Financial instruments: Credit impairments

EEI & AGA 2018 Spring Accounting Conference
May 22, 2018
Topics

- The FASB’s credit loss standard (ASU 2016-13)
  - Scope of the FASB’s credit loss standard
  - Effective dates and transition
  - Overview of the expected credit loss model
  - AFS debt securities
  - Purchased financial assets with credit deterioration (PCD)
  - Disclosures

- Implementation considerations and challenges
Credit losses (ASU 2016-13)

Overview

- The new CECL model will generally accelerate the measurement and recognition of credit losses and increase earnings volatility.

- Entities will be required to disclose significantly more information.

- Today’s concept of other-than-temporary impairment (OTTI) for AFS debt securities will be eliminated and replaced.

- Implementation has begun, led by banks.

- Entities will be required to use more judgement and will likely need to gather and retain additional data and enhance modelling capabilities.

Current expected credit loss (CECL) model

- Financial assets measured at amortized cost:
  - Trade receivables, reinsurance receivables, loans, held-to-maturity (HTM) debt securities, reverse repos
  - Net investment in leases recognized by a lessor
  - Off-balance-sheet credit exposures not accounted for as insurance

AFS debt security impairment model

- Available-for-sale (AFS) debt securities

Model for certain beneficial interests classified as HTM or AFS that are not of high credit quality

CECL objective: Recognize allowance that results in financial statements reflecting net amount expected to be collected

Reasonable and supportable forecasts

Information about current conditions

Historical lifetime loss data (e.g., vintage)

No incurred threshold

Risk of loss, even if that risk is remote

Time value of money

Allowance for credit losses
Interpretation of the credit loss standard is being influenced by a variety of constituents

The model will have implications on:
- Communications with investors and analysts
- Capital management
- Data, technology and processes
- Product pricing
- Internal controls
- Internal audit functions
- External audits
- Regulatory interactions

The measurement of credit losses is exceptionally important to the [banking regulatory agencies] as it is one of the most significant accounting estimates for the nearly 14,000 financial institutions we supervise.

- Interagency comment letter in response to FASB’s December 2012 exposure draft on credit losses

TRG was formed to address practice issues.
Scope of the FASB’s credit loss standard
## Scope

### Current expected credit loss model
- Financial assets measured at amortized cost:
  - Financing receivables (loans)
  - Held-to-maturity (HTM) debt securities
  - Trade receivables
  - Reinsurance receivables
  - Receivables that relate to repurchase and securities lending agreements
- Net investment in leases recognized by a lessor
- Off-balance-sheet credit exposures not accounted for as insurance

### AFS debt security impairment model
- Available-for-sale (AFS) debt securities

Model for certain beneficial interests classified as HTM or AFS that are not of high credit quality

---

These models also include an allowance gross-up approach for purchased financial assets with evidence of credit deterioration.
Effective dates and transition
Effective dates and transition

<table>
<thead>
<tr>
<th>Type of entity</th>
<th>Effective date</th>
<th>Early adoption?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Public business entities (PBEs) that are SEC filers</td>
<td>Annual periods beginning after December 15, 2019, and interim periods therein</td>
<td>Yes, annual periods beginning after December 15, 2018, and interim periods therein</td>
</tr>
<tr>
<td>Other PBEs</td>
<td>Annual periods beginning after December 15, 2020, and interim periods therein</td>
<td></td>
</tr>
<tr>
<td>All other entities</td>
<td>Annual periods beginning after December 15, 2020, and interim periods within annual periods beginning after December 15, 2021</td>
<td></td>
</tr>
</tbody>
</table>

- An entity will apply the new guidance using a modified retrospective approach
  - Recognize a cumulative-effect adjustment as of the beginning of the first reporting period in which the guidance is effective

- Transition relief provided for:
  - Purchased financial assets currently accounted for under ASC 310-30
  - Debt securities for which an other-than-temporary impairment has already been recognized
Overview of expected credit loss model
Credit losses (ASU 2016-13)
Current expected credit loss model – overview

<table>
<thead>
<tr>
<th>Objective</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognize an allowance for credit losses that results in the financial statements reflecting the net amount expected to be collected from the financial asset</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Core concepts</th>
</tr>
</thead>
<tbody>
<tr>
<td>Based on an asset’s amortized cost</td>
</tr>
<tr>
<td>Reflect losses over an asset’s contractual life</td>
</tr>
<tr>
<td>Consider available relevant information</td>
</tr>
<tr>
<td>Reflect the risk of loss</td>
</tr>
</tbody>
</table>

