borrower?

C. Clarification of the measurement principle regarding the use of multiple scenarios

15. Throughout our outreach, many constituents were confused about the Board's intention with the requirement 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. Some suggested that even when an entity considers multiple outcomes but none of those outcomes results in a credit loss (for example, on financial assets that are fully or over-collateralized), then the entity would not be complying with the proposed guidance.
16. The staff believes that the Board intended that the estimate of expected credit losses always reflect the risk of loss, even when that risk is remote. However, the staff also believes that the Board never intended to require an entity to recognize a loss on a financial asset in which the *risk of loss* is greater than zero yet the amount of loss would be zero.

17. As a result, the staff recommends that the Board clarify in the final standard on expected credit losses that the estimate of expected credit losses should always reflect the risk of loss, even when that risk is remote. Furthermore, the staff believes that the final standard also should clarify that the Board does not intend to require an entity to recognize a loss on a financial asset in which the risk of loss is greater than zero yet the amount of loss would be zero. While final wording would be subject to the Board's approval, the staff believes the following clarifications could be made in the final standard:

~~**825-15-25-5** An estimate of expected credit losses shall always reflect the expected risk of credit loss, even when that risk is remote. For example, if an entity believes there is a 97 percent likelihood that no credit loss will be realized and a 3 percent likelihood that none of the recorded investment will be recovered, the allowance for expected credit losses should reflect management's expectation that there is some level of expected risk of credit loss (namely a 3 percent risk of loss). As a result, an entity is prohibited from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode). An estimate of expected credit losses shall neither be a worst case scenario nor a best case scenario. Rather, an estimate of expected credit losses shall always reflect both the possibility that a credit loss results and the possibility that no credit loss results. However, a probability-weighted calculation that considers the likelihood of more than two outcomes is not required. An entity is prohibited from estimating expected credit losses based solely on the most likely outcome (that is, the statistical mode).~~

~~**825-15-55-5** Paragraph 825-15-25-5 requires 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. However, in making this estimate, a variety of credit loss scenarios are not required to be identified and probability weighted to estimate expected credit losses, when a range of at least two outcomes is implicit in the method.~~

825-15-55-65 Paragraph 825-15-25-5 requires that an estimate of expected credit losses always reflect the expected risk of credit loss, even when that risk is very remote. Some measurement methods (such as a loss-rate method, a roll-rate method, a probability-of-default method, and a provision matrix method using loss factors) rely on an extensive population of actual historical loss data as an input when estimating credit losses. Therefore, they implicitly satisfy the requirement in paragraph 825-15-25-5 as long as the population of actual loss data reflects items within that population that ultimately resulted in a loss and those items within that population that resulted in no loss. Similarly, as a practical expedient, an entity may use the fair value of collateral (less estimated costs to sell, as applicable) in estimating credit losses for collateral-dependent financial assets. Such an approach is considered a practical expedient because the fair value of collateral reflects several potential outcomes on a market-weighted basis and may result in expected credit losses of zero when the fair value of collateral exceeds the amortized cost basis of the asset.

825-15-55-6 When assessing the expected risk of loss, an entity should not calculate the amount of loss that would result upon default. Rather, an entity should evaluate the expectation that a loss event will occur. For example, in situations in which the expected risk of loss is greater than zero but the loss amount is zero (for example, when a financial asset or pool of financial assets are fully secured), an entity would satisfy the requirement in 825-15-25-5 that an estimate of expected credit losses shall always reflect the expected risk of credit loss.

Question 5 for the Board

5. Does the Board agree with the staff's recommendation on how to clarify the measurement principle regarding the use of multiple scenarios?

D. Clarification of whether loss rate type approaches “implicitly” satisfy the time value of money measurement principle

18. Paragraph 825-15-25-4 of the proposed Update would require that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. Throughout our outreach, many constituents were confused about the Board's intention with the time value of money measurement principle and whether a discounted cash flow (DCF) technique would be required.
19. Furthermore, many commenters and field visit participants highlighted that various loss-rate methods and probability-of-default methods will not necessarily reconcile perfectly to a DCF technique. As a result, some constituents have a different view about 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 because they may not provide the identical result as a DCF technique.

Staff analysis and recommendation

20. As stated in the FAQ document, the Board decided that loss-rate methods, probability-of-default methods, and a provision matrix using loss factors are all acceptable methods of estimating expected credit losses in a manner that reflects the time value of money. The Board is aware that such methods may not reconcile

perfectly with a strict DCF technique but it is satisfied that those methods, when consistently applied, sufficiently reflect the time value of money for purposes of estimating expected credit losses.

21. As a result, the staff recommends that the Board include the clarification provided in the FAQ document in the final standard on expected credit losses that states which loss estimation methods would satisfy the time value of money principle. The staff believes that doing so would avoid external interpretation differences with the “implicit” time value of money assumption language in the model. The staff also believes that the Board could include in the basis for conclusions the logic expressed in the FAQ document describing why the Board believes that these methods reasonably reflect the time value of money in a manner consistent with the principle.
22. While final wording would be subject to the Board’s approval, the staff believes that its recommendation would require the following clarifications to the original text of the proposed Update:

825-15-25-4 An estimate of expected credit losses shall reflect the time value of money either explicitly or implicitly (see paragraph 825-15-55-3). Discounted cash flow models, loss-rate methods, probability-of-default methods, and a provision matrix using loss factors all reflect the time value of money in a manner consistent with this principle. If an entity estimates expected credit losses using a discounted cash flow model, the discount rate utilized in that model shall be the financial asset’s **effective interest rate**.

