FASB Tackles CECL Questions

The effective date for the new credit impairment rules may still be a long way off (see Appendix A), but early planners and software developers are raising very detailed questions. Some points were clarified but much more work remains.

The Transition Resource Group (TRG) for Credit Losses met for the second time on June 12, 2017, to discuss a variety of implementation issues related to the new credit impairment standard, Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* frequently referred to as the current expected credit loss (CECL) model. The group was formed to solicit, analyze and discuss stakeholder issues arising from implementation of the new guidance. 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 and credit unions, international and regional accounting firms and a senior equity analyst. Banking regulators observing the meeting included Wes Bricker, chief accountant, U.S. Securities and Exchange Commission (SEC); Jeffrey Geer, associate chief accountant, Office of the Comptroller of the Currency; and Joanne Wakim, chief accountant, Federal Reserve.

The issues discussed at this meeting will not lead to amendments to the revenue standard. Consensus was reached on some topics, but further discussion is required on others.

While the TRG members' views are nonauthoritative, entities should consider them as they implement the new standard.

1. Consideration of Prepayments in the Discount Rate Used in a Discounted Cash Flow (DCF) Method

Entities are free to choose what method to use in determining their allowance for credit losses (ACL). If an entity elects a DCF approach, additional guidance requires the use of the asset's effective interest rate (EIR). The EIR definition is the same one used for interest income recognition, which, in most cases, **does not consider expected prepayments**. However, all financial assets (whether or not they are using a DCF method) must measure credit losses over a specific term, **which includes prepayments**. For prepayable financial assets, both loans and securities, the inconsistency in the term used to calculate the EIR and the projected expected cash flows affects the credit allowance's accuracy. Prepayment expectations would cause the net amount expected to be collected to be less than the amortized cost basis, if the loan or security is held at a premium. An entity would be required to record an ACL, even though no credit losses are expected. Similarly, prepayment expectations will always offset the ACL for assets held at a discount.

TRG members agreed that entities should be given a choice—through an accounting policy election—to use an adjusted EIR when using the DCF method. The adjusted EIR can be applied to a class of financial receivables within a portfolio segment. The adjusted EIR should be periodically updated to match any changes in prepayment expectations.

2. Scope of Purchased Financial Assets with Credit Deterioration Guidance for Beneficial Interests Within Accounting Standards Codification (ASC) 325-40

How should contractual cash flows be determined when assessing if a beneficial interest is within the scope of purchased financial assets with credit deterioration (PCD) accounting?

Beneficial interests are generally created through the securitization of a pool of fixed income financial assets. In a tranche structure, multiple classes of beneficial interests (or tranches) are issued, distinguished by a hierarchy of subordination. These structures will have a predefined cash flow "waterfall" that specifies the order in which principal and interest cash flows will be distributed to each security issued.

As defined by ASU 2016-13, PCD assets, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination. An entity is required to gross-up the amortized cost basis of a PCD asset by the estimated amount of credit losses at the date of acquisition. The gross-up is recorded on an asset-by-asset basis to establish the amount of accretable discount. Subsequent changes in credit are recognized through earnings immediately through an adjustment to the ACL.

Under ASU 2016-13, contractual cash flows determine if a beneficial interest should be considered a PCD asset for estimating credit losses; unfortunately, ASU 2016-13 does not define the term contractual cash flows. For corporate bonds, principal and interest payments are spelled out in the indenture agreement so determining contractual cash flows is straightforward. For beneficial interests, cash flows are dependent on the performance of the underlying collateral pool, and the determination of contractual cash flows is more complicated. TRG members were presented with two potential approaches:

- View A – Contractual cash flows are determined assuming both zero credit losses and prepayments. Since prepayments are not contractually required, the determination of contractual cash flows should exclude prepayment assumptions. This approach would result in more beneficial interests being considered PCD assets because there will be a significant difference in expected cash flows and contractual cash flows if prepayments are excluded from contractual cash flows. This would result in a larger initial gross-up on Day One that limits the number of subsequent yield adjustments.
- View B – Contractual cash flows are determined by assuming zero credit losses and expected prepayments. Contractual cash flows would represent the stream of cash flows that the investor would receive if the underlying assets do not experience any credit defaults but prepay in accordance with the entity's expectations at acquisition. This approach would limit the number of beneficial interests that would be considered a PCD asset.

TRG members agreed that View B was the preferred approach. This view limits the scope of beneficial interests treated as PCD assets only to those tranches that are expected to absorb significant credit losses.

3. Transitioning Purchased Credit-Impaired (PCI) Pools

Can entities apply the election to maintain pools at the time of adoption only, or both at the time of adoption and on an ongoing basis?

Since the criteria for a PCD asset differ from the existing guidance for PCI assets, ASU 2016-13 provides transition relief so entities are not forced to re-evaluate existing holdings under the new guidance. Assets accounted for as PCI assets under ASC 310-30 would be classified as PCD assets at the date of adoption.

Unlike ASC 310-30, PCD accounting does not permit a pooling for any purpose other than measuring credit losses; any noncredit discount or premium on the pool of acquired assets must be allocated to each individual asset. Upon adoption of ASU 2016-13, there may be several changes to how pooled PCI assets would have previously been accounted for:

- Interest income will be based on the unit of account at an individual asset level.
- Write-offs will be determined at an individual asset level, whereas under ASC 310-30 entities may not have applied their write-off policies to pooled PCI assets and, instead, reflected amounts deemed uncollectible in the expected cash flows of the pool.
- A modification of a PCD asset that is a troubled debt restructuring (TDR) will be accounted for as such, whereas under ASC 310-30 TDR accounting is not required to be applied when assets are accounted for in a pool.

