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Current Expected Credit Loss Model

This presentation has been prepared to help constituents understand the current status of projects of the Financial Accounting Standards Board (FASB). The views expressed in this presentation are those of the presenter and not necessarily of the FASB. Official positions of the FASB are reached only after extensive due process and deliberations.

Agenda

- Executive summary of differences between CECL and three-bucket model

    – What's the same

    – What's different

- Overview of the CECL model

    – Summary

    – PCI approach

    – Debt securities and FV-OCI

    – The end result

- Questions and answers

Executive summary: CECL as compared to the three-bucket model

- ## What's substantially the same

  – Information set used in estimating expected credit losses

  – Measurement of expected credit losses reflects multiple possible outcomes as opposed to the "most likely outcome" (i.e., statistical mode)

  – Measurement reflects the time value of money

  – Use of same model for securities / non-security debt instruments

  – Use of same model for assets measured at amortized cost and assets measured at FV-OCI

  – Scope

Executive summary: CECL as compared to the three-bucket model

- ## What's different

  - CECL model uses **single measurement objective**, three-bucket model uses dual measurement objective

    - CECL model is a model based on the "absolute" level of credit risk, as opposed to a model based on the "relative" change in credit risk (such as the three-bucket model)

    - CECL model does not have "different measurement objectives" or a "transfer notion"

  - CECL aims to present **PCI assets** on the balance sheet in similar manner to originated (or other purchased) assets

  - CECL includes a practical expedient for assets measured at **FV-OCI**

- The current expected credit loss (CECL) model would:

  – Carry forward several key concepts that have been jointly deliberated and agreed upon with the IASB

  – Replace the five existing impairment models for debt instruments in current U.S. GAAP with a model that uses a single "expected credit loss" measurement objective for the allowance for credit losses

    – Expected credit losses reflect management's current estimate of the contractual cash flows that the entity does not expect to collect

    – Neither a "worst case" nor a "best case" scenario; measure of current likelihood of loss for remaining life of assets

    – For loans, would usually be applied to pools with similar risk characteristics at a reporting period

- Management's estimate based on information about:
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts about the future

- Estimate of expected credit losses should reflect both:
  - an outcome in which a credit loss results; and
  - an outcome in which no credit loss results

    Cumulative loss rates and PD metrics already incorporate this notion

- Estimate of expected credit losses should reflect the time value of money (which is implicit in several approaches)

    Consistent with joint decisions

- Every reporting period, expected credit losses would be re-estimated; favorable and unfavorable changes would be reported in earnings

- A current estimate of expected credit losses would be made, based on the current risk ratings of the assets, historical loss experience for assets with similar risk ratings and remaining lives, adjusted for changes in current circumstances, and reasonable and supportable expectations about the future

- The allowance typically does not relate to any specific asset; it relates to pools of assets with similar credit risk and remaining lives

- The effect in any period will depend on changes in the volume of loans originated, maturing, and the extent of deterioration or recovery. In a stable pool, the effect primarily relates to *changes* in expectations about credit losses

CECL – Example of a Loss Rate Approach

- National Bank A develops a loss rate approach for five-year commercial mortgage loans
    - The bank groups these mortgages into cohorts by risk rating at the beginning of each year. Membership in cohorts remains constant.
    - For each cohort, a historical loss rate is determined based on (a) the amortized cost amount written-off due to credit loss realized over the entire contractual term of financial assets within that cohort as compared to (b) the beginning amortized cost basis of assets within the cohort.
    - The average historical loss rate developed is updated to reflect changes in current conditions and reasonable and supportable forecasts that differ from historical experience.

- National Bank A calculates the following estimate based on its loss rate approach:

($ in 000's)	Pass Category 2	Pass Category 4	Special Mention	Total
Risk rating category	**Pass Category 2**	**Pass Category 4**	**Special Mention**	**Total**
Expected loss rates	0.50%	3.00%	8.00%	1.60%*
Ending balance	27,500	10,000	2,500	40,000
Expected credit loss estimate	138	300	200	638

* The 1.60% weighted average loss rate is calculated as the total expected credit loss estimate divided by the ending balance.

- Follows same approach to estimating expected credit losses as originated and non-PCI assets

    - The allowance would be based on management's current estimate of the contractual cash flows that the entity does not expect to collect

    - Changes in credit impairment allowance (favorable or unfavorable) recognized immediately as bad debt expense

- Initial estimate of expected credit losses is recognized as an adjustment to the cost basis of the asset

- Discount embedded in purchase price attributable to credit (i.e., nonaccretable yield) would not be recognized as interest income

Illustration

- Assumptions
  - Pay $750 for a debt instrument with a par amount of $1,000
  - At time of purchase, the expected credit loss embedded in the purchase price is $175
  - Instrument is classified in amortized cost

- Acquisition date journal entry:

Loan – par amount	1,000	
Non-credit discount		75
Allowance for credit impairment		175
Cash		750

Subsequent changes reported in same way as the rest of the model

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

- Securities and non-securities follow the same approach

- However, as a practical expedient, an entity may elect not to recognize expected credit losses for financial assets classified at FV-OCI when both of the following conditions are met:

  - FV of the financial asset is greater than the amortized cost basis

  - Expected credit losses on the financial asset are insignificant

- Practical expedient was a cost-benefit consideration for the Board

- For investors:

  – Balance sheet reflects management's current estimate of expected credit losses at the reporting date

    – Allowance can be easily understood since it is based on a single measurement objective

  – Income statement reflects changes in expected credit losses during the period

    – No "cliff effect" resulting from a change in measurement objective for the credit impairment allowance

  – Interest income measured using a decoupled approach; however accrual ceases when collection is not probable

    – Consistent with investor's suggestions following the May 2010 ED

  – Disclosures provide insight into the credit quality of financial assets at each reporting date and illustrate credit deterioration occurring during the reporting period

- For preparers:

  – A model that leverages existing internal credit risk management tools and systems; however, the inputs to the measure will change

  – A consistent measurement approach throughout the portfolio with no barriers to recognition

  – An approach for PCI assets that is

    – less complex and costly to implement

    – easier to explain to investors