- Amortized cost basis includes premiums or discounts, foreign exchange and fair value hedge adjustments
- Contractual life will be adjusted for prepayments, but not extensions, unless a TDR is reasonably expected
- Entities will consider information about past events, current conditions and forecasts about the future that are reasonable and supportable
- The standard requires a pool-based approach when similar risk characteristics exist, and entities should consider the risk of loss even when that risk is remote
### Current expected credit loss model

#### Core concepts

- **Based on an asset’s amortized cost**
- **Reflect losses over an asset’s contractual life**
- **Consider available relevant information**
- **Reflect the risk of loss**

- Expected loss refers to the expected losses of the amortized cost basis of an asset
- If an entity measures the allowance for credit losses:
  - **Using a discounted cash flow approach**
    - The allowance should reflect the difference between the amortized cost basis and the expected cash flows discounted to a present value at the effective interest rate.
  - **Not using a discounted cash flow approach**
    - The allowance should reflect the expected credit losses of the amortized cost basis.
Current expected credit loss model
Core concepts

- Expected credit losses should reflect losses that are expected over the remaining contractual life of an asset.
- The life of an asset generally would not include expected extensions, renewals or modifications (unless the entity reasonably expects to execute a TDR with the borrower).
- Expected credit losses should reflect expected prepayments, which mitigate potential loss.
Current expected credit loss model
Core concepts

- Based on an asset's amortized cost
- Reflect losses over an asset's contractual life
- Consider available relevant information
- Reflect the risk of loss

Reasonable and supportable forecasts

Historical loss information

Current conditions

Qualitative factors should be considered when ....
Current expected credit loss model
Core concepts – Information to consider

<table>
<thead>
<tr>
<th>Credit profile of borrower</th>
<th>An entity’s other considerations</th>
</tr>
</thead>
<tbody>
<tr>
<td>▶ Borrower’s financial condition, credit rating, asset quality or business prospects</td>
<td>▶ Nature and volume of the entity’s financial assets</td>
</tr>
<tr>
<td>▶ Borrower’s failure to make scheduled interest or principal payments</td>
<td>▶ Volume and severity of past-due financial assets and the volume and severity of adversely classified or graded financial assets</td>
</tr>
<tr>
<td>▶ Remaining payment terms of the financial asset</td>
<td>▶ Lending policies and procedures, including changes in underwriting standards and collection, write-offs and recovery practices</td>
</tr>
<tr>
<td>▶ Remaining time to maturity and the timing and extent of prepayments on the financial asset</td>
<td>▶ Quality of the entity’s credit review system</td>
</tr>
<tr>
<td>▶ Value of underlying collateral when the collateral-dependent practical expedient has not been used</td>
<td>▶ Experience, ability and depth of the entity’s management and other relevant staff</td>
</tr>
<tr>
<td>▶ Environmental factors of a borrower</td>
<td>▶ Areas in which the entity’s credit is concentrated</td>
</tr>
</tbody>
</table>
Expected credit loss model
Core concepts – Forecasting

► New standard provides little application guidance on
  ► How to develop a forecast
  ► What the forecast should cover

► For periods in which the entity is unable to reasonably and supportably forecast expected credit losses, the entity should revert to historical credit loss information that is reflective of the asset’s contractual term

► Reversion may be immediate, on a straight-line basis or using another rational and systematic basis

<table>
<thead>
<tr>
<th>Potential economic variables</th>
</tr>
</thead>
<tbody>
<tr>
<td>► Gross domestic product</td>
</tr>
<tr>
<td>► Inflation</td>
</tr>
<tr>
<td>► Unemployment</td>
</tr>
<tr>
<td>► Interest rate environment</td>
</tr>
<tr>
<td>► Credit spreads</td>
</tr>
<tr>
<td>► Business confidence metrics</td>
</tr>
<tr>
<td>► House price indices</td>
</tr>
<tr>
<td>► Factory orders</td>
</tr>
<tr>
<td>► Bankruptcies</td>
</tr>
<tr>
<td>► Stock market indices</td>
</tr>
<tr>
<td>► Savings rates</td>
</tr>
</tbody>
</table>
Current expected credit loss model
Core concepts

- Expected credit losses should include a measure of the expected risk of credit loss, even if that risk is remote
- Level of aggregation
  - Requires a collective or pool-based approach when similar risk characteristics exist
  - Allows individual approach when there are no shared risk characteristics
- An entity is not permitted to estimate a zero loss simply because the current value of the collateral exceeds the financial asset’s amortized cost basis
- There are only limited circumstances under which an estimate of zero expected loss would be appropriate
# AFS debt security impairment model

