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## **FASB Staff Position 115-2 Accounting for Debt Security Impairments (OTTI)**

June 25, 2009

# Overview

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- ✦ FSP FAS 115-2 amends U.S. generally accepted accounting principles (GAAP) for recognition and measurement guidance related to Other Than Temporary Impairment (OTTI) of available-for-sale and held-to-maturity *debt* securities.
- ✦ It does not amend existing recognition and measurement guidance related to OTTI of *equity* securities.
- ✦ It also improves the presentation and disclosure of OTTI for debt and equity securities in the financial statements.

# FAS 115-2 Guidance

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- ✦ Under FSP FAS 115-2, an impairment for debt securities is separated into the **credit loss** amount recognized in earnings and the amount related to all other factors (**non-credit loss**) recognized in other comprehensive income, net of applicable taxes.
- ✦ If the “intent” to sell OR it is “more likely than not” that an institution will be required to sell the security before recovery of its amortized cost basis, OTTI equal to the entire difference between the security’s amortized cost basis and its fair value shall be recognized in earnings.
- ✦ Otherwise, if the “expectation” is that the company will not be able to recover the entire amortized cost basis, the OTTI shall be separated and recognized as follows:
  - ✦ The credit loss amount shall be recognized in earnings.
  - ✦ The non-credit loss shall be recognized in other comprehensive income (OCI), net of applicable taxes which is similar to existing accounting for unrealized losses of AFS securities.
- ✦ The credit loss component is the difference between the present value of the cash flows expected to be collected and the amortized cost basis where NPV definition is consistent with SFAS 114.

# Implementation Timeline & Adoption

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- ✦ The FSP is applied to existing and new investments held by an entity as of the beginning of the interim period in which it is adopted (for example, as of April 1, 2009, if an entity adopts the FSP for periods ending after June 15, 2009).
- ✦ The transition provisions require the institution to recognize the cumulative effect of initially applying FSP FAS 115-2 as an adjustment to the opening balance of retained earnings with a corresponding adjustment to accumulated other comprehensive income (**AOCI**). In other words, previous loss recognition of a non-credit component of impairment is reclassified from retained earnings to AOCI. The adjustment shall be calculated in accordance with paragraph 45 of FSP FAS 115-2.

# Net Present Value & Impairment Calculation

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- ✦ Net Present Value Inputs:
  - ✦ Expected Cash Flows :
    - ✦ Principal
    - ✦ Interest
    - ✦ Principal Loss (Reduction in receipts)
    - ✦ Interest Loss (Reduction in receipts)
    - ✦ Insurance Coverage - amount recovered from insurer on defaulted cash flows.  
*\*If Applicable*
  - ✦ Cash Flows Modeling - can be modeled a variety of ways for determination of NPV:
    - ✦ Examples:
      - ✦ Observed Loss Severity Rates
      - ✦ Geographical Default and Foreclosure Rates
      - ✦ Delinquency Transition Rates
      - ✦ Underlying Collateral Analysis
      - ✦ Third Party Cash Flow Models
      - ✦ Historical similar collateral performance
    - ✦ Models should be consistent and replicable across entire portfolio.
    - ✦ Expected Principal Payments drive other cash flow variables in model.

# Net Present Value & Impairment Calculation *(cont)*

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- ✦ Discount Rate - used to calculate NPV of cash flows. :
  - ✦ No single prescribed method for discounting of cash flows:
    - ✦ Management discretion as to most appropriate discount factor comes into play for determination of discount rate.
    - ✦ Variety of discount rates can be used to assign appropriate risk to cash flows:
      - ✦ Effective Yield of Asset
      - ✦ 10 year Treasury Bond yield plus spread (risk premium)
      - ✦ Swap Spreads plus additional spread (equal to risk premium)
      - ✦ Entity Level Weighted Average Cost of Capital
      - ✦ Yield Curve approach to account for term approach to interest rates
- ✦ Calculating the NPV
  - ✦ After calculating nominal expected cash flows, discount at chosen discount factor and sum all DCFs to arrive at expected present value of cash flows of asset.
  - ✦ Periodic modeling is not a static process – at each measurement period, an assessment of proper discount rate and expected cash flows needs to be conducted to insure proper PV calculation at each period in changing market conditions.

# Net Present Value & Impairment Calculation *(cont.)*

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- ✦ Impairment Calculation Inputs:
  - ✦ Book Value (BV) – This is the basis in the security. For example, the sum of UPB and the Unamortized Balance of all deferred items (e.g. premium/discount, deferred price adjustments, etc.)
  - ✦ Fair Value (FV) – Market value under FAS 157 guidance.
  