The ASU's language is unclear whether this transition relief applied only at the date of adoption.

Participants from the larger banks did not see much of a benefit grandfathering and maintaining existing PCI pools after transition. However, for smaller banks, credit unions and nonbank entities, the transitional relief for PCI pools only at transition would be extremely limited. Day Two operational challenge would be significant due to less sophisticated systems that may not maintain amortized cost basis for individual loans in a pool. Smaller entities would be challenged in allocating a credit allowance down to a single unit of account for existing PCI pools. The lead time for the standard's adoption should permit smaller entities to enhance systems to capture the necessary data for future PCD assets.

TRG members agreed that entities should be given a choice—through an accounting policy election—that the transition relief afforded existing pools of PCI assets can apply both at adoption and on an ongoing basis. Entities that elect to maintain existing PCI pools after adoption would not be able to remove assets from the pool until they are paid off, written off or sold (following existing guidance), but would be required to follow the guidance in ASU 2016-13 for interest income and the ACL.

4. Accounting for Troubled Debt Restructurings

Should entities forecast all types of reasonably expected future TDRs on a portfolio basis and include the effect of those reasonably expected TDRs in the calculation of expected credit losses?

A TDR is a loan modification intended to reduce credit losses and may include interest rate reductions, balance forgiveness or extensions of the contractual term. Two views were presented for the determination of reasonably expected TDRs that extend the contractual term in their estimate of credit losses. (TDRs that do not extend the contractual term, *e.g.*, interest rate concessions, should already be included in the estimate of credit losses.)

- View A – Entities should forecast reasonably expected TDRs that extend the contractual term on a **portfolio basis** and include the effect of those reasonably expected TDRs in the calculation of expected credit losses. Under this approach an entity would project future TDRs that affect the contractual term based on historical data, current conditions and future expectations. This would result in earlier recognition of credit loss.

- View B – Entities should extend the term over which they are measuring credit losses when a TDR is reasonably expected at an **individual financial asset level**, *i.e.*, the loan for which a TDR is expected can be specifically identified, and include the effect of that reasonably expected TDR in the calculation of expected credit losses. Entities would consider TDRs that extend the contractual life only when an entity expects to execute modification with an individual borrower. This would result in later recognition of credit losses relative to View A.

All attendees agreed that the alternatives presented would not change the amount of impairment, only the timing of recognition. The regulators present strongly supported View A. Geer noted one of the new CECL model's benefits was the elimination of thresholds for loss recognition. He noted that reasonable and supportable expectations on all TDRs should be reflected in calculation of expected credit losses. Waiting for specific identification of a TDR would reintroduce one of the limitations of the current incurred loss model, which would delay loss recognition.

All the banking representatives preferred View B due to the perceived complexity and cost of View A.

No consensus reached. Further discussions required.

5. Determining the Estimated Life of a Credit Card Receivable

Should all principal payments expected after the measurement date be applied to the credit card receivable balance existing at the measurement date until that balance is exhausted, or should those payments be allocated between the measurement date balance and future purchases?

Determining the estimated life of a closed-end loan such as a mortgage is readily determinable from tracking historical payments. Credit card expected lives are more challenging due to the revolving nature of the lending agreement, especially for balances that never reduced to zero. Existing regulations under the *Credit Card Accountability Responsibility and Disclosure Act* of 2009 (CARD Act) drives the way financial institutions track balances, calculate finance charges and apply payments. The CARD Act dictates the application of payments based on the balance's annual percentage rates, *e.g.*, when credit cards offer promotional rates for cash advances or balance transfers.

How expected payments are applied could have a significant effect on the estimated life of the credit card receivable, which would affect the size of estimated credit losses. Generally, the longer the estimated life of a credit card receivable, the greater the expectation of future default.

TRG members were presented with these views along with illustrative examples of each approach:

- View A – When evaluating the estimated life of a credit card receivable balance, all expected principal payments, *i.e.*, payments after finance charges and fees assessed have been paid, should be applied to the measurement date balance until that balance is extinguished using a first-in, first-out method. This approach treats the measurement date receivable balance as if it were a closed-end loan.

- View B – When evaluating the estimated life of a credit card receivable balance, all expected principal payments, *i.e.*, payments after finance charges and fees assessed have been paid, should be applied to the measurement date balance **and** anticipated future draws.

Some TRG members noted that View B was conceptually flawed since it could result in a credit loss recorded on unfunded amounts. View A was generally seen as less complex and costly to implement than View B. However, questions arose on the availability of historical data—existing data includes additional draws—and the appropriateness of adjusting data to fit the closed-end View A model. The examples provided failed to clearly distinguish between the two approaches.

The regulators noted that either approach was acceptable as long as these conditions were met:

- Entities should always segregate balances that are paid in full every month from those that carry an outstanding balance. Failure to do so would incorrectly shorten the expected life of the credit card portfolio.
- Entities should be consistent in the way they project future payments and their approach for estimating credit losses, "apples to apples," per Wakim. If an entity chooses to consider unfunded amounts in determining the estimated life for credit card receivables, it also should allocate payments to principal and interest considering the unfunded balances.

No consensus reached. Further discussions are required.

BKD will continue to monitor this project. Visit BKD's Hot Topics page to learn more.

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Appendix A

CECL Implementation Dates*			
Entity	**2020**	**2021**	**2022**
Public Business Entity (PBE) – SEC Filers	Interim & Annual		
PBE – Small (Non-SEC Filer)		Interim & Annual	
All Others		Annual	Interim
** Early adoption permitted for all entities for periods beginning after December 15, 2018*			