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Grant Thornton

# New Developments Summary

## Transition Resource Group for Credit Losses

**Summary of issues as of October 6, 2017**

### Summary

On June 12, 2017, the Transition Resource Group for Credit Losses (TRG), formed by the FASB to consider issues that arise from implementing the new credit loss standard, met for first time since the issuance of ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. This bulletin not only summarizes the major issues discussed at that meeting, but has been updated to include the FASB's subsequent discussions on those topics.

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## A. Overview

The Transition Resource Group for Credit Losses (TRG) was formed by the FASB to help entities implement the new guidance on measuring credit losses on financial instruments in ASU 2016-13, *Measurement of Credit Losses on Financial Instruments*. TRG members include financial statement preparers from the banking and insurance industries, auditors, and financial statement users. Representatives from the Securities Exchange Commission, the Public Company Accounting Oversight Board, the FASB's Private Company Council, and the federal financial institution regulatory agencies are invited as observers. Although it does not issue authoritative guidance, the TRG

- Solicits and discusses stakeholder issues arising from implementation of the new credit losses standard
- Identifies areas where the new guidance may be unclear or could lead to diversity in practice, requiring additional clarification or guidance by the FASB
- Provides a forum for stakeholders to learn about the new credit losses standard

The TRG meets periodically to discuss issues submitted by stakeholders. To submit an issue and to access all meeting dates, materials, and archived webcasts of meetings, visit the TRG homepage on the FASB website.

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# B. Highlights of issues discussed during the July 12 TRG meeting

## Considering prepayments in the discount rate used to discount future cash flows

### *Background*

The guidance in ASU 2016-13 does not require the use of a discounted cash flow (DCF) approach for measuring credit losses. If entities choose to utilize a DCF approach, the guidance requires them to adjust estimates of future cash flows for expected prepayments and to discount those prepayment-adjusted cash flows at the financial asset's effective interest rate (EIR). However, the definition of EIR, which was not amended by ASU 2016-13, does not generally require a similar adjustment for expected prepayments.

#### Question

Discounting prepayment-adjusted cash flows using an EIR that is not similarly adjusted for expected prepayment would cause the net amount expected to be collected to differ from the amortized cost, and that difference would be captured by the allowance for credit losses. Stakeholders asked whether this outcome is acceptable under the new credit losses standard, even though it may be contrary to the standard's intent, which is that the allowance for credit losses should reflect only shortfalls in contractual cash flows due to credit losses, with other shortfalls (for instance, due to prepayment) impacting interest income.

#### TRG views

The TRG generally agreed that use of either a prepayment-adjusted EIR or an EIR without adjusting for prepayments should be an accounting policy election. The TRG further generally agreed that using a prepayment-adjusted EIR may result in a more appropriate estimate of the allowance for credit losses.

> **Impact on interest income**
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> The FASB staff further stated that while an entity may elect to use a prepayment-adjusted EIR for estimating the allowance for credit losses when utilizing a DCF approach, the TRG's discussion does not impact the determination of the EIR for purposes of recognizing interest income. Accordingly, expected prepayments would impact the EIR used to recognize interest only for assets within the scope of the guidance in ASC 310-20-35-26 through 35-33, *Receivables: Nonrefundable Fees or Other Costs,* or in ASC 325-40, *Investments – Other: Beneficial Interests in Securitized Financial Assets.*

## Determining when beneficial interests qualify as PCD assets

### *Background*

Beneficial interests in securitized financial assets within the scope of ASC 325-40 are considered purchased credit deteriorated (PCD) assets under ASU 2016-13 if there is either (a) a more than insignificant deterioration in credit quality since origination, or (b) a significant difference between contractual cash flows and expected cash flows from those beneficial interests.

### *Question*

Stakeholders asked how the holder of a beneficial interest should determine the expected cash flows from beneficial interests, specifically when contractual cash flows are not specified, such as with interest-only strips and residual interests.