## What’s changing?

- FASB made targeted amendments to the existing impairment guidance

<table>
<thead>
<tr>
<th>Current guidance</th>
<th>New standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Recognize other-than-temporary impairment as a reduction of the security’s cost basis</td>
<td>Recognized through an allowance for credit losses</td>
</tr>
<tr>
<td>Recognize reversals of impairment as an adjustment to future interest income</td>
<td>Recognize reversals of impairment immediately as a reduction of the allowance for credit losses</td>
</tr>
<tr>
<td>Focuses on whether the impairment is other than temporary</td>
<td>Focuses on whether the unrealized loss results, at least in part, from a credit loss</td>
</tr>
</tbody>
</table>

---

The length of time a security has been in an unrealized loss position may not be used as a factor, by itself or in combination with others, to conclude whether there is a credit loss. Entities will need to develop new processes to identify securities that contain credit impairment.
Debt securities
Available for sale

Decision tree based on the Accounting Standard Update (ASU) 2016-13, Measurement of Credit Losses on Financial Instruments.

1. Does Company A intend to sell the security?
   - No
   - Yes

2. Is it more likely than not Company A will be required to sell the security before it recovers in value?
   - No
   - Yes

3. Is a portion of the unrealized loss a result of a credit loss?
   - No
   - Yes

Recognize impairment loss in earnings by writing down the security’s amortized cost basis to FV.

Recognize credit loss in earnings by recording an allowance for credit losses.

Portion of loss related to other factors will continue to be recognized in other comprehensive income (OCI).
AFS debt securities
Transition considerations

- Cumulative-effect adjustment to the opening retained earnings as of the beginning of the first reporting period in which the standard is effective.

- Similarly, debt securities on which other-than-temporary impairment had been recognized prior to the effective date will transition to the new standard prospectively (i.e., with no change in the amortized cost basis of these securities).

- The effective interest on the security will remain unchanged.

- Similar to today’s practices:
  - Amounts previously recognized in accumulated other comprehensive income as of the adoption date that relate to improvements in cash flows will continue to be accreted to interest income over the remaining life of the debt security on a level-yield basis.
  - Recoveries of amounts previously written off relating to improvements in cash flows after the date of adoption will recorded into income in the period received.

Follow PCD transition considerations for those debt securities classified as PCI prior to the adoption of the standard.
## Debt securities
Comparison between AFS and HTM

<table>
<thead>
<tr>
<th>Topic</th>
<th>AFS debt security impairment model*</th>
<th>HTM current expected credit loss model</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unit of measurement</td>
<td>Individual AFS debt security</td>
<td>Collective (pool) when similar risk characteristics exist**; otherwise, individual</td>
</tr>
<tr>
<td>Allowance recognition threshold</td>
<td>When a decline in fair value below the amortized cost basis has resulted from a credit loss</td>
<td>None</td>
</tr>
<tr>
<td>Measurement of credit losses</td>
<td>Excess of the amortized cost basis over the best estimate of the present value of cash flows expected to be collected, limited by the amount that fair value is less than amortized cost</td>
<td>Expected credit loss that reflects the risk of loss even if that risk is remote</td>
</tr>
<tr>
<td>Acceptable methods for measuring credit losses</td>
<td>Discounted cash flow (DCF)</td>
<td>Various methods are appropriate, including DCF, loss rate, probability of default (PD) and others that faithfully estimate collectability by applying the principles in ASC 326-20</td>
</tr>
</tbody>
</table>

* When the entity has decided to sell the debt security or it’s more likely than not the entity will be required to sell the security before recovery of the security’s amortized cost basis, the security’s amortized cost basis should be written down to fair value through earnings at the reporting date.

** Certain measurement methods may rely on an extensive population of actual loss data as an input when estimating credit losses and inherently reflect collective evaluation, even when the loss rates are applied to individual assets.
Purchased financial assets with credit deterioration (PCD)
Purchased financial assets with credit deterioration (PCD)

- Guidance in ASC 310-30 that applies to purchased credit-impaired financial assets would be eliminated
  - Entities would apply an allowance “gross up” approach for purchased financial assets with evidence of credit deterioration
- Definition of a PCD financial asset

**ASU 2016-13**
Acquired individual financial assets (or acquired groups of financial assets with shared risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer’s assessment.

