NAREIT Alert (June 23, 2016)

NAREIT Alert Important Industry Updates from NAREIT

June 23, 2016

On June 16, the Financial Accounting Standards Board (FASB or Board) issued a final Financial Instruments – Credit Losses Standard (the Standard). The Standard will require more timely recognition of credit losses associated with financial assets. The scope of the Standard is not limited to financial institutions; rather, its scope is asset-based. The Standard will be of particular interest to Mortgage REITs that invest in loans and debt securities.

Consistent with some of NAREIT's recommendations in its submission, the Standard:

- Is not applicable to operating leases;
- Will allow the credit loss allowance to be based on management's "best estimate";
- Defines the time horizon for developing an expected credit loss based on the expected life of an asset; and,
- Permits the reversal of previously recorded credit losses.

Scope

The Standard will apply to financial assets, which include:

- Loans;
- Loan commitments;
- Held-to-maturity debt securities;
- Financial guarantees;
- Finance-type leases;
- Reinsurance receivables; and,
- Trade receivables.

Overview of the Current Expected Credit Loss (CECL) Model

The Standard requires that entities measure all current expected credit losses for financial assets held at the reporting date based on historical experience, current market conditions, and reasonable and supportable forecasts. The Standard does not prescribe a specific credit loss methodology, which will allow for management judgement in determining the estimation method that is best suited for its financial assets.

The recognition of a credit loss will be required at *inception* of the loan or finance-type lease receivable. The credit loss will be based on management's estimate of the full amount of credit losses that are expected to be incurred. Generally, the initial estimate of the credit loss and subsequent changes to the estimate will be recognized in net income. The credit losses will be recorded through an allowance for loan and lease losses in the balance sheet.

The CECL methodology represents a fundamental change from current U.S. GAAP. Current U.S. GAAP requires recognition of credit losses based on an "incurred loss" methodology that delays recognition until it is probable that a loss has been incurred. This model was highly criticized after the financial crisis as requiring companies to recognize an insufficient and untimely amount of credit losses.

Available-for-Sale Debt Securities

The Standard does not change the current guidance related to measurement of credit losses for available-for-sale debt securities. However, the Standard will require that credit losses be recorded through an allowance for credit losses and will allow subsequent reversals in credit loss estimates to be recognized in current income. The allowance will be limited by the amount that fair value is less than the amortized cost.

Transition

The Standard requires entities to apply the amendments through a cumulative-effect adjustment to retained earnings as of the beginning of the first reporting period in which the guidance is effective. Thus, the Board chose a modified-retrospective approach by not requiring entities to restate prior periods presented upon the adoption of the Standard.

Effective Date

For public companies, the Standard is effective for fiscal years beginning after Dec. 15, 2019, and for interim periods within those fiscal years. Thus, the Standard will be effective beginning on Jan. 1, 2020 for publicly traded REITs.

The FASB will permit early adoption for all entities for fiscal years, and interim periods within those years, beginning after Dec. 15, 2018.

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