Association of International Certified Professional Accountants

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

Session 16
Tuesday, Sept. 12, 2017
Presented by members of the AICPA Depository Institutions Expert Panel (DIEP) and FASB Credit Losses Transition Resource Group (TRG)

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AICPA Depository Institutions Expert Panel (DIEP)

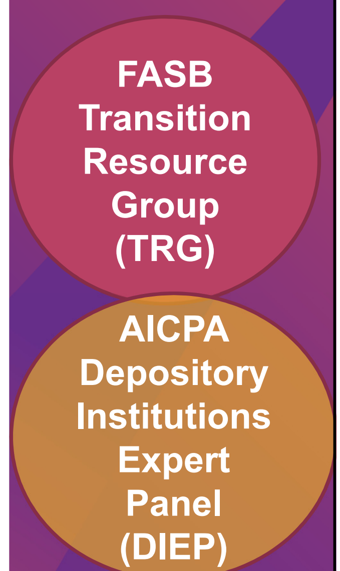
FASB Credit Losses Transition Resource Group (TRG)

Agenda

- AICPA Depository Institutions Expert Panel (DIEP)
  - Recent activities
- Issues
  - Big Picture
  - Resolved at the FASB Credit Losses TRG meeting
  - Other
- AICPA DIEP
  - Next steps
- Questions

AICPA Depository Institutions Expert Panel

- 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 DIEP
  - 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



Big Picture Issues

- Reasonable & Supportable Forecasts and Reversion
- Zero Credit Loss
- Transfers from Held for Sale to Held For Investment
- Variable Rate Loans
- Impact of TDRs on CECL Estimate
- Credit Cards – Life Estimation

Reasonable & Supportable Forecasts and Reversion

- Determining the reasonable and supportable period requires judgment
  - No bright lines
  - Not a policy election
  - Relates to ability to make or obtain forecasts of economic conditions
  - May differ between entities, or even for different assumptions
  - "Back testing" not required to support the length of the period
- Consider consistency with other forecasts made or used
- Is the reversion approach a practical expedient?

Zero Credit Loss

- CECL allows assumption of zero credit losses where expectation of non-payment is zero.
  - Probability of default could be non zero but loss given default is zero
- US Treasury Bonds
  - High credit ratings
  - Long history of no credit losses
  - Explicit guarantee by high credit quality sovereign entity
  - Widely recognized as a 'risk free rate'
  - US can print its own currency to pay off bonds
  - Dollar is reserve currency

Zero Credit Loss

- Securities issued by Ginnie Mae, a US agency
  - 40+ years of history with no credit losses to investors,
  - Payments are explicitly guaranteed by US
  - Underlying mortgage loans are either insured by the FHA or guaranteed by the VA, both US agencies
  - US can print currency to retire GNMA's obligations
- Fannie Mae and Freddie Mac MBS (Agency MBS)
  - P&I payments are guaranteed by the issuing agency
  - Explicit guarantee by the US subject to a cap (part of the Purchase Agreement when the agencies were taken into conservatorship in 2008)
  - Widely believed to have an implied guarantee by the US
  - Long history of no credit losses to investors

Yields are higher than Treasuries – due to prepayment and liquidity risks

Zero Credit Loss

- Other asset classes subject to future discussion
  - Other sovereign debt
  - Seasoned loans and debt securities with underlying collateral that has low Loan to Value ratio

- *ASC 326-20-30-10 - "…an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral."*

Transfers from Held for Sale to Held for Investment / Held to Maturity

- Issue: Whether an entity would recognize an allowance for expected credit losses even in circumstances where credit deterioration was previously recognized in earnings through LOCOM (loans) or impairment (AFS securities)

- Perceived to be "double counting"

- Possible anomaly arises because PCD accounting would not be applied

Variable Rate Instruments

- Issue: Determination of effective interest rate used to discount expected cash flows when a discounted cash flow method is used to measure expected credit losses

Non-refundable fees and costs (FAS 91/ 310-20)		
• Interest income recognition	May float or fix	310-20-35-18c
Expected credit loss measurement		
• Loans/ HTM debt securities	Must float	326-20-30-4
• AFS debt securities	May float or fix	326-30-35-11
• Off-balance sheet credit exposures	May float or fix	310-20-35-18c*

**via reference from 326-20-30-11*

Mismatch between interest income recognition and expected credit loss measurement