### *TRG views*

The TRG generally agreed that if beneficial interests' contractual cash flows are not specified, the holder of the beneficial interest should look to the contractual cash flows of the underlying assets. Further, when assessing whether there is a significant difference between contractual and expected cash flows, the holder of the beneficial interest should not conclude that a significant difference exists due to expected prepayments on the underlying assets.

**Estimating the 'day one gross-up'**

In addition to clarifying the scope of the PCD guidance for beneficial interests, the TRG generally agreed that the initial estimate of the allowance for credit losses (and the associated "day one gross-up") for beneficial interests that are PCD assets should include only the effect of credit risk, and not the effect of expected prepayments. However, the TRG also generally agreed that all subsequent changes in expected cash flows, including those related to expected prepayments, would impact the allowance for credit loss.

This means that all subsequent decreases in cash flows would result in an increase to the allowance for credit losses, while increases in expected cash flows would reduce the allowance for credit losses until it is reduced to zero, at which point, the EIR of the beneficial interest would be prospectively adjusted upward. This is consistent with the integrated interest income and impairment model in ASC 325-40.

## Transition of 'PCI' assets to PCD accounting

### *Background*

ASU 2016-13 eliminates the guidance in Subtopic 30 of ASC 310, which prescribes the accounting for PCI assets. Under ASC 310-30, PCI assets may be accounted for either individually or pooled with other PCI assets. If the PCI assets are pooled, the pool becomes the unit of account. Assets or pools of assets designated as PCI assets under ASC 310-30 are within the scope of the PCD guidance under ASU 2016-13. Additionally, ASU 2016-13 provides transition guidance that allows entities with PCI pools to maintain those pools for the purpose of PCD accounting upon adoption of the guidance in ASU 2016-13.

### *Question*

While ASU 2016-13 requires financial assets measured at amortized cost with similar risk characteristics to be pooled for the purpose of estimating the allowance for credit loss, the unit of account remains the individual financial asset. Financial assets may move between pools or even be analyzed individually as their risk characteristics change over time. Given the different guidance on the unit of account in ASC 310-30 and in ASU 2016-13, stakeholders asked whether financial assets that currently are within PCI pools (for which the pool is the unit of account) should be broken out from their PCI pool if they no longer share risk characteristics with the other financial assets in the pool after an entity initially applies the PCD guidance in ASU 2016-13.

### *TRG views*

The TRG generally agreed that entities can make an accounting policy election to maintain an existing PCI pool both when transitioning to the new guidance and on an ongoing basis. If such an election is made, the PCI pool would continue to be the unit of account, and financial assets within the PCI pool would not be removed from the pool until they are paid off, written off, or sold, consistent with the guidance in ASC 310-30. However, the PCI pool would otherwise follow the PCD guidance in ASU 2016-13 for purposes of recognizing income and estimating the allowance for credit loss.

**Reference to ASC 310-30 upon adoption of ASU 2016-13**

ASU 2016-13 eliminates the guidance in Subtopic 30 of ASC 310. However, the TRG generally agreed that entities that elect to maintain their PCI pools subsequent to the adoption of ASU 2016-13 will need to refer to certain aspects of extant guidance in ASC 310-30, such as the basis at which financial assets are removed from the pool upon resolution via payoff, write-off, or sale.

## Forecasting troubled debt restructurings

### *Background*

The guidance in ASU 2016-13 requires entities to pool together financial assets with shared risk characteristics and to estimate the allowance for credit loss on a pooled basis. Additionally, this guidance states that expected credit losses on financial assets should be estimated over the contractual life of the financial assets and that the contractual life should be extended only for reasonably expected troubled debt restructurings (TDRs) with a borrower. However, while estimates of expected credit losses are generally required on a pool basis, ASU 2016-13 did not change the definition of a TDR, and, under ASC 310-10, TDRs are identified on an individual financial asset basis.

### *Question*

The question posed to the TRG is should a reasonable expectation of the occurrence of a TDR be forecasted on an individual financial asset basis or on a pool of loans basis? In addition, should the impact on the estimate of expected credit losses due to a TDR be forecasted on an individual financial asset basis or on a pool of loans basis?

