FDIC Banker Teleconference on
FASB Proposal to Change the Accounting for Credit Losses

May 16, 2013

Coordinator: Welcome and thank you for standing by. At this time all participants are in listen-only mode. To ask a question after the presentation, press star then 1 and record your name at the prompt. This conference is being recorded. If there are any objections, you may disconnect at this time. I would now like to turn the meeting over to Bob Storch. Sir, you may begin.

Bob Storch: Thank you and good afternoon everyone. This is Bob Storch, Chief Accountant in the FDIC's Division of Risk Management Supervision. With me this afternoon is the Division's Deputy Chief Accountant, Greg Eller.

On behalf of the FDIC, we would like to welcome everyone to today's banker teleconference on the proposed Accounting Standards Update (ASU) on credit losses that the Financial Accounting Standards Board (FASB) issued for public comment this past December.

Thank you for taking time to join us this afternoon as we discuss the key elements of what the FASB has labeled its "current expected credit loss" or "CECL" model. We'd also like to apologize for any difficulties you had dialing in to this teleconference as a result of a revision to the phone number for this event.

We hope that the teleconference will provide you with a basic understanding of the proposed ASU and how it differs from the way that credit losses on loans and debt securities are currently accounted for.

The Financial Institution Letter announcing this teleconference included a link to the slides we will be using this afternoon. After Greg and I cover the topics presented in the slides, there will be time for you to ask questions about the proposal. A transcript of today's teleconference will be prepared and posted on the FDIC's Website later this month.

The FASB's proposed ASU on credit losses is available at and can be downloaded from the FASB's Website, www.fasb.org. Our Financial Institution Letter included a link to this proposal. In addition, on March 25, the FASB staff issued a frequently-asked-questions document in which they responded to common questions about the proposed ASU on credit losses. The FAQ document is available on the impairment project page on the FASB's Website. The FASB's comment deadline was originally April 30 and that date shows up on some of the pages on the FASB's Website. The deadline has been extended to May 31.

As an alternative to submitting a comment letter to the FASB, the FASB has created an electronic feedback form for the proposed ASU on its Website. The FDIC's Financial Institution Letter for this teleconference included a link to the FASB's feedback form.

We would encourage you to provide your comments and feedback on the CECL model and other aspects of the proposed ASU to the FASB. When commenting, you need not address every provision in the proposal. Rather you can comment on those elements that are of most interest to you.

As bankers, I'm sure that you're well aware that the allowance for loan and lease losses (ALLL) that you report on your balance sheet represents one of the most significant estimates that a financial institution must make in its financial statements and regulatory reports. Arriving at the appropriate level for the allowance requires significant judgment by management.

For examiners, a key focus of an examination is the evaluation of an institution's allowance methodology and documentation, as well as the appropriateness of the level of the institution's ALLL.

The accounting model currently in place for recognizing and measuring loan loss allowances is referred to as the incurred-loss model, which has been in place since the mid-1970s when FASB Statement No. 5, *Accounting for Contingencies*, took effect. Statement No. 5 was later amended and supplemented in 1993 by FASB Statement No. 114, *Accounting by Creditors for Impairment of a Loan*. These standards have been incorporated into the FASB's Accounting Standards Codification (ASC) in Subtopic 450-20 and Section 310-10-35. Those standards are the ones we currently expect institutions to apply when measuring the ALLL for Call Report purposes and ensuring compliance with our supervisory policy guidance on the allowance.

As the global financial crisis unfolded in 2008, questions were raised about investor confidence in financial markets and the need for improvements in financial reporting. The FASB and the International Accounting Standards Board (IASB) established the Financial Crisis Advisory Group (FCAG) that was asked, among other things, to help identify significant accounting issues requiring the two Boards' urgent and immediate attention.

In its report to the Boards about the accounting standard-setting implications of the financial crisis in July 2009, the FCAG identified delayed recognition of credit losses on loans and other financial instruments as one of the primary weaknesses in current accounting standards. In other words, the incurred-loss model that has been around since the 1970s was criticized for producing loan loss allowances that were "too little and too late." That is because credit losses are not recognized when applying these standards until a credit loss is probable or has been incurred.

The FCAG recommended that the FASB and the IASB explore alternatives to the incurred-loss model that would use more forward-looking information. In 2009, the FASB and the IASB agreed to undertake a joint project to improve and converge the accounting for financial instruments under U.S. generally accepted accounting principles (GAAP) and International Financial Reporting Standards. Without getting into all the detailed history since then, the FASB's current proposal on credit losses is actually its third proposal and request for public comment on impairment since May 2010.

The FASB's efforts to improve financial instrument accounting have also included a proposed ASU on the classification and measurement of financial instruments. This other proposal was issued in February 2013 and its public comment period ended yesterday.

With all this as background, we'd like to cover several aspects of the FASB's proposed CECL model this afternoon and these topics are listed on Slide 3 in your materials. Greg Eller will cover recognition and measurement, then I'll discuss the scope of the proposal and its nonaccrual and charge-off provisions.

Greg will conclude with comments on the effective date and international convergence. There's another aspect of the CECL model that we will not be covering and that is the set of proposed disclosures that are included in the FASB's Exposure Draft on credit losses. You may want to review and consider those proposed disclosure requirements on your own. With that, I'll turn it over to Greg.

Greg Eller: Good afternoon, everyone. Thank you for calling in for this discussion. We look forward to hearing your views and questions. The first aspect of this proposed ASU that we're going to describe is its recognition requirements.

As Bob indicated, the chief criticism of the existing accounting rules has been that they result in delayed recognition of credit losses because the level of confidence needed to book a credit loss is quite high. One has to be confident that a loss is at least probable in order to book a credit loss when applying the impairment guidance in ASC Topics 450 and 310, formerly known as Statement Nos. 5 and 114.

The FASB's proposal would eliminate any sort of triggering events, such as the likelihood of a credit loss rising to the probable threshold. In fact, the proposed ASU would eliminate the trigger and require recognition of expected credit losses without regard to their likelihood. Instead, under the proposed ASU the probability of loss affects the measured amount of credit loss.

Expected loss is defined as an estimate of all of contractual cash flows not expected to be collected from a recognized financial asset or group of financial assets, or commitments to extend credit. So, unlike the current model for impairment, there would be no threshold that needs to be met before a credit loss is measured; rather, it's simply recognition from Day 1 of the expected credit loss inherent in assets on the balance sheet and commitments to extend credit.

The proposed ASU, if adopted, would mean virtually any credit deterioration would affect a bank's financial performance and financial position rather than allowing credit deterioration to build to a point where credit loss is probable of being incurred before that deterioration is reflected in financial results. The FASB's proposed ASU would require periodic estimates of lifetime expected credit losses for all assets and commitments within its scope, which would then be recognized on the financial statement date as allowances for expected credit loss. Changes in the estimate of expected credit loss would be reflected as provisions, or reductions in provisions, from one period to the next. The estimation process would cover financial assets and commitments that are reported at either amortized cost or fair value with changes shown in other comprehensive income (OCI).

Earlier the FASB had been considering a "three-bucket" approach, which was jointly developed with the IASB. On a reporting date under this model, lifetime expected credit losses would be reflected for those financial assets on which there has been significant deterioration in credit quality while for financial assets that do not have significant deterioration, an allowance would reflect lifetime expected credit losses resulting from default events that are possible within the next 12 months.

The "three-bucket" approach was criticized in comments to the FASB when it conducted outreach activities last year. Essentially, the chief complaint was that the "three-bucket" approach was not understandable, operational, or auditable. Because the "three-bucket" approach was found to have significant defects, the FASB decided to take a different tack and ultimately developed the proposed ASU. Under this proposal, there is no bucketing scheme for financial assets. It's essentially lifetime credit loss for the portfolio as a whole. Thus, the FASB's current proposal eliminates many of the conceptual and practical problems regarding how assets transition through each of the three buckets.

Moving from recognition to measurement, the CECL model broadens the range of information to be used in estimating credit loss. Under current GAAP, one uses past loss history as the starting point in estimating incurred credit losses and adjusts the estimate to reflect the effects of past events and current conditions. GAAP currently prohibits forecasting future conditions and incorporating their effect on probable credit losses when measuring the ALLL as of a reporting date. Rather, historical loss rates are adjusted only to reflect past events and current conditions that affect the amount of credit loss. Under the CECL model, an entity would incorporate not just past events and current conditions, but also reasonable and supportable forecasts of future conditions that would impact the amount of expected credit loss, adjusting historical loss rates accordingly.