- ✦ Calculating the Impairment
  - ✦ BV minus the NPV of security
    - ✦ If positive value, no impairment is created for OTTI
    - ✦ If negative value, the difference is the impairment
      - ✦ This value is the OTTI credit loss recognized with a charge to earning. Book value is then reduced to the present value of security.

NOTE: In general, any additional decrease in the PV of the expected cash flows below the new book value would result in an additional OTTI. However, improvements in the PV of the expected future cash flows are accounted for as a prospective adjustment accretable to yield through interest income.

# Day 1 Accounting – Adoption

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✦ The adoption date effectively becomes April 1, 2009 with the cumulative effect entry hitting OCI, Retained Earnings and Deferred Taxes.

✦ Adoption Accounting Facts:

- ✦ Previously Booked Cumulative Impairments (Positions at 04/01) (300)
- ✦ NPV Less BV at 04/01/2009 - (e.g. \$1,200 - \$1,300) (100)
- ✦ Change in Retained Earnings as a result of FSP 115-2 Adoption 200

<b>Sample Journal Entries at Adoption</b>	<b>DR</b>	<b>CR</b>
OCI	200	
Retained Earnings		200
Deferred Tax Asset *	70	
OCI		70

\* Assumes 35% Tax Rate

# Day 1 Accounting – Post Adoption

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## Accounting Facts – Day 1

✦ Fair Market Value (FMV) of Security (FAS 157) (Input from 157 Valuation pre-impairment)	80
✦ Book Value (BV) Pre OTTI (FAS 91/115) (assumes no premium/discount)	100
✦ Net Present Value (FSP 115-2)	92
✦ Resulting Credit Impairment	(8)
✦ Book Value Post OTTI (FSP 115-2)	92
✦ Non-Credit Loss (i.e. Unrealized Loss)	(12)

## Key Relationships:

$NPV - BV = OTTI \text{ Impairment (i.e. Credit Loss)}$

$FMV - BV \text{ Post FSP 115-2} = \text{Non-Credit Loss (i.e. Unrealized Loss)}$

# Day 1 Accounting – JE Post Adoption

<u>Journal Entry</u>	<u>DR</u>	<u>CR</u>
Initial Book Value at purchase (Day 0)	100	
Cash (Day 0)		100
<b><u>Post-OTTI Determination Journal Entries</u></b>		
BS MBS Assets – Credit Impairment – Non-Accrutable		8
P&L – Credit Impairment Loss (Non-Accrutable)	8	
BS MBS Assets – Unrealized Loss		12
BS OCI – Unrealized Gain/Loss	12	
<b><u>Resulting Account Balances</u></b>		
Security Book Value	92	
Unrealized Gain/Loss		12
<b>Fair Market Value of Asset</b>	<b>80</b>	
Non-Interest Income - Realized Credit Loss	8	* Closed to Retained Earnings
OCI Balance	12	
<b>Total Reduction in Equity</b>	<b>20</b>	

# Subsequent Accounting – Post Initial Impairment

## Accounting Facts – Subsequent Measurement Periods

$$FMV_1 - 80 \qquad FMV_2 - 70 \qquad FMV_3 - 87$$

$$\Delta FMV_{2,1} = FMV_2 - FMV_1 = 70 - 80 = (10)$$

$$\Delta FMV_{3,2} = FMV_3 - FMV_2 = 87 - 70 = 17$$

$$NPV_1 - 92$$

$$NPV_2 - 91$$

$$NPV_3 - 94$$

$$\Delta NPV_{2,1} = NPV_2 - NPV_1 = 91 - 92 = (1)$$

$$\Delta NPV_{3,2} = NPV_3 - NPV_2 = 94 - 91 = 3$$

$$BV_1 - 92$$

$$BV_2 - 91$$

$$BV_3 - 91$$

$$\text{Where, } BV_{2,1} = BV_1 \pm NPV \text{ Deterioration} \pm \text{Accretion (FAS 91)} \pm \text{Volume } \Delta \text{ (FAS 115)} = 92 - 1 \pm 0 \pm 0 = 91$$

$$BV_{3,2} = BV_2 \pm NPV \text{ Deterioration} \pm \text{Accretion (FAS 91)} \pm \text{Volume } \Delta \text{ (FAS 115)} = 92 \pm 0 \pm 0 \pm 0 = 92$$