### *TRG discussion*

The TRG expressed differing views on whether the impact of TDRs should be forecasted on a pooled basis or on an individual loan basis. Similarly, the TRG expressed differing views regarding when entities should recognize the effect of the extension of the contractual life of the financial asset and when they should recognize the effect of other concessions, such as interest rate concessions, associated with reasonably expected TDRs. The TRG noted that for most TDRs, the effect of concessions on the estimate of credit losses could be measured by a number of approaches, including analyzing to what extent historical loss information captures the impact of previously executed TDRs. However, certain TRG members felt that only a DCF approach would capture the effect of certain modifications, such as interest rate concessions.

### *Subsequent FASB clarification*

On September 6, the FASB discussed (and subsequently documented via Memo 6A) the FASB staff's analysis of the issue based on outreach with issuers, financial statement users, and auditors.

The FASB first addressed what effects of reasonably expected TDRs should be captured by an entity's estimate of expected credit losses. The FASB concluded that *all* effects of reasonably expected TDRs should be captured, including interest rate concessions. Accordingly, the FASB noted that in some instances (for example, when an entity provides only an interest rate concession), entities may be able to measure the effects of reasonably expected TDRs only by using a DCF approach (or any method that can be reconciled to a DCF approach).

The FASB then addressed what constitutes the unit of account (pool or individual loan) for identifying reasonably expected TDRs. The FASB concluded that the unit of account for TDR identification should be an individual asset as opposed to a pool of assets. Accordingly, an entity should not predict a "rate" of TDRs for a pool of assets, but should wait to recognize TDRs until it can identify individual assets for which a TDR is reasonably expected. Because the FASB defined the unit of account for identifying reasonably expected TDRs as the individual asset, the identification of TDRs upon adoption of ASC 326, *Financial Instruments – Credit Losses*, is unlikely to be significantly accelerated compared to current GAAP in most circumstances.

The Board also agreed that the unit of account for measuring the effect of reasonably expected TDRs may be either an individual asset or a pool, depending on the risk characteristics of the loan, consistent with the general guidance in ASC 326-20. The FASB noted that utilizing a DCF approach on an asset-by-asset basis would be appropriate under ASC 326. It further noted that an entity may estimate the effect of reasonably expected TDRs on a pool basis if a reasonably expected TDR shares common risk characteristics with other loans and the entity has compiled historical TDR data on past loans with similar risk characteristics.

**Measuring the impact of TDRs**

While a variety of approaches are allowed under ASC 326 when estimating expected credit losses, the method used for reasonably expected TDRs must capture the effect of the TDRs' concessions. Accordingly, if an entity is not using a DCF approach but is using historical data to estimate the effect of reasonably expected TDRs, the entity should consider whether its historical data captures the full effect of past TDRs.

Paragraphs 14 through 20 of Memo 6A provide illustrations of scenarios when historical information may not fully capture the effect of past TDRs. Certain effects, such as the reduction in credit losses afforded by successful TDRs, are likely to be captured by historical loss information, while other effects are less likely to be captured. Specifically, the FASB noted that net charge-off (NCO) data will not capture the effect of interest rate concessions or loan term extensions.

Additionally, entities that apply nonaccrual approaches may find that their NCO data masks certain effects of concessions granted in TDRs, particularly the effect of lost interest. By ceasing the accrual of interest and in some cases reversing accrued-but-uncollected interest, nonaccrual policies result in NCO data that does not capture losses of interest cash flows, as discussed in Paragraphs 16 through 18 of Memo 6A. As a result, the FASB concluded that it would be difficult, if not impossible, to capture losses of interest cash flows through the use of a non-DCF method.

The Board further concluded that if a DCF method is the only method available that will capture the effect of concessions associated with a reasonably expected TDR, then the entity must use a DCF method.

## Determining the contractual life of a credit card receivable

### *Background*

The guidance in ASU 2016-13 requires that an entity estimate expected credit losses over a financial asset's contractual life. This presents a particular challenge for credit card receivables for three reasons:

- Credit card receivables do not have a stated contractual life.
- The application of payments received against a card's revolving balance is complicated by the interest charges and fees associated with the various components, along with different interest rates, that may comprise the total card balance.
- Entities may not estimate an allowance for undrawn commitments to extend credit that can be unilaterally cancelled by the lender, which is typically the case for the undrawn portion of a credit card relationship.