~~825-15-55-3 Paragraph 825-15-25-4 requires that an estimate of expected credit losses reflect the time value of money either explicitly or implicitly. A discounted cash flow model is an example of a method that explicitly reflects the time value of money by forecasting future cash flows (or cash shortfalls) and discounting these amounts to a present value using the effective interest rate. Other 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 because of credit loss and the amortized cost basis of the asset and by applying the loss statistic (after updating it for current conditions and reasonable and supportable forecasts of the future) to the amortized cost balance as of the reporting date to estimate the portion of the recorded amortized cost basis that is not expected to be recovered because of credit loss. Such methods~~

~~may include loss rate methods, roll rate methods, probability of default methods, and a provision matrix method using loss factors. The requirement in paragraph 825-15-25-4 is met when the method used to estimate expected credit losses either explicitly or implicitly reflects the time value of money.~~

Question 6 for the Board

6. Does the Board believe that the final standard on expected credit losses should indicate which loss estimation methods satisfy the time value of money principle as described in the staff's analysis?

E. Application guidance to assess current conditions and to develop forecasts about the future

23. During outreach, several constituents indicated that it would be helpful to provide more guidance on items that management should consider when assessing current conditions and developing forecasts about the future. Many suggested that the Board could leverage current regulatory guidance that provides considerations for making qualitative adjustments to historical loss rates.
24. The staff believes that it would be helpful to provide further application guidance on factors to consider when assessing current conditions and developing forecasts about the future. As a result, the staff believes the Board could provide the following application guidance, which largely leverages current regulatory guidance regarding qualitatively adjusting historical loss rates:²

The estimate of expected credit losses should reflect consideration of all significant factors that affect the expected collectibility as of the reporting date. Normally, an institution should determine the historical loss rate for each group of loans with similar risk characteristics in its portfolio on the basis of its own loss experience for loans in that group. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses, do not by themselves form a sufficient basis to determine the appropriate level for the expected credit loss estimate. Management also should consider those qualitative or environmental factors that are likely to cause

² The following potential application guidance is taken from the 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* and has been modified by the FASB staff to reflect the principles in the proposed Update.

expected credit losses associated with the institution's existing portfolio to differ from historical loss experience, including any of the following:

- (a) Changes in the entity's lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices.
- (b) Changes in the nature and volume of the portfolio and in the terms of loans.
- (c) Changes in the experience, ability, and depth of lending management and other relevant staff.
- (d) Changes in the quality of the institution's loan review system.
- (e) Changes in (and forecasted changes in) international, national, regional, and local economic and business conditions and developments that are expected to affect the collectibility of the portfolio, including the condition of various market segments. Credit loss and recovery experience may vary significantly depending upon the stage of the business cycle. For example, an over reliance on credit loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.
- (f) Changes in (and forecasted changes in) the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans.
- (g) Changes in (and forecasted changes in) the value of underlying collateral for collateral-dependent loans.
- (h) Changes in (and forecasted changes in) the timing and extent of prepayments on outstanding loans. [Note – This item was not included in the Interagency Policy Statement, but added by the FASB staff]
- (i) The effect of other existing or forecasted external factors such as competition and legal and regulatory requirements on the level of expected credit losses in the institution's existing portfolio.

Question 7 for the Board

7. Does the Board believe that the final standard on expected credit losses should include additional application guidance for assessing current conditions and developing forecasts about the future? If so, does the Board agree with the staff's proposed application guidance that would leverage current regulatory guidance that provides considerations for making qualitative adjustments to historical loss rates?

F. How the Board expects auditors will be able to opine on the estimate of expected credit losses

25. In comment letters and field visits, auditors and preparers expressed concern with the auditor's ability to opine on management's estimate of expected credit losses, particularly for so-called "good loans" that have not yet deteriorated. Auditors and preparers are particularly concerned because the estimate of expected credit losses is based on "management's assessment" as opposed to relying on a consistent and comparable foundation for the estimate such as the "market" for fair value estimates (even though the so-called "market" is often hypothetical). Investors have consistently noted that they understand that there is significant judgment involved in estimating expected credit losses and have merely sought transparency into management's judgments. Investors appear to understand that the estimate will always be "wrong," whereas preparers and auditors appear concerned that they will be expected to estimate an allowance that will be "right" in predicting the future.

Staff analysis and recommendation

26. The staff believes that much of this issue has to do with external pressures applied by the PCAOB on audit firms in the United States. Some constituents have suggested that the Board could alleviate some concerns by clarifying what the Board believes the expectation on the auditor should be given the measurement objective the Board is developing. Furthermore, some constituents have recommended that the Board consider amending the language used in the proposed Update related to the phrase *reasonable and supportable forecasts*. Specifically, they suggest that striking the term *reasonable* will relieve the pressure for the auditors to reach a similar (or same conclusion) as management with regard to near-term economic forecasts.
27. In addition, some preparers further expressed concern during field visits that the auditor will need to have a consistent view of near-term economic conditions *across their client base*, causing greater stress over management's ability to utilize

its own supportable view of near-term future economic conditions when estimating expected credit losses. As a result, they believe the term *supportable* is sufficient to ensure that the expectation is reasonable and as a result believe that regulatory influence and transparency provided to the investor with regard to the forecasts will be sufficient in mitigating any concerns that the term *reasonable* was intended to address.

28. The staff's views on this issue are generally mixed. Accordingly, the staff is not providing a recommendation to the Board.

Question 8 for the Board

8. Does the Board believe that it should amend the language used in the proposed Update related to the phrase *reasonable and supportable forecasts* by eliminating the term *reasonable* to alleviate concerns regarding an auditor's ability to opine on such information?