The CECL model does not prescribe any one method for measuring expected credit losses. When I think of expected loss, my bias is to frame it in terms of Basel-type measurements where expected loss is based on the probability of default and loss given default. The proposed ASU makes clear, however, that such a method of measuring expected credit loss is not the sole approach that can be used. In fact, the FASB offers five examples of how expected losses can be measured. If you have the proposal, the examples are described beginning on page 27. The FASB's intent is to base the accounting measurement of expected credit loss on information drawn from an institution's systems of risk management. Credit risk management is intended to be the foundation that feeds the accounting measurement of expected credit loss. I encourage you to look at those examples and evaluate whether they resemble the practices you apply within your institutions. If you use a method of risk management that differs substantially from those described in the proposed ASU, it would be worth commenting to the FASB, either by comment letter or their feedback form. If they are aware of different methods used to monitor and control credit risk, perhaps they can expand the examples and include different approaches in their final standard. This could ultimately reduce the implementation and compliance costs involved in applying the CECL model if it is adopted as GAAP.

While FASB intends for the CECL model to draw heavily on the risk management process, it's likely though that banks, particularly community banks, currently don't have readily available the information that's needed to implement the CECL model.

The starting point for applying the CECL model is historical loss information on your loans. This would not be an annualized loss rate, which is often used today, but rather the beginning-to-end – or cradle-to-grave – loss experience for the types of loans made in the past that are comparable to the types of loans on the books as of the measurement date. Because life-of-loan loss experience is not an annualized loss rate, the use of annualized loss rates multiplied by the years of remaining life for financial assets generally would not be appropriate for the CECL model. Rather, to apply the CECL model, we believe it would require an understanding of both the amount and timing of credit loss. Such an understanding might be gained through vintage analysis of loan cohorts or similar approaches that reveal both the amount and timing of credit loss. This information can be the basis for estimating historical lifetime loss rates under the CECL model. The baseline lifetime loss rate would then be adjusted qualitatively for current and forecast conditions and differences between the characteristics of the loans during the historical period and the characteristics of the pool currently being measured.

Recapping the key differences from how credit losses are reported in financial statements today versus under the CECL model, a key change is the removal of the probable loss threshold before credit loss is measured. That is a significant step in addressing the view that the current recognition and measurement requirements in GAAP serve to delay the reporting of credit loss.

The other aspect of existing GAAP that has been criticized is its fixation on past events and current conditions and not permitting the estimate of probable loss to consider future events – regardless of how likely those events may be – and their impact on credit losses inherent in an institution's loan portfolio. The CECL model, rather than prohibiting, would require an institution to factor in reasonable and supportable forecasts of conditions affecting collectability.

The estimate of expected credit losses is not intended to be a best case nor a worst-case scenario. Instead, it should be an unbiased estimate that is neither conservative nor optimistic for purposes of establishing the amount of expected losses inherent in the portfolio of financial assets being measured.

Now I'll turn it over to Bob for the scope of the FASB's proposal.

Bob Storch: Before we get to the scope, maybe we can follow up on some of the aspects of what you talked about Greg. You used the term "lifetime losses," but in looking at the proposal, the FASB avoided using that term although they explicitly refer to estimating the cash flows you don't expect to collect over the contractual life of the asset.

It's interesting to note in their question-and-answer guidance that the FASB explains why the proposal doesn't use the term "lifetime losses," although I think many people outside the FASB are using this term. The FASB said that they chose not to characterize the credit loss estimate in their proposal as "lifetime losses" because that term suggested that projections would be necessary over the entire lifetime of an asset, which is not the case.

You also mentioned the use of reasonable and supportable forecasts. Is there the expectation that beyond the forecast period some amount of estimated credit losses would be factored into the overall credit loss measurement?

Greg Eller: Yes Bob, the FASB uses “life of loan” rather than “lifetime” because some of its constituents thought “lifetime” connotes something different from the entire contractual term of a financial asset that the FASB had intended. Hence, the FASB’s use of the phrase “life of loan.” With that said, I find it extremely convenient to use “lifetime” as shorthand when speaking about expected losses. I don’t intend to imply with my remarks something different than FASB’s carefully chosen terminology.

Regarding forecasts, the FASB indicated that beyond the reasonable-and-supportable forecast period, it seems unreasonable to assume that losses would drop to zero. In their Q&A document, the FASB staff mentions two different approaches that would be acceptable for measuring what I’ve been short-handing as “lifetime” expected credit losses.

Essentially, an institution would develop a historical loss rate that’s been built from its past experience. Reasonable and supportable forecasts would then enable the bank to deviate from and adjust those historical loss rates to reflect what its current view is on expected credit losses. For that portion of the remaining contractual life that lies beyond the range of reasonable and supportable forecasts, the FASB staff suggests that expected credit losses may revert to their long-term average or, as an alternative, conditions beyond the forecast period would essentially be the same as those expected to exist at the end of the reasonable and supportable forecast – in effect freezing conditions at the end of the forecast. The FASB staff indicates either approach would be acceptable for estimating credit losses for the remaining life of assets that extend beyond the forecast period.

Bob Storch: It would be useful for the FASB to clarify those points in any final standard they issue. You mentioned also the allowance methodologies that institutions use today that are based on an annualized loss rate.

Do you think it would be appropriate under the FASB's proposal for a bank that has, for example, a 50-basis-point historical annual loss rate on a type of loan with a seven-year life to just multiply the half a percent times the seven years to estimate the expected credit losses on those loans?

Greg Eller: Generally no, unless there's some quirk of the portfolio. Typically, a group of loans have a fairly defined default and loss schedule - the cumulative loss curve I've heard it called - where essentially more losses occur on the loans in the group in earlier years, then losses taper off while the majority of loans are repaid in full over their contractual term. In other words, there normally are minimal losses late in the life of a vintage of loans. So the estimate of expected credit loss wouldn't just simply be a linear extrapolation of one year's loss rate times the lifetime of that vintage.

Bob Storch: Yes, I would agree. In one of the examples in the FASB's proposal, they actually state that, as a generalization, an approach of just multiplying the annual loss rate times the life of the loan would not achieve the objective of the proposal. Those sorts of dire outcomes really are not expected to reflect the proper application of the proposal if the FASB went forward with it.

Today, there's a strong emphasis when you're starting with historical loss experience that you must also consider qualitative factors and the need to adjust the historical loss experience. In the new measurement approach the FASB has proposed, do they continue to acknowledge the need to consider qualitative factors or is the expected loss estimate primarily experience-driven?

Greg Eller: The starting point of historical losses is a major part of the CECL model, so I think the model is heavily dependent upon experience. With that said, I believe that qualitative factors would still be an equally important aspect to provisioning under the CECL model. Certainly the model is qualitative in terms of how one expects the future will unfold when considering the effect of reasonable and supportable forecasts. I don't believe the FASB expects entities to average a dozen forecasts and come up with a mean forecast. Rather, they are expecting an entity to identify the forecasts it finds most likely. If I were to interpret it, those forecasts would be the ones that drive the entity's business behavior – the ones that are the basis on which the entity is undertaking action – and it would be consistent that those forecasts also serve a purpose from a qualitative standpoint when estimating expected credit loss.

Bob Storch: Would bank management also have to be considering changes in their underwriting standards as a qualitative factor?

Greg Eller: I think that would be a reasonable conclusion to make when applying the CECL model. If historical loss rates were developed under one underwriting regime and underwriting has changed, then an entity would need to adjust its provisions to reflect credit loss expectations given the new regime. I suppose – hypothetically speaking – if a bank had mapped credit loss data to different underwriting standards, then the adjustment could be quantitative, too. In any event, if a bank has changed its underwriting requirements – or its collection practices for that matter – how these changes will play out in terms of credit losses need to be considered and may well impact the entity's estimate of expected loss today.

Another example might be if there's a change in law – such as a revision to the bankruptcy code that could affect the future performance of certain loans in the portfolio. Under the CECL model, the revision wouldn't be a factor that's already reflected in the historical loss rates. Nevertheless, the effect of the change in bankruptcy law would be a factor to consider in your expected loss measurement. Such an event may need to be factored into loss estimates when the implications of its enactment into law on loan collectibility are incorporated into a reasonable and supportable forecast.

Bob Storch: Thanks, Greg. I think we'll probably get questions along these lines from the bankers when we get to the question-and-answer session. Now, if everyone is on Slide 8, we'll talk about the scope of the proposal.

