

**Anna Krayn**

Senior Director and Team Lead, Capital Planning and Stress Testing

Anna is responsible for the business development of stress testing and capital planning solutions. Her clients include a variety of financial services institutions, including those in the insurance, banking, and consumer finance sectors across the Americas. Anna holds a B.S. and MBA from Stern School of Business at New York University.

**Christian Henkel**

Senior Director – Risk Management

Christian Henkel is a Senior Director in the Moody's Analytics Risk Measurement Services group. He leads a national team of risk consultants who work closely with banks, insurers, and other financial institutions. He has a BA and an MBA from the University of Texas at Dallas in Finance and Accounting, and he graduated valedictorian from the Southwestern Graduate School of Banking at SMU.

View all articles of this edition at MoodyAnalytics.com/RiskPerspectives

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.

© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

CREDIT RATINGS ISSUED BY MOODY'S INVESTORS SERVICE, INC. AND ITS RATINGS AFFILIATES ("MIS") ARE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES, AND CREDIT RATINGS AND RESEARCH PUBLICATIONS PUBLISHED BY MOODY'S ("MOODY'S PUBLICATIONS") MAY INCLUDE MOODY'S CURRENT OPINIONS OF THE RELATIVE FUTURE CREDIT RISK OF ENTITIES, CREDIT COMMITMENTS, OR DEBT OR DEBT-LIKE SECURITIES. MOODY'S DEFINES CREDIT RISK AS THE RISK THAT AN ENTITY MAY NOT MEET ITS CONTRACTUAL, FINANCIAL OBLIGATIONS AS THEY COME DUE AND ANY ESTIMATED FINANCIAL LOSS IN THE EVENT OF DEFAULT. CREDIT RATINGS DO NOT ADDRESS ANY OTHER RISK, INCLUDING BUT NOT LIMITED TO: LIQUIDITY RISK, MARKET VALUE RISK, OR PRICE VOLATILITY. CREDIT RATINGS AND MOODY'S OPINIONS INCLUDED IN MOODY'S PUBLICATIONS ARE NOT STATEMENTS OF CURRENT OR HISTORICAL FACT. MOODY'S PUBLICATIONS MAY ALSO INCLUDE QUANTITATIVE MODEL-BASED ESTIMATES OF CREDIT RISK AND RELATED OPINIONS OR COMMENTARY PUBLISHED BY MOODY'S ANALYTICS, INC. CREDIT RATINGS AND MOODY'S PUBLICATIONS DO NOT CONSTITUTE OR PROVIDE INVESTMENT OR FINANCIAL ADVICE, AND CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT AND DO NOT PROVIDE RECOMMENDATIONS TO PURCHASE, SELL, OR HOLD PARTICULAR SECURITIES. NEITHER CREDIT RATINGS NOR MOODY'S PUBLICATIONS COMMENT ON THE SUITABILITY OF AN INVESTMENT FOR ANY PARTICULAR INVESTOR. MOODY'S ISSUES ITS CREDIT RATINGS AND PUBLISHES MOODY'S PUBLICATIONS WITH THE EXPECTATION AND UNDERSTANDING THAT EACH INVESTOR WILL, WITH DUE CARE, MAKE ITS OWN STUDY AND EVALUATION OF EACH SECURITY THAT IS UNDER CONSIDERATION FOR PURCHASE, HOLDING, OR SALE.

MOODY'S CREDIT RATINGS AND MOODY'S PUBLICATIONS ARE NOT INTENDED FOR USE BY RETAIL INVESTORS AND IT WOULD BE RECKLESS AND INAPPROPRIATE FOR RETAIL INVESTORS TO USE MOODY'S CREDIT RATINGS OR MOODY'S PUBLICATIONS WHEN MAKING AN INVESTMENT DECISION. IF IN DOUBT YOU SHOULD CONTACT YOUR FINANCIAL OR OTHER PROFESSIONAL ADVISER.

