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Implications of the FASB's new credit loss impairment standard: A paradigm shift in allowance for financial instruments

BY ANNA KRAYN AND CHRISTIAN HENKEL

On June 16, 2016, FASB issued the much-anticipated financial instruments impairment standards update. The implications of this standard are significant and will change the way credit losses are measured for most financial assets (e.g., receivables, debt securities, and loans). The impact is greatest for banks and other financial institutions; however non-financial firms will be affected as well. While interpretation by the industry, auditors, and regulators will take some time, we highlight five implications from the standard and the associated guidance from the banking agencies.

I. The anticipated rise in allowance balances will be punishing to profitability and may require capital increases in advance of the implementation.

By most industry estimates, the shift to expected credit losses (ECL) is likely to result in a rise in allowance balances, which will flow through earnings on Day 1 of adoption and therefore result in a net capital reduction. In a statement published on June 17, 2016, the banking agencies reminded firms not to increase allowance levels in advance of the new standard's effective date. This means that the Day 1 "adoption hit" can be significant. Coupled with higher capital requirements for banks, the new credit loss standard is likely to put additional pressure on bank profitability. As a result, it would not be surprising to see capital-raising activity driven by this confluence of regulatory and accounting standard-setting.

II. Process changes will likely increase the volatility of allowance for loan and lease losses (quarter-over-quarter).

One of the many implementation challenges for the ECL standard will be managing the volatility in the allowance (and thus earnings) driven by quarter-over-quarter changes to economic forecasts. Calibrating for the pro-cyclicality that is inferred through economic forecasts will be a new challenge. Additionally, the complexity of the new standard may make it difficult to quickly understand the impact of changing assumptions. To test the impact of specific changes, firms will need to quickly evaluate a range of economic scenarios. For smaller firms, this will be one of the more challenging elements in their overall framework design. While the banking agencies were clear that expectations for smaller banks are lower, the potential for increased earnings

volatility makes sensitivity analysis critical regardless of institution size. Larger firms subject to Dodd-Frank may be able to leverage stress testing models that already incorporate scenario analysis. However, given conservatism built into those models, this will require significant recalibration.

III. Forecasts will present new challenges to auditors, investors, and regulators.

The ECL approach entails management's forecast of economic conditions and prepayments. It is conceivable, and likely, that two firms with the same exposure may take diverging views on the forecasted economic environment. This will result in a lack of comparability across firms – a frequently industry-cited concern before the standard was finalized. Additionally, it will create challenges for auditors and regulators, who will have to develop standards of review that focus on process and methodology, rather than accuracy of the final result.

IV. Measurement approaches will need to change.

The new accounting standard will require firms to provision for expected credit losses (ECL) at the time of origination, for the life of the loan. The measurement of ECL will be a combination of historical and current information with supportable economic and prepayment forecasts. Although the new standard does not prescribe a certain methodology for calculating ECL, auditors and supervisors acknowledge the new standard will require many firms to change their existing credit risk management systems to meet these requirements. For most institutions, the new standard will initially expose gaps in data currently being collected, and limitations with existing risk rating processes. The ensuing benefits from more timely and accurate reporting of credit losses, however, will result in a greater discipline in the measurement and management of credit risk.

V. Process governance and disclosure will require rethinking of systems.

The forecast aspect of the ECL calculation will also put the onus on management to substantiate period-over- period changes in forecast and resulting allowance. Today, many firms manage the allowance process through an amalgamation of Excel spreadsheets and credit memos that are prone to version control issues. ECL is a more complex modeling framework, and together with associated disclosure requirements, will require technology infrastructure to govern data assembly and cleansing, calculations, override management, and approval processes. The joint statement of the banking regulatory agencies recognizes this aspect of implementation: "Institutions are encouraged to build strong processes and controls over their allowance methodology." Finally, the new allowance process will require skills from across an institution to be brought together under one umbrella. Organizationally, this can be challenging and requires good governance and advanced planning.

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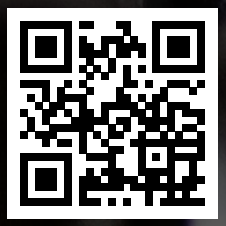

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