We've already described the proposal's recognition and measurement concepts, but we haven't really said what instruments specifically the proposal would apply to. When discussing impairment accounting today, we think mostly about the allowance for loan and lease losses. Impairment accounting today, however, actually applies to not just loans but also debt securities.

And within the loan framework – loans held for investment – there are actually three discrete models for how you measure impairment today. We have individually evaluated loans that are determined to be impaired for which allowances are measured under what used to be FAS 114, but is now ASC 310-10-35. We also have what used to be FAS 5, which is now ASC 450-20, for groups of loans with similar risk characteristics that are collectively evaluated for impairment. In addition, some institutions have what are known as purchased credit-impaired loans – and there can actually be purchased credit-impaired debt securities as well – for which there is a separate discrete model often referred to as SOP 03-3, but under the codification it's found in ASC 310-30.

Under today's accounting, debt securities that are not held for trading have two impairment models. We have FAS 115 as it was amended about four years ago, which is now ASC Topic 320, that addresses impairment for most debt securities and then for certain beneficial interests in securitized financial assets, there's a model that used to be known as EITF 99-20, but it's now codified as ASC 325-40.

One of the FASB's objectives in developing the CECL model was to replace the five existing impairment models with the single expected credit loss approach that Greg has outlined. This essentially means that regardless of the type of instrument you're evaluating, there would be the same single measurement approach for estimating expected credit losses.

Let's think about the CECL model in tandem with the FASB's classification and measurement proposal for which the comment period just ended. Without necessarily knowing how many banks are familiar with this other proposal, the held-for-investment loan category, the available-for-sale debt securities category, and the held-to-maturity debt securities category, which are labels that we're currently accustomed to, would actually go away under the FASB's classification and measurement proposal. However, there would be similar accounting categories, but with some differences in how financial assets would fall into the proposed new categories.

Under this other proposal from the FASB, you would have certain assets measured at amortized cost, which could include loans and debt securities, or at fair value with qualifying changes in fair value reported in other comprehensive income. That's like the accounting for available-for-sale securities today, but under the FASB's classification and measurement proposal, both loans and debt securities could fall into this category.

So, even in that separate proposal from the FASB, the distinction between loans and debt securities and the different accounting models that apply to them would go away.

In addition to loans and debt securities, the CECL model would also apply to lease receivables that are on a lessor's balance sheet and to loan commitments, which Greg mentioned earlier.

Now, if we turn to Slide 9, let's think first about debt securities. Many banks have had to deal with other-than-temporary impairment (OTTI) where judgments have to be made when the fair value of a debt security that is not held for trading is less than its amortized cost.

In that situation, a bank has to determine whether it has the ability to recover all of the amortized cost basis of the debt security and, in particular, whether there is a credit loss that must be recognized through an other-than-temporary impairment charge to earnings.

The FASB's proposal would do away with the OTTI model and move to the expected credit loss model for debt securities. Banks would no longer record direct write-downs through earnings of the amortized cost basis of debt securities, which they do today when an other-than-temporary impairment loss has occurred. In that situation, the debt securities are restated on the balance sheet to fair value, if they are not already at fair value, and some or all of the decline in fair value goes through earnings, depending on the circumstances.

Under the FASB's proposal, we would for the first time begin to have allowances for credit losses on debt securities, which is something examiners sometimes would have liked banks to establish, but it isn't allowed under current accounting standards.

The FASB's proposal would apply a single impairment model to debt securities as well as loans. Under the CECL model, expected credit losses could be estimated for individually evaluated loans with clear evidence of significant credit deterioration and also for pools of loans with shared risk characteristics. The FASB's proposal also would allow expected losses to be calculated either individually or on a pool basis for debt securities.

One of the interesting aspects of the proposal is a practical expedient that could be used for qualifying debt securities. Technically, it would also apply to any loans that might fall into the fair value through other comprehensive income category under the FASB's classification and measurement proposal.

Under this proposed practical expedient, an entity could elect not to recognize the expected credit losses on securities and other financial assets measured at fair value through other comprehensive income when two conditions are met.

First, the fair value of the individual financial asset must be greater than or equal to its amortized cost, which means there's appreciation on the asset, and, second, the expected credit losses on the individual financial asset are insignificant considering the credit quality indicators for the asset on the reporting date. So, for a debt security like a U.S. Treasury security that had appreciation, an institution could elect not to recognize expected credit losses because the credit losses on Treasuries would be expected to be insignificant or immaterial.

Although this practical expedient is offered in the proposal and may allow for some efficiency and relief in applying the expected credit loss model, the dilemma is that the fair value of a debt security can fluctuate up or down. The fair value may exceed the cost basis in one period and in the next period it may drop below the cost basis and in that latter situation the practical expedient could not be applied. So, on the one hand the practical expedient sounds like it might be beneficial, but there may also be some drawbacks to it.

Greg Eller: One aspect of this proposed model that you alluded to, which I think might be viewed favorably, is the use of a valuation allowance for credit losses on debt securities rather than what's essentially a charge-off today. So, for example, if a bank took an OTTI charge on mortgage-backed securities at the height of the financial crisis and the estimate of expected future cash flows on those securities later improved, the proposed ASU would allow the recovery of expected cash flows to be reflected immediately in earnings through a lower provision expense, whereas today the recovery is reported as additional yield over the life of the security.

Bob Storch: That's right. That could be viewed as a benefit of the CECL model even if you weren't applying its practical expedient for qualifying debt securities. If a bank established allowances for expected credit losses on its debt securities, if there later was some improvement in credit quality, that would be reflected in a reduction in the allowance for those securities.

So, there is some potential upside that doesn't exist today under the OTTI model we have for most debt securities.

Another topic of interest to both bankers and examiners is troubled debt restructurings. The FASB's proposed standard doesn't change the current rules with respect to identifying which loans or debt securities that undergo a modification of terms would constitute a troubled debt restructuring (TDR).

The TDR designation remains in the proposal but one element of the proposal to be aware of is a change in the measurement of troubled debt restructurings.

According to the proposal, when a creditor changes the contractual terms in a modification that is a troubled debt restructuring, the creditor would have to adjust the cost basis of that particular troubled loan or troubled debt security. The creditor would have to determine the present value of the modified contractual cash flows discounted at the original effective interest rate and adjust the cost basis of the modified loan or debt security by writing it down to reflect the present value of the revised contractual payments.

The bank would retain the effective yield that it had on Day 1 for that particular loan or debt security notwithstanding the troubled debt restructuring. The other half of the entry to adjust the cost basis would go to the allowance for expected credit losses. Thereafter, the bank would apply the expected credit loss model to the revised set of cash flows for the troubled debt restructuring.

So, troubled debt restructurings haven't gone away under the proposal, but there is a change to the accounting for them.

Finally, the proposal addresses purchased credit-impaired loans. These loans are not necessarily something that every bank has in its portfolio. The accounting rules today for purchased credit-impaired loans – or PCI loans – may sound great theoretically but they are very difficult from a practical standpoint to implement.

The FASB has heard the complaints from preparers and users about the understandability and the operationality of PCI loan accounting and they've made some changes to PCI loan accounting in the proposal that most observers seem to view as beneficial.

Today, a purchased credit-impaired loan or debt security is identified at the individual asset level. An asset would meet the PCI definition today when there's evidence of credit deterioration since origination on an acquired loan and it's probable when the asset is acquired that all contractually required payments will be unable to be collected.

The revised definition would streamline the PCI analysis somewhat. Under the proposal, a bank would have to identify acquired assets that have experienced a significant deterioration in credit quality since origination and this identification could be done on a group basis and not solely on an individual asset basis as it is today.

So, if a bank was engaging in a merger and acquiring a large loan portfolio, the proposed revised PCI definition would allow the bank to group loans with similar risk characteristics when determining whether the purchased credit-impaired criteria had been met, which would be more efficient.

In addition, today when purchased credit-impaired loans are first booked they're recorded at their fair value and there is no separate recognition of an allowance for loan losses on the purchased credit-impaired loans at their acquisition date. In effect, the discount on the loans has the expected credit losses embedded in it. In the absence of a loan loss allowance for PCI loans, at least initially, it has been hard for users of financial statements to understand what the credit losses associated with this particular type of asset are.

The FASB has proposed to address this difficulty in understanding the credit risk profile of PCI loans by allowing, if the proposal is finalized, the cost basis at which purchased credit-impaired loans would be booked to be the fair value purchase price plus the portion of the discount that represents the estimated expected credit losses. So, this would result in an expected credit loss allowance to be recognized and accounted for from day one on for PCI loans.