ALL INFORMATION CONTAINED HEREIN IS PROTECTED BY LAW, INCLUDING BUT NOT LIMITED TO, COPYRIGHT LAW, AND NONE OF SUCH INFORMATION MAY BE COPIED OR OTHERWISE REPRODUCED, REPACKAGED, FURTHER TRANSMITTED, TRANSFERRED, DISSEMINATED, REDISTRIBUTED OR RESOLD, OR STORED FOR SUBSEQUENT USE FOR ANY SUCH PURPOSE, IN WHOLE OR IN PART, IN ANY FORM OR MANNER OR BY ANY MEANS WHATSOEVER, BY ANY PERSON WITHOUT MOODY'S PRIOR WRITTEN CONSENT.

All information contained herein is obtained by MOODY'S from sources believed by it to be accurate and reliable. Because of the possibility of human or mechanical error as well as other factors, however, all information contained herein is provided "AS IS" without warranty of any kind. MOODY'S adopts all necessary measures so that the information it uses in assigning a credit rating is of sufficient quality and from sources MOODY'S considers to be reliable including, when appropriate, independent third-party sources. However, MOODY'S is not an auditor and cannot in every instance independently verify or validate information received in the rating process or in preparing the Moody's Publications.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability to any person or entity for any indirect, special, consequential, or incidental losses or damages whatsoever arising from or in connection with the information contained herein or the use of or inability to use any such information, even if MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers is advised in advance of the possibility of such losses or damages, including but not limited to: (a) any loss of present or prospective profits or (b) any loss or damage arising where the relevant financial instrument is not the subject of a particular credit rating assigned by MOODY'S.

To the extent permitted by law, MOODY'S and its directors, officers, employees, agents, representatives, licensors and suppliers disclaim liability for any direct or compensatory losses or damages caused to any person or entity, including but not limited to by any negligence (but excluding fraud, willful misconduct or any other type of liability that, for the avoidance of doubt, by law cannot be excluded) on the part of, or any contingency within or beyond the control of, MOODY'S or any of its directors, officers, employees, agents, representatives, licensors or suppliers, arising from or in connection with the information contained herein or the use of or inability to use any such information.

NO WARRANTY, EXPRESS OR IMPLIED, AS TO THE ACCURACY, TIMELINESS, COMPLETENESS, MERCHANTABILITY OR FITNESS FOR ANY PARTICULAR PURPOSE OF ANY SUCH RATING OR OTHER OPINION OR INFORMATION IS GIVEN OR MADE BY MOODY'S IN ANY FORM OR MANNER WHATSOEVER.

Moody's Investors Service, Inc., a wholly-owned credit rating agency subsidiary of Moody's Corporation ("MCO"), hereby discloses that most issuers of debt securities (including corporate and municipal bonds, debentures, notes and commercial paper) and preferred stock rated by Moody's Investors Service, Inc. have, prior to assignment of any rating, agreed to pay to Moody's Investors Service, Inc. for appraisal and rating services rendered by it fees ranging from \$1,500 to approximately \$2,500,000. MCO and MIS also maintain policies and procedures to address the independence of MIS's ratings and rating processes. Information regarding certain affiliations that may exist between directors of MCO and rated entities, and between entities who hold ratings from MIS and have also publicly reported to the SEC an ownership interest in MCO of more than 5%, is posted annually at www.moody.com under the heading "Investor Relations — Corporate Governance — Director and Shareholder Affiliation Policy."

RISK PERSPECTIVES

Find additional integrated risk management articles, interviews, and multimedia content at MoodyAnalytics.com/RiskPerspectives

CONTACT US

Visit us at moodyanalytics.com or contact us at a location below:

AMERICAS
+1.212.553.1653
clientservices@moody.com

EMEA
+44.20.7772.5454
clientservices.emea@moody.com

Asia (excluding Japan)
+852.3551.3077
clientservices.asia@moody.com

JAPAN
+813.5408.4100
clientservices.japan@moody.com



© 2016 Moody's Corporation, Moody's Investors Service, Inc., Moody's Analytics, Inc. and/or their licensors and affiliates (collectively, "MOODY'S"). All rights reserved.

MOODY'S
ANALYTICS