Additional Clarifications to CECL Model

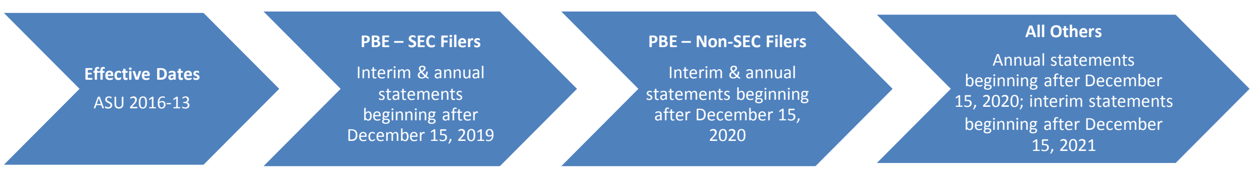
The effective date is slowly drawing nearer for the new credit impairment standard, Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, commonly referred to as CECL (Current Expected Credit Loss). Several large banks have indicated they plan to parallel test the CECL model for a full year starting in 2019 and have generated detailed questions on how the model will work.

The Transition Resource Group (TRG) for Credit Losses recently met to discuss these critical implementation issues. The group was formed to solicit, analyze and discuss stakeholder issues. These meetings inform the Financial Accounting Standards Board (FASB) about implementation issues and help the board determine what, if any, action will be needed to address those issues. The TRG group includes senior accounting professionals from large financial institutions as well as community banks, credit unions and both international and regional accounting firms. Banking regulators observing this meeting included Jeffrey Geer, Office of the Comptroller of the Currency; Sarah Chae, Federal Reserve Board; and Robert Storch, Federal Deposit Insurance Corporation. The conclusions and next steps are summarized below.

Future standard-setting meetings will begin in the third quarter of 2018. FASB is cognizant of concluding on these issues in a timely manner to permit adequate time for system development for 2019 parallel testing.

Other issues raised to the TRG will be discussed by FASB at a July 2018 meeting:

- Request for a one-time election to apply the fair value option (FVO) to existing financial instruments on adoption. This would allow entities that choose to elect FVO for instruments going forward from having two different accounting models for portfolios (CECL and FV).
- As written, nonpublic entities with calendar year-ends would have to calculate their allowance for credit losses on January 1, 2021, due to quarterly reporting requirements. This would not allow any additional time for nonpublic business entities to implement the standard.



Official Agenda Items

Capitalized Interest

How should entities consider interest amounts that will be earned when estimating expected credit losses, when following a method other than the discounted cash flow (DCF) method?

The allowance for credit losses should be based on amortized cost at the reporting date. Unearned future interest resulting from interest deferral features should not be considered, *e.g.*, a four-year deferred student loan or zero coupon bond. It would be inappropriate to calculate an allowance on a nonexistent asset. Capitalized interest should **not** be treated the same way as a discount.

FASB staff noted that entities are not precluded from applying the CECL guidance in a manner that results in an allowance that increases (or decreases) over time as amortized cost basis increases (as a discount is unwound) or decreases (as a premium is unwound) when using a non-DCF methodology, *e.g.*, loss rates. An example was provided in the meeting materials, but TRG members felt it was inoperable given current systems.

FASB's clarifications will be incorporated into a technical corrections project that will include an exposure draft and full due process.

Accrued Interest

Diversity in practice exists between entities on the presentation, nonaccrual policies and the reversal of accrued but not collected interest on financial assets. Within entities, practice differs on nonaccrual treatment of available-for-sale (AFS) debt securities, loans and credit cards.

As written, ASU 2016-13 includes accrued interest in the definition of amortized cost basis. Currently, IT systems do not track accrued interest on an individual loan basis needed for CECL pooling and vintage disclosure requirements.

TRG members agreed that including accrued interest in amortized cost was theoretically sound, but operationally challenging. In general, for large institutions, systems that calculate interest income and accrue for amounts not yet collected are separate from credit risk management systems. In general, interest earned but not collected is presented as an accrued interest receivable in other assets, separate and apart from the loan balance. As written, ASU 2016-13 requires presentation of the accrued interest in the amortized cost basis of the loans in the same balance sheet line item. Because of the current separate tracking of loans and accrued interest, required vintage disclosures also would be challenging. Costly and extensive changes to systems and processes would be required to meet these requirements.