One other change is worth noting. Today, if there's an improvement in the expected cash flows on purchased credit-impaired loans, the improvement would be reflected as an increase in the yield prospectively rather than an immediate gain. The proposal would allow these increases in expected cash flows, because there would be a credit loss allowance from day one on, to be reflected immediately in income as an adjustment to the allowance, thereby affecting the provision for credit losses for the reporting period.

Another key element that the banking agencies are pleased to see in the proposal is that principles for nonaccrual status and charge-offs would for the first time be included within generally accepted accounting principles. The existence of nonaccrual status and charge-offs is recognized in GAAP, and there are certainly expectations that banks will apply these concepts from a supervisory standpoint and for regulatory reporting purposes. However, there have never been specific accounting principles for general financial reporting purposes addressing when financial assets should be placed in nonaccrual status and when charge-offs should be taken.

The proposal includes guidance on both of these accounting topics. Let's first look at the nonaccrual principle that the FASB has proposed. The FASB has indicated that an entity shall cease its accrual of interest income when it is not probable that the entity will receive substantially all of the principal and substantially all of the interest on a financial asset.

Now the FASB's nonaccrual principle is not worded exactly the same as the Call Report instructions that banks follow, both for regulatory purposes and very often for other financial reporting purposes. For Call Report purposes, the general rule is that an institution should not accrue interest on any asset for which payment in full of principal or interest is not expected or upon which principal or interest has been in default for a period of 90 days or more, unless the asset is both well secured and in the process of collection. The Call Report instructions include further details and certain exceptions, but that's the general rule.

We're pleased to see that there is language in the FASB's proposal about nonaccrual status. Even though the FASB's wording is not the same as the Call Report instructions, our expectation would be that in practice if a bank followed the Call Report nonaccrual treatment, that would conform to what the FASB has specified as the conditions for placing an asset in nonaccrual status under their expected loss model.

The FASB's proposal goes on to explain when cash basis income recognition and the cost recovery method should be applied to nonaccrual assets. There's also some coverage of these topics in the Call Report Glossary entry on nonaccrual status where the entry addresses the application of payments after a loan is placed in nonaccrual status.

What the FASB has done in its proposal is in some respects similar to the current regulatory reporting instructions. The FASB says that if it's not probable that an entity would receive payment of substantially all of the principal on an asset, then the entity should apply cost recovery accounting. This is similar to what we currently say in the Call Report instructions – that if recovery of the recorded investment in the loan is not expected, an institution should apply all payments received, whether they're designated as principal or interest, to reduce the recorded investment down to the level where there is no longer doubt that the institution would be able to recover the remaining recorded investment.

Under the FASB's proposal, cash basis income recognition would be permitted where the entity expects to receive substantially all of the principal but not substantially all of the interest. In that case, cash basis income recognition would be acceptable while the asset's in nonaccrual status.

From the standpoint of charge-offs or write-offs, the FASB has proposed a principle for the first time. The FASB's language for write-offs states that the cost basis of a financial asset should be directly reduced in the period in which the entity determines that it has no reasonable expectation of future recovery.

The FASB's wording is not quite the same as the regulatory definition of loss. The banking agencies' guidance says assets classified loss are considered uncollectable and of such little value that their continuance as bankable assets is not warranted. Thus, amounts classified loss should be promptly charged off.

Here again, even though the FASB's wording is somewhat different than the regulatory guidance, we're optimistic that, from a practice standpoint, banks that continue to apply the charge-off policies of the banking agencies using the loss definition that we have in place would be in compliance with the FASB's proposed language on write-offs.

A benefit to having clear GAAP nonaccrual and charge-off principles is that this would enable there to be greater comparability between banks, which currently follow these principles for Call Report purposes and normally for other financial reporting purposes, and other financial institutions that are not supervised by the banking agencies. In addition, companies outside the financial institution sector – manufacturing companies that may finance purchases of their products for example – would also have to apply these nonaccrual and charge-off principles to the loans and receivables they have on their balance sheets.

One other definition to highlight because of changes the FASB has proposed is "collateral dependent." This definition is often a key issue in determining what impairment measurement method should or shouldn't apply to individually impaired loans. Today, the definition of "collateral dependent" generally is that repayment of the loan is expected to come solely from the underlying collateral – either from the sale or the operation of the underlying collateral. However, the definition in the proposal would say that repayment is expected to come substantially from the operation by the lender of the collateral or the sale of the collateral.

Today, when the agencies assess whether a property is collateral dependent from the operation of the collateral, we consider operation of the collateral by the borrower as meeting the definition, but the FASB has proposed to limit the meaning of operation of the collateral to operation by the lender. When banks foreclose on real estate, they are normally required to dispose of the property within a specified period of time rather than keep it as an investment asset for the generation of cash flow.

Of course, the FASB's proposal would apply to lenders outside the banking industry. Perhaps other types of investment organizations, such as real estate investment trusts, can operate collateral and that may be why the FASB has changed the collateral dependent definition.

The FASB may receive comments from various parties questioning the rationale for changing the collateral dependent definition. One other aspect of the definitional change from an application standpoint is that today the use of the fair value of collateral method is required when measuring impairment for GAAP purposes only if foreclosure is probable. That requirement would be removed under the FASB's expected loss model. The use of the fair value of collateral method would still be permitted but it would not be required.

Depending on how the FASB finalizes the standard and how the collateral dependent definition turns out, the agencies may have to revisit some of their policies on impairment analysis for collateral dependent loans.

With that, I think we're ready to turn it back to you, Greg.

Greg Eller: Okay, Bob. The next topic is the effective date and the first thing to note is the FASB has not set any sort of date for implementation of this proposal. Looking at it realistically, however, so far they've covered the four corners of credit loss recognition and measurement. I get the sense, speaking for myself, that they are about ready to put their pencils down and that any changes may be around the margins or otherwise may be the pulling together of the IASB and the FASB – that is, compromise – toward a converged expected loss model.

So what's the earliest possible effective date? We threw out as a target January 1, 2015, and I guess depending on your point of view regarding the proposal that's either an optimistic date or a pessimistic date. But we threw a date out there because we're looking at the implementation of this proposal by banks as something akin to a Y2K sort of project. Since the CECL model represents a significant change from current practice, it would require the development of new data or mining through existing data to establish the timing and amount of cash flows not collected for various types of loans and debt securities – the loss rate underlying expected credit loss – and that is a significant undertaking. Besides collecting raw data, banks will also need to establish robust systems that are up to the task of supporting their financial reporting under the new model. For public companies, those systems will need to be SOX (Sarbanes-Oxley) compliant, so the systems work will not be a trivial task. So our arbitrary date is a device for reminding management and accountants to start their creative juices flowing, thinking about how the bank might apply this standard and figure out a timeline and milestones for implementation, recognizing that the accounting proposal is still somewhat fluid at this time.

Bob Storch: Do you think it's more likely that 2016 or 2017 would actually be the effective date? We're almost at mid-year 2013 and the FASB will have to redeliberate the proposal after the comment period ends before issuing a final standard that provides lead time for education, data and systems preparations, and all those sorts of things.

Greg Eller: Bob, it's hard to say how long a transition period is needed. Looking back over recent standards – recent being over the last 15 years – the proposal for accounting for derivatives and hedge accounting that became a final standard – FAS 133 – had a transition period that was on the order of three years. Implementing that standard was a significant undertaking for those banks that dealt in or used derivatives for end-user purposes. The FASB's expected credit loss proposal is a much more pervasive change in accounting standards, touching every bank that makes a loan or holds a security. So, the FASB's proposal is a significant change and I would think that the implementation date would reflect that. Maybe 2017 is a better guess.

Another issue affecting the selection of the effective date is that this proposal is only one piece of the changes being considered by the FASB for financial instrument accounting. The other one you touched on is classification and measurement of financial assets and liabilities, for which the comment period just closed. Implementing that proposal, if adopted in its current form, could be as daunting as the CECL model, in terms of interpretation of its requirements, systems development, setting accounting policies, and so forth.

So if the FASB intends for both proposed ASUs to be adopted at the same time, which seems like a rational thing to do from the perspective of financial statement users, that would suggest an implementation date farther out in the future. So it's difficult to say with any degree of certainty when these proposals may actually be the basis for preparing financial statements.

The banking agencies have been talking among themselves and with the FASB about whether additional guidance needs to be provided for non-public companies and whether additional lead time is necessary for them, given these companies' resource constraints and special circumstances in that they're not reporting to a diffuse group of investors. So that's yet another issue to fold into the decision about effective date that the FASB will make. But in any event, the key point we're making here is that banks should be monitoring the proposed changes to GAAP now and thinking about implementation as a project in terms of objectives, constraints, and available resources.