**Current GAAP**
Loans with evidence of deterioration of credit quality since origination acquired by completion of a transfer for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments receivable.
Purchased Credit Deteriorated (PCD)  
Accounting overview

- Initial accounting: allocate to each individual financial asset the non-credit-related discount or premium resulting from acquiring a pool of PCD assets
- Subsequent accounting for PCD assets will be the same as other originated loans

<table>
<thead>
<tr>
<th>Allowance for credit loss method</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Does not</strong> discount future expected cash flows</td>
<td><strong>Does</strong> discount future expected cash flows</td>
</tr>
<tr>
<td>Base the allowance on the par amount of the PCD asset</td>
<td>Use the discount rate that equates the purchase price of the PCD asset with the present value of estimated future cash flows</td>
</tr>
</tbody>
</table>

Assume Company A acquires a PCD asset with the following characteristics:
- Par amount of $100,000
- Purchase price of $80,000
- Credit loss embedded in the $20,000 purchase discount is $15,000

**Journal entry at purchase:**

<table>
<thead>
<tr>
<th>Debt instrument (par amount)</th>
<th>100,000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt instrument (noncredit discount)</td>
<td>5,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>15,000</td>
</tr>
<tr>
<td>Cash</td>
<td>80,000</td>
</tr>
</tbody>
</table>

- Non-credit discount of $5,000 would be accreted into interest income over the life of the instrument
- The allowance recorded at acquisition would not flow through the income statement
Approach for PCD financial assets
Transition considerations

- Prospective application for all assets that were PCI prior to adoption
  - Gross-up adjustment to the amortized cost basis for the allowance for credit losses at the date of adoption
- No reassessment of PCD at the adoption date
- Loan pools accounted for under ASC 310-30 may be maintained
- No reassessment of whether prior modifications of PCI loans in pools are TDRs at the adoption date
- PCI=>PCD pools will follow ASC 326 for allowance measurement

Transition provisions were discussed at the June 2017 TRG Meeting
Credit losses (ASU 2016-13)
Disclosures

Forecasts
Discuss the factors that influenced management’s reasonable and supportable forecasts. For forecast periods beyond which management deems are reasonable and supportable, discuss the reversion method applied in the allowance calculation.

Purchased financial assets with credit deterioration
Reconcile the difference between the purchase price of the financial assets and the par value of the assets for purchased financial assets with credit deterioration.

Rollforward of the allowance
By portfolio segment and major security type, provide the quantitative disclosures of the activity in the allowance for credit losses for financial assets (also applies to AFS and HTM debt securities).

Collateral-dependent financial assets
Describe the type of collateral by class of financing receivable and major security type and the extent to which collateral secures financial assets. Also qualitatively explain, by class of financing receivable and major security type, significant changes in the extent to which the collateral secures the entity’s financial assets.

Vintage analysis for certain in scope assets
Disclose the amortized cost amount within each credit quality indicator by year of origination for the most recent five years (PBE’s only).

Qualitative disclosures
Discuss how the allowance was developed including the factors that influenced management’s estimate such as past events and current conditions as well as the changes in those factors.

Loan commitments
Describe the accounting policies and methodology used to estimate the liability and discuss relevant risk elements.
Implementation considerations and challenges
Implementation challenges

Bringing together multiple disciplines within the organization
Ø Bridging the knowledge gap between the accounting and credit risk modeling disciplines to develop a practical approach that is consistent with the accounting requirements

C-Suite concerns
Ø Potential increased volatility in earnings, and the related implications for earnings forecasts, analyst estimates, and the financial reporting communication exercise
Ø Potential legal, regulatory and reporting risk when outside parties use hindsight in analysing the forecasts selected by management and the expected credit loss estimate recorded
Ø Uncertainty related to regulatory expectations on model sophistication and qualitative factors

Developing the estimate
Ø Availability and limitations of historical lifetime loss data, including the processes, controls, and system changes necessary to obtain, verify, and be able to process that data
Ø Inherent uncertainty in forecasts of the future, and the need for a well-governed, robust and consistent process for developing or obtaining forecasts
Ø Credit loss modeling, including quantifying the effect of forecasts on the estimate of loss

Financial reporting and governance
Ø Linking the accounting concepts with the entity’s selected approach when updating policy, process and governance documentation
Ø Consistency of data and forecasts with those used for other reporting or regulatory needs
Ø System, data, processes, and controls changes to support increased disclosure, including the disaggregation of credit quality indicators by vintage
About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. For more information about our organization, please visit ey.com.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2017 Ernst & Young LLP.
All Rights Reserved.

1706-2345381
ED None

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.

ey.com