FASB acknowledged the operational challenges in its amortized cost basis definition and will consider a practical expedient that would allow entities to:

- Estimate expected credit losses on accrued interest separately from the related loan balances
- Continue current practices for the presentation of accrued interest, *e.g.*, in other assets
- Disclose the accrued interest amounts included in amortized cost for the vintage disclosure table by:
    - Including the amounts in the vintage year and class of financing receivable amounts
    - Including the amounts in the class of financing receivable amounts only
    - Not including them in any amounts and adding a footnote to the table that states the total amount

These changes will be included in a set of technical corrections.

How should the reversal of accrued interest be reflected in the statement of operations when a loan is placed on nonaccrual status?

Regulated entities must follow the regulatory guidance for the accrual and nonaccrual of interest income and generally use the same methodology for financial reporting. These institutions have systems and processes to track accrued interest separate from the individual loan balances. Their current practice for reversing accrued interest is to debit the appropriate interest income line in the income statement, regardless of whether the interest was accrued in the current period or a prior period. Nonregulated financial institutions also have established internal nonaccrual polices that may be similar to regulatory guidelines but can be more subjective.

FASB's intent in updating credit loss guidance was **not** to change existing nonaccrual practices; however, ASU 2016-13 requires the write-off of uncollectible financial assets, including any accrued interest. These amounts would be deducted from the allowance for credit losses. Current regulated nonaccrual policies specifically allow the reversal of accrued interest through interest income. Changes from current practice would require substantial system updates and could have an effect on the net interest margin ratio, which is widely used by financial analysts.

FASB was sensitive to concerns raised and will consider a solution that provides flexibility for regulated and nonregulated entities:

- For entities with nonaccrual policies, the reversal of accrued interest applicable to a loan placed in nonaccrual status may be accomplished through a debit to interest income and a credit to the amortized cost basis of the loan. Because the accrued interest that will not be collected will be reversed through interest income, it should not be required for these entities to measure an allowance on accrued interest.
- For entities that do not follow a nonaccrual policy, the reversal of accrued interest should be accomplished through a partial write-off of the amortized cost basis, *i.e.*, by debiting the allowance and crediting the amortized cost basis. Because the accrued interest amounts will be reversed through the allowance, these entities would be required to measure an allowance on accrued interest.

These changes would be included in a set of technical corrections. FASB also will consider how to include accrued interest on AFS securities and provide greater clarity on the substantiveness of nonaccrual policies.

Transfers Between Classifications

TRG members came to a consensus on the accounting treatment for various classification changes noted below. TRG members and regulators did not agree on the presentation—financial institutions preferred net presentation while FASB and the regulators preferred gross presentation.

How should the guidance apply when transferring credit-impaired debt securities classified as AFS to held to maturity (HTM)?

For individual AFS debt securities, Accounting Standards Codification (ASC) 326-30 requires an entity to determine whether a decline in FV below the amortized cost basis has resulted from a credit loss or other factors. Any impairment relating to credit losses should be recorded through an allowance for credit losses. The allowance is limited by the amount that the FV is less than the amortized cost basis, *i.e.*, the allowance floored at the debt security's FV. Any changes in FV unrelated to credit losses are recorded through other comprehensive income (OCI) as unrealized gains or losses.

At the transfer date from AFS to HTM, the debt security is recorded at its FV, which becomes the security's new amortized cost basis. Any unrealized gain or loss in OCI—those amounts that have not been recorded through an allowance for credit losses—remain in OCI and are accreted or amortized to income over the remaining life, similar to the treatment of a discount or premium. This amount will directly affect the security's yield.

Because the transfer from AFS to HTM is **not** considered an acquisition, the debt securities cannot be accounted for as purchased financial assets with credit deterioration (PCD) when transferred. Stakeholders are concerned that the requirement to record an expected credit loss under ASC 326-20 will duplicate the previously recorded AFS security's allowance.

FASB will consider amendments to avoid a potential double count of the credit allowance. Upon transfer of debt securities from AFS to HTM, an entity would reclassify any credit allowance for the AFS security to the HTM security to avoid double counting. The security would be transferred at its amortized cost less any remaining unrealized gain or loss at the transfer date. The remaining unrealized loss would continue to be reported in OCI but would be amortized over the security's remaining life. The HTM security would then be evaluated for losses under ASC 326-20. The meeting materials provided the example in Appendix A.