The next and final topic is international convergence. Its position as the last item in the slide deck doesn't represent our view on its importance. From the community bank standpoint, however, it's probably fairly low in the grand scheme of things. From the banking agencies' perspective, however, in terms of consistent capital standards (such as Basel III) and a resilient global financial system, the need for international convergence is extremely high.

Looking back at recent history, the FASB and the IASB were fairly closely coupled on an expected loss approach to measuring credit loss up until feedback came in to the FASB last year on the “three-bucket” proposal the two Boards were developing. The FASB heard lot of complaints in the U.S. that such a standard would not be understandable, operational, or auditable. The FASB took that feedback to heart and rethought the model and essentially decided that the “three–bucket” approach was fatally flawed. The FASB and IASB had a difference of opinion, shall we say, on whether the approach was fatally flawed. Since then, the IASB has continued to espouse the “three-bucket” approach, after making some changes to it, and issued a proposal in March. As mentioned earlier, for the IASB’s first bucket, the allowance provides for expected credit losses resulting from default events on assets that are possible within the next 12 months. Financial assets move to one of the other two buckets when credit risk has increased significantly since their initial recognition, which triggers the recognition and measurement of full lifetime expected credit losses.

So the IASB is exploring its path on expected credit loss and the FASB is exploring theirs. The IASB proposal comment deadline is July 5, 2013, should anybody on this call be interested in commenting on it. We are hopeful that at the end of this long process of standard setting, the two paths will converge back to one high quality approach that applies internationally.

Bob Storch: I believe the two boards have agreed that each will review the comments that the other receives on its respective proposal. Hopefully, that will enable some dialogue to take place that will bring the two proposals into a converged position. We’ll just have to wait and see what happens. The length of those discussions also might affect the effective date of the FASB’s final impairment standard.

Greg Eller: Yes, indeed.

Bob Storch: We are ready now to invite the bankers on the line who would like to ask questions to do so. Let's turn the teleconference back to the operator and begin the question session please.

Coordinator: Thank you. If you would like to ask a question from the phone line at this time, press star, then 1, and record your name at the prompt. Please unmute your line when you record your name. Once again, to ask a question, star 1.

Bob Storch: While we're waiting for the first question, we did receive an email question that one banker was kind enough to send directly to me before this teleconference. It would probably be best to just read the question. We can then talk about what the person was asking.

The banker wrote, "I wondered if you could address the allowance calculation mechanics for community banks in the proposal. We currently use a three part summation formula: individual projected losses for impaired loans, actual 12-period weighted average for historical losses applied to the pools of non-impaired loans, and a separate economic conditions factor" – presumably a qualitative factor – "applied to the pool of non-impaired loans. A cursory review of the proposal would lead me to believe that this same formula could be viewed as based on reasonable and supportable forecasts that would work under the proposal. I understand the proposal doesn't specify a method for measuring credit losses. Could you comment?"

Maybe we should first talk a bit about contrasting the way he's determining his loan loss allowance now and then with how we might think the proposal would work.

For the individually projected losses for impaired loans, I think all the commentary I've heard suggests that loans that have already been identified as impaired or troubled, where you're applying FAS 114 today, you are currently supposed to consider reasonable and supportable assumptions and projections when measuring impairment. So, the allowance for an impaired loan probably is not going to be very different, although arguably it will be an expected loss estimate under the FASB's proposal. But both today and under the proposal, you have already identified a specific loan with specific types of problems.

Greg Eller: I would agree with that. The one exception I might mention is say you've got a real-estate-backed loan today that's impaired and you're measuring it under FAS 114. Under GAAP, you're supposed to be looking at current conditions as to that real estate, if that's your primary or an important source of repayment, in your estimate of impairment. But under the FASB's proposal, you would be looking at what real estate prices might do over the period it takes you to wind up that credit. So that may be a difference of degree rather than a real fundamental difference in measurement for such loans, I'd say.

Bob Storch: Yes, I think that your additional comment fits into this banker's observation that reasonable and supportable forecasts would have to be considered, whereas you're not permitted to do that today.

And then the banker's actual 12-period weighted average for historical losses; to the extent that's an annualized average loss rate, that rate would not work as an estimate of expected losses.

Greg Eller: Unless your portfolio consists of one-year-maturity credits, perhaps.

Bob Storch: That's true. I don't know how many one-year loans are out there, but it will take an effort by banks to move from an annualized loss rate to estimating the lifetime losses on the types of loans in their portfolios. What is the bank's loss experience based on tracking the performance of all the loans from a certain year or vintage, how many were repaid and how many didn't fully repay? And, then, adjusting this loss experience for reasonable and supportable forecasts. When we consider the effect of economic conditions on collectibility, that's supposed to be based only on current conditions and past events today. Under the FASB's proposal, going forward, you would also consider future conditions based on reasonable and supportable forecasts.

Right now under current accounting standards, if we were anticipating a declining local economy in the future and the bank expected that this would adversely affect some of its loans a year or 18 months from now, the bank couldn't really factor that future expectation into the allowance as a qualitative factor today. But the FASB's new model would say, "Yes, we have a reasonable and supportable forecast that indicates an economic decline is going to happen because local employers are expected to be facing financial difficulties or other problems." So I think the banker is sort of on the right path.

Greg Eller: Yes, I agree. The big difference under the FASB's proposal – well, it's a matter of degree – is that you take your historical loss experience, which reflects a certain period of time in the past, both in terms of the economy or underwriting, all those other factors combined. The key accounting question will be: is that historical loss experience representative of what you think your losses will be in the future? That is where the forecast will come into play – what is the entity's view regarding the collectability of its portfolio over its remaining life?

So what the banker lays out in his question – it's a good baseline, a good basis for moving into the expected loss model going forward, but there will need to be work done in terms of determining the timing and amount of losses in the types of loans in the bank's portfolio in developing that historical loss experience.

Bob Storch: It would probably be fair to say that there's a good deal of judgment today in making qualitative adjustments to historical loss experience. Now a bank will have to bring a forecast into the picture and how might the collectability of its loans be affected based on the forecasted conditions. This will be a further element of judgment on top of all the existing judgments management has to make.

Greg Eller: Right. So the FASB is taking away the judgment on whether loss is probable, which has been controversial in some situations, and bringing this judgment about reasonable and supportable forecasts into the mix. So determining the appropriate allowance will still be highly judgmental.

Bob Storch: Operator, are there any questions in the queue?

Coordinator: Yes sir, thank you. Our first question is from (Mary Sayshore).

(Mary Sayshore): Yes, good afternoon. Objections to the FASB proposal have centered on assumptions about the need to increase funding of the allowance for expected losses. Is there any evidence or analysis as to what the effect will actually be?

Bob Storch: Do you mean in terms of how much larger allowances would be?

(Mary Sayshore): Correct. Theoretically the losses experienced by an institution should be the same over time but we're talking about a difference in timing as to when and how they're recognized. Is that correct?

Bob Storch: That is correct. I mean, it's primarily a measurement issue, at least as I understand it. Credit loss measurements today are predicated on meeting a probable threshold and that would go away under the FASB's proposal. So, yes, over the life of the portfolio, the losses – that is, charge-offs – would still be the same but presumably you would be providing for them sooner under the proposal than you do today. That's the FASB's effort to address the too-little-too-late criticism of today's incurred loss model.

The example that's cited is that before the financial crisis there was a widely held view, and I think it was proven out at many banks, that credit underwriting had significantly weakened. Yet because those weaker loans hadn't yet met the probable-loss standard, allowances weren't being established at a level commensurate with the risk of the loans. So then when the economy faltered and defaults increased, many banks had to dramatically increase the level of their allowance.

The FASB's model would enable you to build up the allowance sooner, as you see those storm clouds on the horizon. Alternatively, when conditions are improving, you would be able to reduce your allowance level because the expected losses would decline.

So, yes, the conceptual question is in what periods should you measure your provision expense when the overall amount of losses that you're going to sustain from charge-offs on the portfolio over time is not going to be different, regardless of the method you're using to measure those losses.

(Mary Sayshore): So have we had any numbers run on, if we were to implement this proposal say two years from now, what would the allowance look like?

Bob Storch: There are various parties who are trying to perform these types of analyses. One of the drawbacks is that the charge-off data in the Call Report is just annualized data – we don't really have a readily available source ourselves for the lifetime loss data needed under the proposal.

