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Allowance for loan and lease losses - FASB issues final impairment standard

What happened?

On June 16, 2016, the FASB issued Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326)* (the "ASU"), which introduces new guidance for the accounting for credit losses on instruments within its scope. Given the breadth of that scope, the new ASU will impact both financial services and non-financial services entities.

At a glance

New impairment guidance for certain financial instruments will replace the current "incurred loss" model for estimating credit losses with a forward-looking "expected loss" model.

Key provisions

The new guidance introduces an approach based on expected losses to estimate credit losses on certain types of financial instruments. It also modifies the impairment model for available-for-sale (AFS) debt securities and provides for a simplified accounting model for purchased financial assets with credit deterioration since their origination.

Current expected credit losses

The new model, referred to as the current expected credit losses (CECL) model, will apply to: (1) financial assets subject to credit losses and measured at amortized cost, and (2) certain off-balance sheet credit exposures. This includes loans, held-to-maturity debt securities, loan commitments, financial guarantees, and net investments in leases, as well as reinsurance and trade receivables. Upon initial recognition of the exposure, the CECL model requires an entity to estimate the credit losses expected over the life of an exposure (or pool of exposures). The estimate of expected credit losses (ECL) should consider historical information, current information, and reasonable and supportable forecasts, including estimates of prepayments. Financial instruments with similar risk characteristics should be grouped together when estimating ECL. The ASU does not prescribe a specific method to make the estimate so its application will require significant judgment.

Generally, the initial estimate of the ECL and subsequent changes in the estimate will be reported in current earnings. The ECL will be recorded through an allowance for loan and lease losses (ALLL) in the statement of financial position. See below for different accounting that may apply for purchased financial assets.

Available-for-sale debt securities

The ASU amends the current AFS security other-than-temporary impairment (OTTI) model for debt securities. The new model will require an estimate of ECL only when the fair value is below the amortized cost of the asset. The length of time the fair value of an AFS debt security has been below the amortized cost will no longer impact the determination of whether a credit loss exists. As such, it is no longer an other-than-temporary model. In addition, credit losses on AFS debt securities will now be limited to the difference between the security's amortized cost basis and its fair value. The AFS debt security model will also require the use of an allowance to record estimated credit losses (and subsequent recoveries). This is a significant change from the current model.

Purchased financial assets with credit deterioration

The purchased financial assets with credit deterioration (PCD) model applies to purchased financial assets (measured at amortized cost or AFS) that have experienced more than insignificant credit deterioration since origination. This represents a change from the scope of what are considered purchased credit-impaired assets under today's model. Different than the accounting for originated or purchased assets that do not qualify as PCD, the initial estimate of expected credit losses for a PCD would be recognized through an ALLL with an offset to the cost basis of the related financial asset at acquisition (i.e., there is no impact to net income at initial recognition). Subsequently, the accounting will follow the applicable CECL or AFS debt security impairment model with all adjustments of the ALLL recognized through earnings. Beneficial interests classified as held-to-maturity or AFS will need to apply the PCD model if the beneficial interest meets the definition of PCD or if there is a significant difference between contractual and expected cash flows at initial recognition.

Disclosure

ASU 2016-13 also expands the disclosure requirements regarding an entity's assumptions, models, and methods for estimating the ALLL. In addition, public business entities (PBEs) will need to disclose the amortized cost balance for each class of financial asset by credit quality indicator, disaggregated by the year of origination (i.e., by vintage year). This disclosure will not be required for other reporting entities.

Why is this important?

Financial service entities will be heavily affected. However, given its broad scope, which includes trade and lease receivables, all entities will need to evaluate the ASU's impact. The ASU's requirement to estimate ECL will likely result in an increase in credit reserves for those who currently apply the "incurred loss" approach. Changes to systems, processes, and controls will likely be required to apply the new guidance and may require a considerable amount of time to implement.

What's next?

The ASU will be effective for PBEs that are SEC filers in fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities will have one additional year. Non-public business entities will not be required to apply the provisions to interim periods until fiscal years beginning after December 15, 2021. Early application of the guidance will be permitted for all entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

We will be discussing the new impairment standard in a webcast on July 25, 2016 at 1:00 EDT. To register, please click here: PwC Impairment Webcast.

Questions?

PwC clients who have questions about this *In brief* should contact their engagement partner. Engagement teams who have questions should contact the Financial Instruments team in the National Professional Services Group (973-236-7803).

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