FASB's Current Expected Credit Loss (CECL) Model: Interpretative Issues

Session 21
Wednesday, Sept. 18, 2018
Presented by members of the AICPA Depository Institutions Expert Panel (DIEP) and FASB Credit Losses Transition Resource Group (TRG)

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Panelists

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AICPA Depository Institutions Expert Panel (DIEP)

FASB Credit Losses Transition Resource Group (TRG)

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Agenda

- AICPA Credit Losses Task Force
  - Composition
    - Depository Institutions Expert Panel (DIEP)
    - Insurance Expert Panel (IEP)
  - Objectives
  - Recent activities
- FASB Transition Resource Group (TRG)
  - June 2018 meeting
  - November 2018 meeting
- Questions (and Answers)

Cecil the Lion

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AICPA Credit Losses Task Force Activities

- FASB ASU 2016-13, "Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments," issued June 16, 2016
  - Different types of accounting issues
    - Working closely with FASB staff
    - Different paths to resolution
  - Auditing
    - Auditor expectations
    - IAASB, ASB, PCAOB developments
  - Requests of the AICPA
    - Provide a forum for issue identification and discussion
    - Serve as a "clearing house" for issues as needed
    - Serve as a vehicle to update of the AICPA A&A Guide

FASB Transition Resource Group (TRG)

AICPA Depository Institutions Expert Panel (DIEP)

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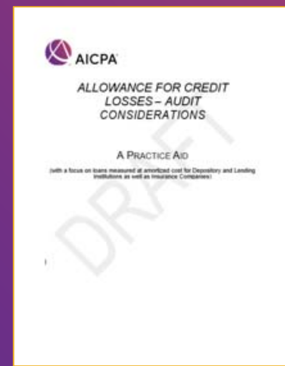
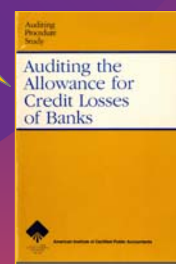
AICPA Credit Losses Task Force Activities

- Objectives
  - AICPA Practice Aid
    - Similar to the alternative investments practice aid from 2006
    - Helpful for preparers to understand auditor expectations
  - AICPA CECL Audit & Accounting Guide
    - To document and communicate conclusions reached, for example:
      - By the TRG
      - By the DIEP or other AICPA panels
      - By other stakeholders
    - To include practice aid for auditor expectations
- “Issues” Tracker
  - Provide issues and proposed resolution on AICPA’s website for public input



Circa 1986



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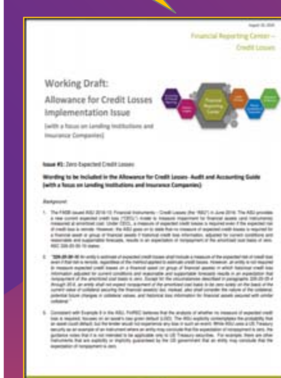
AICPA Credit Losses Task Force Activities

- Zero Credit Loss (Issue 1)
  - CECL allows assumption of zero credit losses where expectation of non-payment is zero.
  - Types
    - US Treasury Bonds
    - Securities issued by Ginnie Mae, a US agency
    - Fannie Mae and Freddie Mac MBS (Agency MBS)
- Reasonable & Supportable Forecasts and Reversion (Issue 22)
  - Determining the reasonable and supportable period requires judgment
  - Consider consistency with other forecasts made or used
  - Is the reversion approach a practical expedient?

Out for Comment



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Where Have We Been?

- FASB TRG Meeting - June 11, 2018
  - No. 7 Cover Memo, which includes staff responses to 3 technical inquires
  - No. 8 Capitalized Interest
  - No. 9 Accrued Interest
  - No. 10 Transfer of Loans from Held for Sale to Held for Investment and Transfer of Credit Impaired Debt Securities from Available-for-Sale to Held-to-Maturity
  - No. 11 Recoveries
  - No. 12 Refinancing and Loan Prepayments
- FASB Board Meetings
  - August 29, 2018 – action on TRG topics
  - Sept. 5, 2018 – approved staff to proceed with drafting proposed ASU for Codification Improvements

June 12, 2017 Agenda

No. 1 Discounting Expected Cash Flows at the Effective Interest Rate

No. 2 Scope of PCD Assets for Beneficial Interests

No. 3 Transition Guidance for PCD Assets

No. 4 Accounting for Troubled Debt Restructurings

No. 5 Determining the Estimated Life of a Credit Card Receivable

No. 6 Summary of Issues and Next Steps

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Accrued Interest

- Sub-Issue 1: Should accrued interest be included in Amortized Cost?
  - View A – Yes
  - View B – No. Provide practical expedient:
    - Accrued interest may be reported separately (and disclosed)
    - Consider collectability of accrued interest separately (consistent with Sub-Issue 2)
    - Either include amounts in vintage tables (by class of finance receivable or both vintage year and class) or disclose total amount as footnote to vintage tables
  - View C – No. Remove from definition of Amortized Cost
- FASB conclusion:
  - Provide practical expedient (View B)