One thing that people have looked at is loss curves and the loss data coming out of different types of loan securitizations. These data typically show an increase in losses in the early years of the lives of the loans and then losses tail off. I think Greg had described that earlier, in terms of how losses typically occur.

And the allowance level at any point in time is really going to depend on what the underwriting standards were that applied to the loans in the portfolio. We've heard various anecdotal estimates that for some types of loans the impact of the proposal may be a 20 to 25 basis points increase. I don't want to say a 25% increase because that sounds huge, but if the allowance level was 1%, it might go up to 1.25%. That type of increase might be for shorter-term loans where most of the losses are already reflected in the allowance today.

I think the concern is what will the estimate be for the longer-term loans. That's where the FASB has attempted to ensure that people aren't misunderstanding the proposal and thinking that the allowance should be a projection of annual losses times the life of the loan. I've heard some people saying for some longer term loans the allowance may be two times the level of today. But there have been some stories suggesting that the allowance will be five to seven times the level today. I haven't seen documentation for an analysis that would back up an estimate of that magnitude of an increase. I would have to see the math and see whether an understanding of the FASB's proposal is really reflected in the outcome.

Greg Eller: Right. Some of the examples I've seen through email say, "My loss rate is 50 basis points per annum today and my loans are ten year average lifetime. I will need to take a five percentage point reserve against that." And that's not accurate for how loans in a static pool lapse into default and loss. The expected loss estimate is not just a straight-line annualized rate.

Bob Storch: If your bank has done an estimation of the effect of the proposal, I think that the FASB would be interested in seeing your calculations. And certainly if you'd want to share them with your primary federal bank regulator too so they can get an understanding of what the impact would be on your bank, that would be helpful.

(Mary Sayshore): Thanks so much for the teleconference and your patient answering of my question.

Bob Storch: You're welcome.

Coordinator: Your next question is from (Tom Cahnus).

Bob Storch: (Tom), do you have a question?

(Tom Cahnus): I did have. I was just waiting to find out if we can get a copy of the recording. But I sent Greg an email so that's okay.

Greg Eller: Okay. I can't tell you the exact timing but it will be available.

Bob Storch: It will be a transcript but not an audio copy.

(Tom Cahnus): Okay, that's fine.

Bob Storch: Operator?

Coordinator: Yes sir. (Glen Jurin) has our next question.

(Glen Jurin): Yes, my question relates to going back to troubled debt restructurings. A lot of times a TDR has been the result of a collateral dependent loan position. How are they taking into effect or is there going to be a change in accounting if you have an A and B structure to adjust your cost basis, which has really been based off of, more than likely, fair value as opposed to the present value of discounted cash flows?

Bob Storch: That's a good question. The FASB did not propose to change anything in the existing troubled debt restructuring literature, other than the adjustment calculation that I mentioned, where you'd have to calculate what the present value of the revised contractual cash flows is to see what sort of adjustment to your cost basis you would need to record.

The A/B structure is recognized in the existing codification – there's a paragraph that talks about it. I'd have to look to be sure if that paragraph will still survive.

Greg Eller: But one thing to consider is the FASB's change in the definition of collateral dependent to essentially where the lender is taking control of the collateral. So if they narrow the definition in that fashion, you may have loans that are collateral dependent today but under that future model they aren't. So it depends on how that plays out.

(Glen Jurin): Excuse me. But in very many cases the regulators are requiring you to basically charge off the B structure so the collateral dependency is just based on the A piece that you really have left.

Bob Storch: Collateral will still be allowed to be considered in terms of estimating expected losses. The notion is that you have to, at a minimum, at least conceptually, consider what is the probability of getting full repayment, including cash flows from the collateral or from the collateral itself, as well as at least one outcome where you would not expect to collect all the cash flows.

So it seems like you'd still be able to do the A/B note structure. It's a regulatory reporting rule that the B note has to be charged off so that you essentially have only one instrument, the A note, on the books. Obviously you can still try to collect the B note that's been charged off. If the two notes remain on the books as assets, they are really being viewed essentially as, in substance, one single instrument with the same source of repayment.

I think there will be more of an ability, perhaps, given the potential change in the collateral dependent definition, to look to cash flow and not so much to the fair value of the collateral, if that's what your bottom-line question is.

(Glen Jurin): Yes, and one last piece is will the collateral dependency definition that's brought about by FASB be adopted for Call Report purposes or will the definition remain the same as it is now?

Bob Storch: I think that's something the agencies collectively will have to talk about since the Call Report instructions are interagency.

By law our regulatory reporting instructions are supposed to be uniform and consistent with GAAP unless certain safety and soundness criteria are not met by a particular GAAP principle. The agencies have tried to avoid creating GAAP/RAP differences. My sense is that there would be a bias toward adopting whatever the new definition is for Call Report purposes rather than having a more-stringent-than-GAAP definition. That will also be something that we would have to talk to our supervisory examination side about as well.

So if the collateral dependent definition changes it's definitely something we'll have to consider adopting for the Call Report. Would there be a valid safety-and-soundness reason not to adopt the revised definition? But we'll have to see the outcome of the comment process and the FASB's redeliberations to find out whether the revised definition survives.

(Glen Jurin): All right, thank you very much.

Bob Storch: You're welcome.

Coordinator: Our next question is from (David Norton).

(David Norton): Good afternoon. My question has changed slightly as a result of the original email question that you addressed earlier. And so it's really developed into two parts.

As it pertains to what was the FAS 5 analysis of the whole of a loan portfolio, it would seem to me in our interpretation of qualitative factors as it applies to that portfolio in essence is already the forecasting tool of what you think would happen to your historical loss numbers going forward into the future. Isn't that what this is trying to address?

Bob Storch: If I understand your question correctly, the qualitative factors we consider today are intended for FAS 5 purposes to assess how conditions today are different than the conditions that existed during your historical loss period since the historical loss data serves as the starting point for your FAS 5 analysis.

Going forward that would still be true, but you'd also have to consider how conditions in the period covered by your reasonable and supportable forecasts are expected to differ from the conditions that existed over the period you developed your historical lifetime loss estimates. Also, how are the conditions reflected in the reasonable and supportable forecasts different than conditions today?

You would have to be more forward-looking in terms of evaluating qualitative factors than is supposed to be done under the FAS 5 model today.

(David Norton): I assume that you're looking out into the future relative to a portfolio of loans' expected life, correct?

Bob Storch: Yes, the expected loss estimates would be for the remaining life of the existing loans. You wouldn't be saying, well I'm going to put loans on two years from now and I have to provide for their expected loss today. That's certainly not what's anticipated.

But the reasonable and supportable forecasts, depending on the type of loan, may cover the entire remaining life of the loan for a relatively short-term loan. The forecasts may be reasonable and supportable for, say, two to three years and you may be using them for general credit risk management purposes as well.

But if you had a loan with a remaining life that is out seven to ten years, I think most people would not feel very confident that you could have reasonable and supportable forecasts out seven to ten years. That's why I think the FASB staff, in the question-and-answer document they issued at the end of March that's available on the FASB's Website, tried to clarify that you are not supposed to be predicting something that might happen seven years from now if your loans will still be on the books then because the presumption is that you really can't develop reasonable and supportable forecasts that far into the future. At that point, if your reasonable and supportable forecasts hypothetically cover the next three years, but the loans are going to wind down over the next seven years for the open portfolio you have now, there will be some level of expected losses out beyond your reasonable and supportable forecast period. The FASB would say you need to factor those additional losses into your overall allowance calculation.

The question-and-answer document indicates – I think Greg alluded to this in his comments – that you would be allowed to say, okay, after that three-year period, we expect that the loss level will revert to its long-term historical average.

(David Norton): Right.

Bob Storch: Or you could assume that the conditions that existed at the end of my hypothetical three-year forecast period will remain in place for the remainder of the seven years. To me, that actually might be an unsupportable forecast because you essentially would be saying, "I think it's reasonable and supportable to assume that the conditions three years from now will continue to exist for the next four years beyond that."

(David Norton): It just seems to me that it really is introducing a crystal ball approach to trying to determine what your future losses are when you try to go that far out, especially for banks that do a fair amount of commercial real estate lending where your amortizations are 20 and 25 years out.