Accordingly, the method used to estimate the amount of future expected payments and to allocate future expected payments to the credit card receivable balance at the measurement date may have a significant effect on the life of the receivable, which, in turn, may have a significant effect on the estimate of the allowance for credit losses under the current expected credit losses (CECL) model in ASU 2016-13.

### *Question*

Stakeholders asked whether (and, if so, how) an entity may consider future expected draws on a credit card when estimating future expected payments on that card. If an entity is allowed to consider expected future draws when estimating expected future payments under ASU 2016-13, should expected future payments be allocated between the credit card receivable balance at the measurement date and expected future draws when estimating the expected credit loss?

### *TRG discussion*

The TRG reached general agreement that future cash flows on credit card receivables could be estimated by either considering future borrower draws or without considering future borrower draws.

> **Modelling capabilities**
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> Several TRG members indicated that many financial institutions lack the modelling capabilities and data to estimate future customer draws. While the TRG did not reach agreement about the preferability of any particular approach to estimating future payments on credit card receivables, including whether future draws must be considered, entities may want to begin evaluating their data sets and modelling capabilities in advance of the implementation date.

The TRG did not, however, reach agreement on how to determine the amount of expected future principal payments (that is, payments after finance charges and fees assessed have been paid) that should be available to service the credit card receivable at the measurement date when an entity estimates future payments by considering future borrower draws. It discussed two approaches that could be used to determine the availability of future expected principal payments to service the credit card balance at the measurement date:

- View A: Applying all expected principal payments only to the balance at the measurement date, according to the 2009 Credit Card Accountability, Responsibility, and Disclosure Act (Credit CARD Act) payment allocation hierarchy
- View B: Applying expected principal payments to the measurement-date balance and to future anticipated draws in a way that reflects how the Credit CARD Act payment allocation hierarchy is expected to affect the application of principal payments over time

Under both approaches, principal payments would be applied to components of the balance of the credit card receivable according to the Credit CARD Act, which requires that payments be applied to the components of the overall balance in descending order based on their interest rate.

Some TRG members questioned whether applying any future expected principal payments to future draws violates the CECL model's prohibition against recognizing an allowance for credit loss associated with unconditionally cancellable undrawn amounts. Other members did not believe that it was appropriate to project future payments based on future draws without considering the impact of those future draws on whether the expected payments can service the existing card balance.

### *Subsequent FASB clarification*

On October 3, the FASB discussed (and subsequently documented in Memo 6B) the FASB staff's analysis of the payment determination issue based on its outreach with stakeholders. The FASB reiterated that there are two views (Views A and B, as described above) regarding the determination of future expected principal payments available to service the measurement-date card balance when an entity estimates future payments by considering future borrower draws.

The Board did note, however, that View B may be more appropriate for populations of credit card borrowers that demonstrate a link between their monthly draws and their monthly payments. Additionally, the Board concluded that View B may result in a more "precise" estimate of expected credit losses in certain circumstances. Still, the FASB concluded that an entity can choose any approach that faithfully estimates the expected credit losses to make this determination.

### Considering the use of View B

During the discussion of Views A and B for determining future expected principal payments, the FASB staff and several Board members indicated that while View B might be appropriate for certain borrower populations in certain circumstances, neither View A nor View B is required. This conclusion is consistent with the FASB's general approach in ASC 326 of not requiring a particular method of estimating expected credit losses, but allowing entities to select a method that is *appropriate* in their circumstances, without justifying that a selected method is the *best* method available.

However, members of the Federal Banking Agencies who participated in the TRG meetings indicated at those meetings a preference for View B when the facts and circumstances supported that view. Accordingly, regulated financial institutions may wish to consider the views of their primary federal regulator when determining which view they will utilize in estimating the lives of their credit card receivables.

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