NOTE 1: No accretion in period 1 as credit impairment is not accretable

NOTE 2: Assumes no pay-downs or other amortization for the period

NOTE 3: The \$3 of NPV recovery in period 3 will be reclassified to accretable

# Subsequent Accounting Entries – Period 2

<u>Journal Entries – Period 2</u>	<u>DR</u>	<u>CR</u>
BS MBS Assets – Credit Impairment – Non-Accrutable		1
P&L – Credit Impairment Loss (Non-Accrutable)	1	
BS MBS Assets – Unrealized Loss [(21) – (12)]		9
BS OCI – Unrealized Gain/Loss	9	
<b><u>Resulting Account Balances</u></b>		
Security Book Value	91	
Unrealized Gain/Loss		21
<b>Fair Market Value of Asset</b>	<b>70</b>	
Non-Interest Income - Realized Credit Loss	9	* Closed to Retained Earnings
OCI Balance	21	
<b>Total Change in Equity from Day 0</b>	<b>(30)</b>	

# Subsequent Accounting Entries – Period 3

<b>Journal Entries – Period 3</b>	<b>DR</b>	<b>CR</b>
BS MBS Assets – Credit Impairment – Accretable		3
BS MBS Assets – Credit Impairment – Non-Accretable	3	
BS MBS Assets – Unrealized Loss [(4)-(21)]	17	
BS OCI – Unrealized Gain/Loss		17
<b>Resulting Account Balances</b>		
Security Book Value	91	
Unrealized Gain/Loss		4
<b>Fair Market Value of Asset</b>	<b>87</b>	
Realized Credit Loss/Retained Earnings	9	
OCI Balance	4	
<b>Total Change in Equity from Day 0</b>	<b>(13)</b>	

**NOTE: \$3 of accretable impairment will start accretion (for example, \$.50) in period 4 as a component of Net Interest Income**

# Financial Reporting & Disclosure Updates

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- ★ The FSP amends FAS 130, *Reporting Comprehensive Income*, to require presentation of unrealized gains and losses on AFS securities for which an OTTI has been recognized separately from unrealized gains and losses on AFS securities for which an OTTI has not been recognized.
- ★ The FSP also requires disclosure of the unamortized unrealized loss relating to impaired HTM securities within OCI and AOCI.
- ★ Additionally, as part of the revised disclosures required by paragraph 19 of FAS 115, an entity must separately disclose the total OTTI recognized in AOCI by major security type.
- ★ Paragraph 43 of the FSP also requires a tabular rollforward in each interim and annual reporting period of the amount related to credit losses recognized in earnings. The account being rolled forward is a memo account relating to cumulative credit loss activity recorded in income on impaired debt securities for which a portion of the impairment is recorded in OCI. The focus here for investors being the disclosure of additional credit losses recognized on securities for which a credit loss had previously been recognized, as this may provide some indication of management's ability to accurately estimate credit losses on a timely basis.

# Financial Reporting - Prior Period Comparability

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- ✦ The cumulative effect of adopting the FSP is recorded within shareholders' equity as of the adoption date, essentially restating opening retained earnings. Because prior income statements are not restated, the FSP may impact the comparability between current and prior period financial statements.
- ✦ Example:
  - ✦ An entity may recognize an OTTI in the first quarter of 2009. Upon adoption of the FSP in the second quarter of 2009, the cumulative effect entry would effectively reclassify the non-credit portion of the previously recognized loss from retained earnings to AOCI.
  - ✦ When the debt security is sold, the loss in AOCI will be recognized, which results in that charge being recorded in income twice.
  - ✦ The FSP may also have an impact on reported investment yields on OTTI debt securities.
  - ✦ Because prior financial statements are not restated, disclosure of these comparability considerations should be considered.

# Things to watch out for....

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- ✦ **Audit Considerations:** Discount rates and cash flows consistent with other applications within the company and industry. Consistency of inputs with other accounting standards (e.g. 157, 114, 91, etc.).
- ✦ **Financial Reporting:** Explanation of prior period incomparability and adoption of new disclosure requirements.
- ✦ **Impact on Capital Measurement and Capital Planning:** The regulatory capital treatment of losses on debt securities has *not* changed. Note that the new accounting guidance may result in a different amount of non-credit losses on available-for-sale and held-to-maturity debt securities being recognized in OCI instead of earnings. These non-credit losses in AOCI will be added back as part of unrealized losses in determining Tier 1 capital.
- ✦ **Operational Considerations:** Updates to sub-ledgers, chart of accounts, reporting infrastructure, etc.

# Contact Information

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