Greg Eller: I wouldn't necessarily characterize it as needing a crystal ball because businesses should generally have a view about the future when they make long-term business decisions. I think that's true for lending, too. Bankers are making an implicit assumption about the future when they decide to make long-term loans versus short-term loans. Hopefully, they don't consult a crystal ball when making those judgments. So, I think the CECL model is essentially taking those lending expectations and incorporating them, or at least getting their flavor, into the expected-loss model. There are some constraints as to whether auditors and others can say, "Yes, that view seems reasonable given what's out there in terms of the forecasts and economic views of experts and it has been adequately supported." So I think there will be some benchmarking of forecasts and I hope it doesn't evolve into being something prescriptive.

Bob Storch: The type of loan you described, commercial real estate loans, is a very prevalent form of lending at our community institutions. As you can imagine, the banking agencies will need to update all of their supervisory guidance pertaining to credit loss estimations so it conforms to the new model.

It would strike me that we'll need to provide some clear guidance to our examiners in terms of what our expectations are for them and for institutions on these types of credit loss estimates so banks will know what the ground rules will be from an examination standpoint.

And I would venture to say that any sort of supervisory policy guidance the agencies develop to assist institutions in understanding how to implement the new model we would be sharing with the FASB staff to make sure that our commentary is not viewed as contradicting something in whatever the final standard says.

So, you raise a very valid point about how you forecast out on these very long-term loans. This will be something that the agencies will have to address to make sure there's an understanding across the board for examiners and bankers.

I imagine the FASB may need to come up with some more implementation guidance in this area as well.

Greg Eller: And while I don't agree that estimating expected losses is a crystal ball exercise, I certainly agree with you that it's highly subjective and therefore difficult to pin down. Developing an expected-loss estimate based on auditable inputs such as historical loss rates and assumptions about current and future conditions will nevertheless have a great deal of subjectivity.

Bob Storch: If this is a significant concern for you in terms of how the model will apply to longer-term types of loans and the speculative nature of the forecasts, which I'm reading into your question, these may be aspects of the proposal you would want to comment to the FASB on.

(David Norton): Most definitely, okay. Yes. Thank you.

Bob Storch: You're welcome.

Coordinator: Next question is from (Bill McCarthy).

(Bill McCarthy): Hi. I think my question was partially answered earlier. I was wondering about the reasonable and supportable forecasts.

I guess what would be, in your mind, would a one year period be enough of a forecast or do you think it's got to be a two-year, three-year type of horizon?

Bob Storch: My view would be it's probably a two-year to three-year period consistent with the horizon for many of the management-type decisions you're probably making within the bank. You need to be looking out beyond one year and even determining how you want to implement your loan policy and what type of lending you want to do. I think it would be advisable to look beyond one year. We'll just have to see what sort of standards apply to demonstrating that a particular forecast is reasonable and supportable, what sort of consensus views there are for different economic indicators, et cetera. But I think one year would be too short really.

(Bill McCarthy): Okay and my second question is related to the allowance but a little bit different.

The question was, the restriction right now that the amount that can be included in Tier 2 capital for your allowance of being 1.25% of risk-weighted assets, has there been any discussion either in this or any other channels about that going away?

That seems like a very subjective limitation that's put on in terms of your includable amount in Tier 2 capital and I just didn't know if you had any comment on that?

Bob Storch: I know that's an issue that gets raised periodically and I think it probably was raised as part of the Basel III comment process that the U.S. agencies had last year on revising the definitions of regulatory capital. I don't know where that's going with respect to the cap on the amount of allowance included in

Tier 2 capital. The 1.25% standard has been part of the risk-based capital rules since Basel I was implemented around 1990.

You could argue that it should no longer be part of Tier 2 capital because, from a regulatory capital perspective, capital is supposed to be for the unexpected losses. And if the allowance is now for the expected losses why are we giving capital credit for something that's already expected? That's my accounting-type hat on.

Whether the Basel Committee wants to revisit that limit, I think we have to go back to the fact that, in 1990, particularly outside the U.S., the allowance calculations were not as well developed as they are today and there were various methods of measuring the allowance.

The inclusion of the allowance up to 1-1/4% of risk-weighted assets was a crude effort to try to harmonize internationally and recognize the fact there were different ways of estimating allowances in different countries and so forth.

If we ultimately have converged allowance accounting standards, that would perhaps argue for the 1.25% limit to go away entirely rather than being increased, which might not have been the direction you were suggesting that the Tier 2 credit for the allowance should go in.

(Bill McCarthy): Okay, thank you.

Coordinator: Our next question is from (Howard Hoff).

(Howard Hoff): First of all, thank you so much for doing this Webinar. I found it very informative.

The question I have is if you look at the reasonable and supportable forecasts and estimates of future losses, would you believe that given the fact that we can assume that the economy is getting better today that our forecast would actually then forecast, industry-wide, for lower losses so we would see the allowances going down? That's the first part of my question.

My second part is as examiners do you believe this is going to make it harder or easier for you to evaluate the allowances at the banks that you regulate?

Bob Storch: Let me try the second question first. I think there's going to be a learning curve both for bankers and examiners on evaluating the allowance and getting a good feel for what really are reasonable and supportable forecasts, what are credible life-of-loan loss estimates, and so forth. The need for good discussion and dialogue between examiners and bankers has always been important. I think it will be even more important with the FASB's proposed approach. The documentation supporting a bank's implementation of the new model would go a long way in helping the examiner understand what the banker's thought process was.

Going back to the question about improving economic conditions, if that's a consensus view of the people who have the expertise in making those types of forecasts, that – in my mind at least – will be something that bank management would be taking into account in estimating expected losses. Presumably, when examiners are checking for compliance with the accounting standard they would also be looking at these forecasts and how management considered them. This suggests that the expected losses in an improving economic environment would be less than – or may be less than – the expected lifetime losses over a historical loss period.

The question I would ask though would be what period of time was the bank's lifetime expected loss calculation developed over? If it was only developed over the last four or five years where there were stressed economic conditions, then it probably makes sense for allowances to be lower than the lifetime loss rate on the loans on the books during that period. But if a bank – and I'm not suggesting community banks are in a position to do this – but some banks, perhaps larger ones, may have data on the loss experience of loans originated over the last 20 years or so where there have been a variety of economic conditions and the historical average lifetime loss rate reflected conditions that are consistent with what the forecasts are going forward, in that case your historical loss experience number may not need to be subject to a downward adjustment for a view of improving economic conditions because it's already embedded in the historical loss number.

The other thing we always hear about – and examiners observe this quite frequently – is that when conditions are getting better that's the time when banks start to make bad loans because they loosen their underwriting standards. So you've got to counterbalance your view of what you see going on with the economy with what you as the lender are doing in terms of your own underwriting standards. Are you loosening them, which suggests higher losses perhaps than your historical experience would show? Historical experience over the long term perhaps evens out the varying economic conditions and the varying underwriting standards that are being applied. I don't think any single qualitative or forecast factor by itself would say, yes, the allowance has to go up or, yes, the allowance has to go down. You really have to look at the aggregation of factors that have a bearing on the collectability of the loan portfolio as you look forward.

Greg Eller: And just to chime in, the FASB answers that specific question in its Q&A document. If you look at Q&A Number 14, what it says is: should the entity's assessment of current conditions and reasonable and supportable forecasts about the future always serve to increase the reserve estimates? The FASB staff answers the question by saying no it's doesn't only serve to increase the estimate, so there can be expectations about the future where you can reduce the allowance, based on the guidance the staff provides under Q&A 14. I agree with Bob's comment that you can't latch on to any one particular element to a forecast but you have to look at things in total in making a decision as to whether future expectations are for lower credit losses than the historical average.

Bob Storch: And of course even under today's incurred loss model, we're seeing some banks support reductions in their allowances. But, go ahead, sir.

(Howard Hoff): The other question I have relates to the fact that my bank is only 7 years old. So my historical experience is only 7 years so that banks that have a longer history are going to have more data.

Have you given any thought to how that might impact, you know, if I have portions of my portfolio where I've never had a loss. If I've never had a loss in, say, commercial real estate owner-occupied, and now I'm going to project forward how would I do that because my history is short?

Bob Storch: Right. The FASB's proposal indicates that you have to assume at least two possible outcomes. And each one will be associated with a probability – not to suggest you have to do a probability-weighted analysis – but conceptually you have to assume an outcome that you will be fully repaid and another outcome that you will not be fully repaid.

Depending on the type of loan and collateral and your experience, that's all going to weigh into, hypothetically, whether you say there's a 98% chance you're going to get fully repaid and a 2% chance of a loss of 10%, or whether it's a 60% chance of 100% repayment and a 40% chance you're going to lose 50 cents on the dollar on every one of those loans.