How should the guidance apply when transferring loans classified as held for sale (HFS) to held for investment (HFI)?

HFS loans are **not** in the scope of the expected credit loss standard. These loans are reported at the lower of the amortized cost basis or FV. The amount that the amortized cost basis exceeds FV is accounted for as a valuation allowance, and changes in the valuation allowance are reported in the period of the change in net income. When a loan HFS is transferred to HFI, it must be transferred at the lower of the amortized cost basis or FV. Because the transfer from HFS to HFI is **not** considered an acquisition, the loan cannot be accounted for as a PCD asset. As currently written, the standard could require an entity to record an expected credit loss under ASC 326-20, which would be unnecessary if the entity had previously recorded a valuation allowance for the HFS loan.

FASB proposed a solution that would apply to both mortgage, covered by guidance in ASC 948-310, and nonmortgage loans, covered by guidance in ASC 310-10. Upon transfer of loans from HFS to HFI, an entity would reverse any previously recorded valuation allowance and determine if a credit allowance is required under ASC 326-20. The meeting materials provided the example in Appendix B.

Both changes will require standard setting, separate from the technical corrections required for the first two issues.

Recoveries

Should future expected cash receipts from a financial asset that has been written off or may be written off in the future (expected recoveries) be included in the calculation of **pool-level** expected credit losses?

Can expected recoveries be included in the estimate of credit losses when assessing **individual** assets?

TRG members generally agreed recoveries could be included in the estimate of expected credit losses if reasonable and supportable. No consensus was reached in how expected recoveries on charged-off assets should be considered in the credit loss estimate.

They also agreed there should not be a difference between pool-level and individual assessment; therefore, recoveries could be included in the estimate of expected credit losses if reasonable and supportable, either at a pool or individual assessment level.

FASB will clarify language to make its intent more obvious through a set of technical corrections.

Should expected recoveries be included in the calculation of the allowance or directly through a write-up of the financial asset at an individual level?

Because the estimation of expected recoveries is an input to the overall calculation of the allowance for credit losses that offsets the expected amount of loss, it relates to the measurement of the underlying asset and, therefore, should be included as part of the valuation account; the individual financial asset should not be adjusted..

No further work expected.

Can the estimate of expected recoveries exceed their amortized cost?

Entities have historical practices to deal with this situation when it occurs. FASB concluded these practices do not violate the concepts in ASC 326. FASB's intent was to avoid changing practice for write-offs; therefore, this issue is best handled by individual institutions.

No further work expected.

Refinancing & Loan Prepayment

Are entities **required** to use the loan modification guidance in ASC 310 to determine whether a refinancing constitutes a prepayment for measuring expected credit losses under ASC 326?

ASC 326 requires entities to consider the effect of estimated prepayments on the measurement of expected credit losses. Under the current incurred model, expected prepayments have not been a significant input into allowance calculations, so practice has not been established as to what constitutes a "prepayment" for the purposes of calculating the allowance for credit losses. This lack of a unified definition has led to a diversity in views around how to consider certain transactions or events for the purposes of estimating prepayments under ASC 326. It is common for loans to be refinanced with lenders before maturity, whether through a contractual modification or the creation of a new loan agreement, the proceeds of which are used to repay the existing loan. ASC 310 provides a framework for assessing whether these refinancings are new loans for purposes of determining recognition of fees and other costs. There is no specific guidance in ASC 326 to assess whether these events are prepayments for the purposes of estimating expected credit losses.

ASC 326 does not define a specific framework for prepayments and—consistent with other elements of CECL—whether a transaction or amendment should be considered to be a prepayment is a matter of professional judgment. While the framework in ASC 310-20-35-9 through 35-12 may provide one approach to considering prepayments, it is not the only approach, and for many types of loans it may not represent an approach that is either conceptually appropriate or operationally feasible.

TRG members agreed entities should not be required to use the loan modification guidance in ASC 310 to determine what constitutes a prepayment. An entity should not be precluded from using the guidance if the entity determines the guidance provides an appropriate basis for determining prepayments given its specific portfolios and facts and circumstances.

No further work expected.

Other Technical Inquiries

These inquiries were addressed directly with the parties raising each issue. FASB wanted to share them publicly because they may have broader applicability.

Loans & Receivables Between Entities Under Common Control

Loans and receivables between entities under common control are not in the scope of ASC 326-20. Does this scope exception apply at the parent or subsidiary level?

