**Financial Advisory Roundtable Meeting**
**June 6, 2014**
**Recent Financial Reporting Developments and Near-Term Significant Proposals for Financial Instruments Affecting Banks**
**Stephen Ryan**

1. <u>Recent Significant Standards Affecting Securitizations and Repurchase Agreements: FAS 166 and FAS 167 (Effective 2010) and Subsequent Guidance and Proposals</u>
   a. Underlying issues
      i. To obtain sale/largely off-balance sheet accounting for securitizations, transferors must both qualify for sale accounting and not consolidate the securitization entities
         1. For repurchase agreements, transferors must only qualify for sale accounting, because there are no entities to consolidate
      ii. Under prior GAAP (FAS 140), a securitization would qualify for sale accounting if the transferor answered three questions regarding whether it retains control over securitized assets "yes"
         1. Assets are isolated from transferor
         2. Transferee can pledge or exchange asset
         3. Transferor does not maintain effective control over assets

         If the transferor answered any question "no", then it would account for transaction as a secured borrowing/on-balance sheet
      iii. Under prior GAAP (FIN 46(R)), transferors would
         1. Not consolidate the vast majority of securitization entities that were passive qualifying special purpose entities (QSPEs)
         2. Consolidate other securitization entities if they bore the "majority" of the risks and returns of the entity
   b. Main accounting provisions
      i. FAS 166 requires transferors to apply more judgment and probabilistic thinking in evaluating whether they maintain effective control over the securitized assets
      ii. FAS 166/167 eliminated QSPEs, so all securitization entities are evaluated for consolidation
      iii. FAS 167 requires transferors to consolidate securitization entities if they
         1. control the activities of the entities that "most significantly impact" the entities' economic performance
         2. retain "potentially significant" risk and rewards in the entities
   c. Main disclosure provisions
      i. FAS 166 requires disclosures of securitizations accounted for as secured borrowings and repos accounted for as sales
      ii. FAS 167 requires extensive disclosures of continuing involvements in securitization entities, whether or not consolidated
      iii. Oz (2013) finds disclosures reduce information asymmetry/equity bid-ask spreads
   d. Effects on banks to date
   e. Proposal to exempt "agents" (as opposed to "principals") from consolidating variable interest entities
      i. Generalize ASU 2010-10's current exemption for investment funds
      ii. Affect any of banks' entities?

f. Repo-related subsequent guidance and proposal
    i. ASU 2011-3 eliminated large repo haircut as reason why transferor surrenders effective control over repo securities
    ii. Similarly motivated proposal to eliminate repo to maturity as reason why transferor surrenders effective control over repo securities

2. Proposed Financial Instrument Recognition and Measurement ASUs (issued in February and April 2013, considerable recent decisions made to revise proposal, final ASU scheduled for second half of 2014)
    a. Intent is to make recognition and measurement comparable across types of financial instruments regardless of legal form (e.g., securities, loans, liabilities)
    b. Proposed model for debt-like instruments, both assets and liabilities, is similar (but not identical) to that for investment securities under FAS 115
        i. Trading: fair value on balance sheet, both realized and unrealized gains and losses recorded in net income
        ii. Available-for-sale: fair value on balance sheet, realized gains and losses recorded in net income, unrealized gains and losses recorded in other comprehensive income
        iii. Held-to-Maturity: amortized cost on balance sheet, realized gains and losses recorded in net income, unrealized gains and losses not recorded
    c. Proposed model

| | | **Cash Flow Characteristics of Financial Instrument** | |
|---|---|---|---|
| | | *Generate contractual cash flows (debt instruments)* | *Other (equity or hybrid instruments)* |
| **Business Model of Holder of Financial Instrument (can change over time; while changes should be rare, no tainting)** | *Hold to receive contractual cash flows* | Amortized cost on balance sheet, realized gains and losses recorded in net income, unrealized gains and losses not recorded | Fair value on balance sheet, realized and unrealized gains and losses recorded in net income (subject to practicability exception and "equity method" used if equity investment provides sufficient control over investee) |
| | *Hold to receive contractual cash flows or sell* | Fair value on balance sheet, realized gains and losses recorded in net income, unrealized gains and losses recorded in other comprehensive income | |
| | *Hold to trade (includes short sale liabilities)* | Fair value on balance sheet, realized and unrealized gains and losses recorded in net income | |

    d. Other interesting aspects of proposal
        i. Fair value option is only available for jointly managed groups of financial instruments, not unconditionally or for hybrid instruments
        ii. If the reporting firm fair values its own debt under the fair value option, then the portion of the gain or loss associated with its own credit risk is recorded in other comprehensive income, not net income
        iii. Most loan commitments and other forms of contingent lending remain unrecognized on balance sheet
    e. Likely effects?

3. <u>Proposed Credit Losses on Financial Assets ASU (issued in December 2012, some recent decisions made to revise proposal, final ASU scheduled for second half of 2014)</u>
    a. Intent is to make credit loss recognition and measurement comparable across types of financial assets regardless of legal form (e.g., securities, loans)
    b. Proposed "expected" credit loss model
        i. Accrue for expected credit losses over the whole life of assets, even if they are new or currently performing
        ii. Jettison current "probable" and "can be reasonably" estimated requirements to accrue credit losses on loans under FAS 5's incurred loss model
        iii. Include losses associated with "reasonable and supportable" forecasts of losses based on current information
        iv. Expected/forecasted losses must pertain to existing financial assets
            1. Not dynamic loss reserving
        v. Proposal does not match credit losses with interest revenue accrued on credit risky but currently unimpaired assets
            1. Effective interest rate equals internal rate of return that equates amount lent to present value of promised (not expected) cash flows
            2. *Expected c*redit losses (not just credit risk) increase effective interest rate
            3. Increment to interest revenue associated with expected credit losses is earned over life of instrument (until any default)
    c. Likely effects of proposal
        i. Compared to existing GAAP
            1. For securities (FAS 115 OTT impairment)
            2. For loans (FAS 5 incurred loss model)
        ii. Compared to dynamic loss reserving
        iii. Across business cycle
            1. In middle of boom or bust
            2. On front edge of boom or bust
    d. Would it affect findings of research on the benefits of banks' timely loan loss reserving/better credit risk modeling
        i. Less loan origination procyclicality (Beatty and Liao 2011, Bhat et al. 2013)
        ii. Better risk management decisions (Bushman and Williams 2013)
4. <u>Other Possible Items for Discussion</u>
    a. Current accretion of excess interest on previously written-down securities, because the cannot be directly written up when their expected cash flows rise
    b. Minimal convergence on financial instruments between the FASB and IASB.