Inconsistent treatment among instruments

Impact of TDRs on CECL Estimate

- ASU requires that TDRs should be included in the allowance estimate when there is a "reasonable expectation" at the reporting date
  - TRG discussed the timing of TDR estimation generally, and specifically how "reasonable expectation" should be applied
    - Discussion made more difficult because of different considerations for different types of TDRs (payment deferral, interest rate concession, principal forgiveness)

Impact of TDRs on CECL Estimate

- FASB Sept. 6th meeting
  - Identification of a TDR is required when an individual asset is specifically identified as a reasonably expected TDR.
    - FASB did not intend to change the identification method for TDRs.
  - Measurement
    - Required to use a discounted cash flow method (or a method that reconciles to a discounted cash flow model) when an entity grants a concession that can only be measured using a discounted cash flow model (such as an interest rate or term concession).
      - FASB did not intend to allow measurement of TDRs in a way that avoids capturing TDR concessions.
    - If an entity uses a DCF method for measurement of credit losses on a performing loan portfolio, any effects of TDRs that are incremental to what is embedded in the historical loss information should not be incorporated as an input to the DCF method until a TDR is individually identified.

Credit Cards – Life Estimation

- Issue: Estimating the life of a credit card loan given:
  - they do not have stated interest and principal payments,
  - they are revolving,
  - the undrawn commitment is cancellable by the bank,
  - the CARD act provides a payment “hierarchy” for components of a balance
- Payment application discussed by the TRG
  - “FIFO” method: apply estimated payments to current balance
  - “CARD Act” method: forecast future draws and apply estimated payments based on CARD act hierarchy
- Payment determination raised at TRG
  - Forecast all payments to be received on the account
  - Forecast a portion of payments
  - Further FASB Staff activity expected

Resolved by the FASB Credit Losses TRG

- Transition from PCI to PCD
- Effective Interest Rate (EIR)
- Beneficial Interests PCD Scoping

Transition from PCI to PCD

- Transition guidance for an entity's ability to elect to maintain pools of 310-30 loans accounted upon adoption (326-10-65-1(d))
  - View A – Maintain pools only for credit measurement purposes, assuming criteria are met
    - Allocate the non-credit and allowance to individual loans
  - View B – Maintain pools for all areas
    - Gross up applied at pool level and freeze the EIR
  - Discussed at TRG
    - Some felt View A could be operationally challenging
    - Others prefer View A
    - Either is supported under the guidance
    - Election to maintain pools should be determined on a pool-by pool basis

Effective Interest Rate (EIR)

- Issue arises when applying discounted cash flow methodologies to measure expected credit losses
- Many banks use the “contractual method” for interest income
- Cash flows required to include estimated prepayments
- Previous interpretations of ASU 2016-13 required cash flows to be discounted at EIR that was based on contractual cash flows, thereby creating an anomaly related to the mismatch
- TRG agreed that prepayment-adjusted EIR should be permitted but not required for measuring credit losses

Beneficial Interests PCD Scoping

- Term “contractual cash flows” not defined and impacts
  - scope of PCD for Beneficial Interests (“BI”) subject to ASC 325-40
  - initial measurement of credit losses for PCD BI
  - determining initial accretable yield
- Discussed at TRG
  - Look to the contractual terms of the security
  - If contractual payments are not specified consider the terms of the underlying assets
  - “Contractual cash flows” should consider estimated prepayments but not estimated credit losses
  - Isolates credit risk
- ASC 325-40 is an integrated interest income and credit loss model

Other Issues

- Freestanding Credit Insurance
- Collateral Maintenance Provisions

Freestanding Credit Insurance

- Scoped out of impairment guidance
- Not considered in determining credit loss provisions
- Issue submitted to the FASB
  - Timing of recognition of recovery
  - Measurement of recovery

Collateral Maintenance Provisions

– Applies when borrower is required to continuously adjust the collateral

– Practical expedient similar to collateral-dependent loans

– Additional considerations appear to apply only when allowance is reduced to zero:
  - Borrower required to provide collateral > or = cost basis
  - Entity expects borrower to continue to replenish

– Unclear whether additional considerations would apply whenever the expedient is used

AICPA Depository Institutions Expert Panel

- Objective:
  – AICPA CECL A&A Guide
    - To provide a vehicle to help entities get started
    - Addresses accounting and auditing
  – To provide a forum for discussion and issue resolution working closely with key stakeholders
  – To document and communicate conclusions reached, for example:
    - By the TRG
    - By the DIEP or other AICPA panels
    - By other stakeholders
- Timing
  – Provide issues and proposed resolution on AICPA's website for public input

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Thank you

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