It was FASB's intent to provide this scope exception at **all** standalone reporting levels, both parent and subsidiary.

Gains & Losses on Subsequent Disposition of Leased Assets

A lessor's net investments in leases is within ASC 326-20's scope. At the end of the lease or upon early termination, these lessors may either sell or re-lease the leased assets for additional cash flows. How should these expected gains be considered in the CECL allowance?

Entities should estimate expected cash flows from the subsequent disposition of leased assets when calculating expected credit losses on a portfolio of net investments in leases if that estimate is reasonable and supportable.

Billed Operating Lease Receivables

Which guidance covers billed operating leases?

As currently written, operating leases are not within ASC 326's scope. Operating leases are covered by ASC 842 and any change in assessment for collectibility should be recognized through lease income. However, billed operating leases do meet the definition of a financing receivable and FASB may address this further at a future meeting.

Conclusion

The adoption of this ASU will be complex and likely will require significant hours to implement correctly. BKD can help educate your team, provide implementation tools and assist with analysis and documentation. If you would like assistance complying with the CECL standard, contact your trusted BKD advisor. BKD has prepared a library of **BKD Thoughtware®** on this topic. Visit our Hot Topics page to learn more.

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Appendix A – Debt Security Transfer from AFS to HTM

In 20X1, an entity purchases a debt security and classifies the security as AFS. The entity purchased the debt security at par for $1 million. At year-end, the entity reports that the debt security's FV has declined below the amortized cost basis to $900,000. Part of the decline has resulted from a credit loss, which the entity estimates is $80,000.

Accounting Entries – 20X1

DR. AFS Security	1,000,000	
CR. Cash		1,000,000
Purchase of Debt Security		
DR. Provision	80,000	
CR. ALCL-AFS		80,000
Record Allowance for Credit Losses		
DR. Unrealized Loss – AFS	20,000	
CR. AFS Security		20,000
Remainder of Fair Value Loss – Recorded to OCI		

Balance Sheet – Year-End 20X1

Assets	
AFS – Debt Security (Net of Allowance for Credit Losses and Unrealized Loss, 80,000 and 20,000, respectively)	900,000
Other Comprehensive Income	
Unrealized Loss – AFS Debt Security	20,000

Income Statement – Year-End 20X1

Expenses Provision	
Debt Security	80,000

At the beginning of year 20X2, the entity decides to transfer the debt security from AFS to HTM. The following illustrates the accounting entries proposed by the staff to transfer a credit-impaired AFS debt security to HTM. This illustration ignores the accretion of the unrealized loss. In addition, the allowance for the HTM debt security is the same as the allowance previously established for the AFS debt security. Therefore, no income statement impact is required because of the reclassification of the allowance. Any effect on income statement ("true up") from a change in allowance upon transfer would be reflected in earnings as of the transfer point.

While this illustration is a simple transfer of one security, the measurement of allowance for credit losses on HTM securities is performed on a pool basis, which would change the allowance and transfer calculations.

However, the mechanics of the transfer are reflected through this illustration.

Accounting Entries - 20X2

DR HTM Security	980,000	
CR AFS Security		980,000
Transfer Debt Security to HTM		
DR ALCL-AFS	80,000	
CR ALCL-HTM		80,000
Reclassify Allowance on the AFS Debt Security		

Balance Sheet - Year End 20X2

Assets	
HTM - Debt Secuity (Net of Allowance for Credit Losses and Unrealized Loss, 80,000 and 20,000, respectively)	900,000
Other Comprehensive Income	
Unrealized Loss - Debt Security	20,000

Appendix B – Loan Transfer from HFS to HFI

In 20X1, an entity issues a loan and classifies the loan as HFS. The entity issued the loan at par for $1 million. At year-end, the entity reports that the loan's FV has declined below the amortized cost basis to $900,000.

Accounting Entries – 20X1

DR. Loan – HFS	1,000,000	
CR. Cash		1,000,000
Issuance of Loan at Par		
DR. Other Expense	100,000	
CR. Valuation Allowance – Loan – HFS		100,000
Record Valuation Allowance		

Balance Sheet – Year End 20X1

Assets	
Loan – HFS (Net of Valuation Allowance, 100,000)	900,000

Income Statement – Year End 20X1

Expenses	
Other Expense – Loans – HFS	100,000