I think there is the expectation that where you don't have the lifetime loss data yourself, your bank would at least be able to reference the experience of others in that type of lending to get a sense for what lifetime losses would be. But then, qualitatively, you would need to consider your underwriting criteria and the fact that you haven't had losses.

And that could support a favorable adjustment to the loss experience that was based on the experience of a broad spectrum of lenders whose underwriting standards may not have been the same as yours – or may have been worse than yours – and their loss experience also may have been over a longer period of time. Even a bank that's been open only one year and doesn't yet have loss experience of its own would still have to look to what the lifetime loss experience is for the various types of loans in its portfolio as a starting point. This will probably be an area where more guidance will be needed both for our examiners and banks.

(Howard Hoff): Thank you.

Coordinator: Our next question is from (Greg Schmidt).

(Greg Schmidt): Thank you. Some of the discussion is factored in around the concept of the auditability of these forward views. It seems to open up a question on where the SEC is on this proposal and the potential conflict with Sarbanes-Oxley. Has there been any writing or analysis along those lines?

Greg Eller: I haven't been involved in any sort of discussions of that kind. I'm sure the SEC has its methods of communicating with the FASB. The Big Four certainly will be commenting to the FASB on the proposal. And I would imagine they will touch on auditability. It is a significant issue because the allowance is a critical accounting estimate. It's highly subjective and there isn't a lot of data, as our previous caller clearly indicated, for some banks to latch onto. There is going to be a high degree of subjectivity to the estimate, but that is true today also. Auditors must get comfortable with the estimate and the methods by which that estimate was derived by management before they issue an opinion. So auditability is certainly something the FASB is aware of. However, they have to weigh the relevance of financial information – and this measurement of expected credit loss is more relevant to financial statement users than the current probable loss model – against the reliability of that financial information. Something that's highly auditable and therefore reliable is not necessarily all that useful. It's going to require a balancing act on the part of the FASB to get to a position in their final standard that makes available more useful information that improves financial reporting but is not undermined by not being especially reliable.

Bob Storch: For public companies, from our informal conversations with the staff at the Public Company Accounting Oversight Board (PCAOB), which sets the auditing standards that the auditors of public companies have to follow, they are very well aware that the FASB has proposed to change the accounting model for credit losses.

If you've seen PCAOB inspection reports, they have been critical in a number of cases with the quality of the audit work on the loan loss allowance under the existing incurred loss model that some of the audit firms have done on some of their financial institution audits. So I'm sure expected loss estimates are going to be an area where the PCAOB will try to provide more clarity to what's expected of an auditor when they're auditing these estimates given the significant number of judgments that will need to be made and what sort of audit documentation there should be.

If you are with a public company, you may want to discuss the FASB's proposal with your auditor and have those discussions inform any comments you would want to make to the FASB, not just from an accounting policy standpoint but from an auditability standpoint as well.

(Greg Schmidt): Thank you.

Coordinator: Next question is from (Javier Ramirez).

(Javier Ramirez): Okay. My question is more in line with the previous question, but maybe trying to use a real-life example like going back to 2008. You know, I can understand where we are, we got hit pretty hard on the East and West Coasts and we were able to prepare ourselves because it kind of trickled into us and the other parts of the United States. But if I remember correctly, in the early 2000s to 2005 the economy was moving pretty steady. And then as we got into 2007, if I recollect, the economy was still moving and all of it was mostly due to the real estate market. If the real estate values drop, you know obviously it's going to slow down. But nobody anticipated this bubble to burst the way it did. So my concern is in talking about when we will have to increase reserves. As we start doing some acquisition and construction loans and you're looking out one to three years, but nobody's going to know when that bubble's going to burst. But we kind of get an idea.

So am I supposed to anticipate or say, well the bubble's going to burst anytime, we just don't know when? So, using that live example, how would you as regulators want to look at it, you know, as calculating our forecast?

Bob Storch: I would think that if there's a concern that increases in real estate prices will stop and then reverse and drop dramatically, there would need to be some credible evidence to support such a forecast and not just a concern that there is a risk of a price decline out there. Obviously, that's always a risk.

That question may take us back to the distinction I mentioned earlier about the allowance being for expected losses and capital being for unexpected losses. If your construction loans are two to three years in length and assuming they were soundly underwritten at the time for whatever type of construction lending you're doing, are there any clear signs on the horizon suggesting that your expectations about home sales in the subdivision or the completion of an income-producing property and its startup phase are no longer reasonable? Presumably you were evaluating the expected economic conditions going forward when you decided whether to underwrite that loan or not.

In other words, if you're making a three-year construction loan, presumably you've made some judgments already about the viability of that loan over the coming three year period when you decide whether to underwrite it. When estimating expected credit losses, I don't think it's anticipated – actually, I know it's not anticipated – that you're supposed to assume a worst case scenario. That's very clear from the FASB's proposed standard. So, if there's no evidence that there's going to be a run-up and then a run-down in real estate values in the near term that can be demonstrated in a reasonable and supportable forecast, that would be a type of risk that capital should be supporting and it should not be factored into the allowance calculation.

Greg Eller: Yes, I would agree with that. I mean events that would seem to have been obvious in retrospect, like house prices can't go up forever, were not readily foreseeable and predictable beforehand. You can only have a view about what the future has to bear and that prediction may not be right for a host of reasons. I don't think you'll be examined or audited in retrospect and criticized for being wrong in your forecasts if they were reasonable and supportable based on the evidence at the time. All forecasts turn out wrong in some fashion. Hopefully, some are less wrong than others. Hopefully, entities won't be looked at with the benefit of 20/20 hindsight if that's what your concern is.

(Javier Ramirez): Yes, I think that's it but, you know, back in 2008 we saw some things happening, but nobody expected what was going to happen.

Where we live real estate was still going real well, construction, residential was still going real well. There wasn't any indication that the prices were going to drop until after the bubble burst. So that's where we got hit. I think everybody got hit, we didn't know the bubble was going to burst when all those big financial institutions went down.

Greg Eller: Sure, I understand that. I think one of the elements to keep in mind is you're estimating your allowance quarterly so you should be updating your forecasts quarterly as well. As those sorts of events that are in the range of possible outcomes start to look more likely to happen, then that increase in risk should be crystallizing in each successive quarter's estimate of credit loss as things become more clear and actually happen.

Bob Storch: I would add that, from the commentaries I've heard, if the FASB's proposed model had been in place in 2007, everyone acknowledges that the expected loss allowances would have been higher than those determined under the current model because banks should have been taking into account the effect of the loosening of underwriting standards and so forth. But no one could have anticipated how severe the economic downturn actually turned out to be and in some markets how substantially real estate prices dropped. So, the proposed CECL model isn't going to solve that kind of a problem. Instead, the argument would be that you'd be better positioned when a severe downturn occurs because your expected loss allowance will be larger going into it. You would still need to be increasing your allowance to reflect all the current conditions and the forecasts about how dire the downturn is expected to be. But the increase in credit loss provisions shouldn't have as adverse an effect on your earnings and capital because your starting point for the allowance would be higher. And going back to one of the first questions, your credit losses are whatever they're going to be – how borrowers perform isn't influenced by the bank's allowance methodology. It's a question of what period you measure your credit losses in.

(Javier Ramirez): Okay, thanks.

Coordinator: I show no further questions, gentlemen.

Bob Storch: Okay, thank you very much. We sincerely appreciate everyone's participation in this teleconference this afternoon. I guess it's technically still morning on the West Coast. Again, thank you for participating.

As we mentioned earlier there should be a transcript available later this month on the FDIC's Website so look for that if you think it would be useful to further your understanding of the proposal.

In addition, we encourage you to comment to the FASB, make your views known on what the impact of the proposal would be on your institution and what difficulties you see in implementing the proposal if you see difficulties. If you support the proposal, let the FASB know that as well.

Going forward, once we have a clear indication about the contents of the final standard, we will need to provide education and training to our examination staff so they're prepared for the implementation of the new impairment model. We certainly expect to update our existing supervisory policy guidance pertaining to the allowance so bankers will have a feel for what we expect them to do when applying the new standard.

If you have additional questions after this call, the Financial Institution Letter announcing this teleconference provides our contact information. If you have questions as well for the FASB staff, in our experience they're quite responsive. The names and email addresses for the FASB staff who are leading this project are on the FASB's Website.

Thank you very much and we wish everyone a good rest of the day. Thank you.

Coordinator: Thank you for participating on today's conference. You may disconnect at this time.

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