Discussed at June 11, 2018 TRG meeting and at August 29, 2018 Board meeting

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Accrued Interest

- Sub-Issue 2: Where should interest reversal go on income statement?
  - View A: Two separate entries: credit loss expense & interest income
    - "Reversal" of accrued interest = reversal of interest income
    - Elimination of accrued interest results in decrease in amortized cost basis, resulting in simultaneous decrease in allowance – credit loss expense
  - View B: No income statement impact
    - Similar to partial charge-off – balance sheet entry only
- FASB conclusion:
  - Accounting policy choice between above alternatives
  - In addition, if entity has a policy that results in timely reversal or write-off of accrued interest, it may exclude accrued interest from allowance calculation (accounting policy choice)
  - Both accounting policy elections are made at class of financing receivable or major security level

Discussed at June 11, 2018 TRG meeting and at August 29, 2018 Board meeting

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Consideration of Recoveries

- Conflict between CECL measurement principle and guidance on recoveries
  - ASC 326-20-30-1: allowance for net amount expected to be collected
  - ASC 326-20-35-8: "Recoveries…shall be recorded when received"
- FASB recommendations (as discussed at August 29^{th} meeting)
  - Must consider for both pooled and individual allowance measurements
  - May only include amounts recoverable from borrower
  - Recoveries of previously charged off amounts recognized via allowance account rather than adjustment to amortized cost basis
  - Negative allowance may result
  - Estimates must be reasonable and supportable
- Similar issue for collateral dependent loans to be discussed

Board expected to amend guidance to clarify guidance on recoveries

Exposure draft anticipated

FASB Staff to consider extending guidance to amounts recoverable from delinquent financial assets/ underlying collateral

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What's Up Next?

- Submissions for FASB TRG Consideration
  - Recognition of Subsequent Increases in Fair Value for Collateral Dependent Loans
  - Modeling Expected Losses on Short-Term Loans
  - Contractual Extension Provisions (other than TDR)
  - Partial Discounting
  - Vintage Disclosures for Revolvers

Nov. 1, 2018 TRG Meeting

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Partial Discounting

- Issue is specific to non-discounted cash flow approaches
- Basel rules require recoveries to be discounted from recovery date to default date, however there are differing views about whether this approach would also be appropriate under the CECL standard
- Broader issue is whether the CECL standard requires consistency with respect to discounting (or not)
  - Should all expected cash flows be discounted in a DCF method?
  - Is discounting selected cash flows prohibited when a non-DCF method is applied?

Potential TRG Meeting Topic

Basel Advanced approach generally applies to those with > $250B in total assets or > $10B in on-balance sheet foreign exposure

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Contractual Extension Provisions

- CECL standard states that the contractual term should not be extended for expected extensions (unless a TDR is reasonably expected)
- Guidance has generally been interpreted to be:
  - Applicable to 1) extensions that are not contractual, or 2) contractual options within the lender's control
  - Not applicable to provisions outside the lender's control
- AICPA DIEP recommendation:
  - Contractual term should be extended for contractual extension options that are outside of the lender's control
  - The lender should include an estimate of the likelihood of exercise when measuring the allowance

Potential TRG Meeting Topic

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Modeling Expected Losses on Short-Term Loans

- A commercial real estate developer borrows money to finance a project involving real estate construction
- The term of the loan is shorter than the expected duration of the project
- The in-process construction asset serves as collateral for the loan
- Assuming the borrower is not experiencing financial difficulty, how should the lender model expected credit losses on the short-term loan?
- Should the lender consider economic conditions beyond the maturity of the loan if they could impact the ability of the borrower to repay the loan through refinancing?

Potential TRG Meeting Topic

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Vintage Disclosures for Revolvers

- ASC 320-20-50-6 requires disclosures of loans by credit quality indicator by vintage year
  - Revolving loans are included in a separate column (not by year of origination)
- Issue: How should a revolver be treated in vintage disclosures if it is converted into a term loan?
  - Factors to consider:
    - Was conversion into term loan contemplated in original loan agreement?
    - Was conversion outside of lender's control?
    - If conversion was from modification of terms:
      - Did conversion result from TDR?
      - Did modification result in new loan accounting?
      - When did lender make credit decision?

Potential TRG Meeting Topic

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Let's Answer Questions….

Thank you

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