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Financial Asset Impairment Reserves

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On January 31, 2011, the Financial Accounting Standards Board (FASB) issued for public comment a proposed approach for recognizing impairment allowances on financial assets.[1] The intent of the proposed model is to improve the timeliness of reporting about the underlying credit quality of an institution's financial assets. The standard is a direct response to the criticism that deterioration in credit quality is not transparent when institutions follow backward-looking models based on historical loss experience to set reserves for anticipated future credit losses. The standard states: "The FASB proposed this approach because the FASB believed it resolved the concern with respect to the current guidance on impairment that reserves tend to be at their lowest level when they are most needed at the beginning of a downward-trending economic cycle (the 'too little, too late' concern)."

An earlier FASB proposal suggested immediate recognition of anticipated losses on all financial assets. The International Accounting Standards Board (IASB) had also issued a proposal to address the deficiencies in its incurred loss approach to recognizing impairment. The IASB proposal embedded adjustments to reflect increases in credit risk in the interest rate used to amortize the financial asset's value. This approach would decrease the amount of interest revenue recognized each period, effectively recognizing any change in expected credit risk over time (a "time-proportional" approach). The IASB's model results in an allowance that would be insufficient to cover impairment losses if the losses were to occur in the near term, which

[1] *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities—Impairment.*

is a significant concern given the short term funding of institutions' assets. Therefore, the FASB's proposal was viewed as more conservative because its approach required the immediate write off of the total expected loss in the value of the financial asset (i.e., loan principal less the value of expected recoveries).

The Shadow Financial Regulatory Committee believes that both of these earlier proposals moved in the right direction in recognizing the changes in the underlying credit quality of financial assets. However, the Committee believes that the FASB's original proposal would have provided an earlier indication of a change in the credit quality of financial assets in an portfolio. In contrast, the IASB's time-proportional approach, by recognizing the impairment over time, obfuscates any structural shift in the quality of the portfolio. Thus, in the context of the financial crisis, the IASB approach would have provided a less timely signal of the increased emphasis on subprime lending within banks' loan portfolios prior to the deterioration of the subprime market.

The FASB's new proposal issued in January 2011 and currently under comment was prepared following discussions with the IASB and represents an effort at collaboration between the standard setting bodies. The new FASB proposal would require an institution to record an impairment reserve as a function of its intended strategy for recovery of the asset's cash flows. If the institution intends to pursue recovery of the underlying asset, for example through foreclosure, the financial asset is considered to be in the "bad book." If the institution is not pursuing recovery, the financial asset is in the "good book." The FASB's language is that a financial asset belongs in the bad book when "…the collectibility of a financial asset, or group of financial assets, becomes so uncertain that the entity's credit risk management objective changes for that asset or group thereof from receiving the regular payments from the debtor to recovery of all or a portion of the financial asset."

For financial assets in the bad book, the entire expected credit loss over the life of the financial asset (i.e., the impairment in its value) is recognized immediately. Thus, the current proposed model retains the FASB's original approach in the case of financial assets in the bad book. For financial assets in the good book, the impairment allowance would be the greater of expected credit losses for the foreseeable future and the reserve amount computed using the time-proportional approach. This approach establishes a floor for the impairment allowance for financial assets in the good book that is related to the likelihood that the allowance can be reliably measured. The rationale for the difference in the impairment allowance approach between the good book and the bad book is that the anticipated losses in the bad book are likely to be more significant and therefore should be recognized despite concerns about measurement reliability.

In summary, the Committee views setting reserves for anticipated credit losses associated with financial assets based on forward-looking information to be an important element of increasing transparency about the activities of the financial institutions and their capital adequacy. Even if the current FASB proposal is not as strong as its original proposal, the Committee views the collaboration of the IASB and the FASB to move toward a common proposal as a positive feature of the current proposal.