Grant Thornton

New Developments Summary

Transition Resource Group for Credit Losses

Summary of issues as of November 1, 2018

Summary

On November 1, 2018, 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 to discuss issues raised by stakeholders since the group's previous public meeting in June 2018. This bulletin summarizes the issues discussed at that meeting.

See prior summaries of the June 2017 and June 2018 TRG meetings for a discussion of issues previously discussed by the TRG.

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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 SEC, the Public Company Accounting Oversight Board, the FASB's Private Company Council, and the federal financial institution regulatory agencies are invited to TRG meetings as observers. Although it does not issue authoritative guidance, the TRG

- Solicits and discusses stakeholder issues arising from implementing 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.

B. Highlights of issues discussed during the November 1 TRG meeting

On November 1, 2018, the TRG discussed several technical inquiries addressed by the FASB staff since the June 2018 meeting, as well as three issues submitted by stakeholders.

Technical inquiries addressed by the FASB staff

Disclosure of gross write-offs and recoveries

ASC 326, *Credit Losses*, requires public business entities (PBEs) to disclose in the footnotes to the financial statements the amortized cost basis of financial assets by class of financing receivable or major security type, credit quality indicator, and year of origination. Example 15 in ASC 326-20-55-79 illustrates one way in which PBEs might comply with this requirement. The illustration in Example 15 provides a line item for gross write-offs and recoveries for each year presented, which is an incremental disclosure to those explicitly required by ASC 326-20-50-5 through 50-6. Stakeholders asked the FASB staff whether the Board intended the disclosure of gross write-offs and recoveries during each year to be a mandatory disclosure, and the FASB staff responded by saying that was, in fact, the Board's intention.

The TRG expressed varying views during the meeting regarding the FASB staff's response to this query. As a result, the Board decided to expose this issue for public comment in a proposed ASU separate from an ASU comprising other proposed Codification improvements, subject to a 60-day comment period.

Other TRG submissions

The FASB staff reviewed three additional issues submitted by the AICPA's Depository Institutions Expert Panel. The FASB did not prepare specific memos for the TRG to discuss regarding the three additional topics because the FASB staff either (a) believed the guidance in ASC 326 is clear, or (b) concluded that the submission was beyond the remit of the TRG.

Highlights of the TRG's discussion of the three issues are summarized below.

Partial discounting

ASC 326 allows entities to use a variety of methods when estimating the allowance for credit losses (ACL). ASC 326-20-30-4 describes the use of a discounted cash flow method to estimate the ACL, while ASC 326-20-30-5 describes the use of other methods that do not involve discounting inputs to estimate the ACL.

Certain stakeholders questioned whether they could discount certain, but not all, inputs to an estimation method other than a discounted cash flow method as described in ASC 326-20-30-4, which is called "partial discounting." These stakeholders were typically larger, regulated financial institutions that use partial discounting in estimating credit losses in conjunction with certain regulatory requirements, such as the determination of regulatory capital requirements, stress testing and capital adequacy assessments.

Although the FASB staff indicated that the Board wanted to provide entities with some flexibility when estimating the ACL, it believes the current guidance in ASC 326 is clear: An entity that wishes to discount inputs to its method for estimating the ACL must discount *all* inputs to the estimation method using the effective interest rate on the relevant financial instruments, and it must discount to the measurement date and not another interim date. The TRG generally agreed with the FASB staff's analysis.

Regulatory views on partial discounting

Observers to the TRG meeting included the chief accountants of the federal banking regulatory agencies (the FDIC, Federal Reserve, and Office of the Comptroller), who indicated that there are meaningful differences between the requirements in ASC 326 for estimating ACL and the requirements of regulatory stress testing and capital adequacy regimes. While they believe that the loss estimates used for regulatory purposes may provide regulated financial institutions with a reasonable starting point for estimating the ACL, the chief accountants expect the estimate used by regulated institutions to be fully compliant with the requirements of ASC 326, thereby agreeing with the FASB staff's analysis.

Changes in foreign-exchange rates on foreign-currency-denominated available-for-sale securities

The amendments in ASU 2016-13 superseded the other-than-temporary-impairment (OTTI) guidance for available-for-sale debt securities in ASC 320, *Investments in Debt and Certain Equity Securities*, and replaced the OTTI guidance with a new impairment model for available-for-sale securities in ASC 326-30. Under the new impairment model in ASC 326-30, when an available-for-sale security is impaired (meaning that its fair value exceeds its amortized cost), an entity should first assess whether it expects, or will more likely than not be required, to sell the security before recovering the amortized cost basis. In this situation, the entity should recognize the full difference between the amortized cost and the fair value of the available-for-sale security in earnings, by reducing the amortized cost basis of the security.

If an entity does not intend to sell an impaired available-for-sale security, and it is not more likely than not that it will be required to sell the security, then the entity should assess whether any of the impairment is due to credit. If the entity determines that the impairment is at least in part due to credit, then it should measure the credit loss by using the security's effective interest rate to discount its expectation of future cash flows from the security. Any difference between the present value of those cash flows and the amortized cost basis should be recognized in an ACL through earnings, subject to a fair-value floor. Any remaining impairment on the available-for-sale security should be recognized as a component of other comprehensive income (OCI).

Prior to the amendments in ASU 2016-13, entities were required to consider changes in foreign-exchange rates on foreign-currency-denominated debt securities when determining whether an OTTI existed. Some stakeholders questioned whether changes in foreign-exchange rates on available-for-sale securities would still result in an entity recognizing a loss in earnings under the guidance in either ASC 326-30 or ASC 450, *Contingencies*.

The FASB staff indicated that the guidance in ASC 326-30 clearly states that an entity should recognize any credit-related impairment of an available-for-sale security as an ACL through earnings (subject to a fair-value floor), and any other remaining impairment, from any source, as a component of OCI. Changes in foreign-exchange rates from an available-for-sale security denominated in a foreign currency should be recognized in earnings when any one of the following events occur:

- When the security matures
- When the security is sold
- When an entity intends to sell the security
- If the entity will more likely than not be required to sell the security before recovering its amortized cost basis.

Finally, the FASB staff indicated that both ASC 320 and ASC 326 provide comprehensive guidance for recognizing changes in the fair value of an available-for-sale security. The TRG generally agreed with the FASB staff's analysis.

The TRG expanded on the process an entity should follow to recognize changes in foreign-exchange rates on an available-for-sale security. Similarly to available-for-sale securities that are not denominated in a foreign currency, an entity should begin by assessing whether there is a credit loss on the security. If so, the entity should estimate the credit loss in the foreign currency and then translate the credit loss to its reporting currency using the guidance in ASC 830, *Foreign Currency*.

Applying ASC 830 to changes in foreign-exchange rates on available-for-sale securities

Entity A purchases a €1 million euro-denominated debt security at par on 1/1/X1, which it classifies as available-for-sale. Entity A's reporting currency is U.S. dollars (USD). At the acquisition date (1/1/X1), the foreign-exchange rate of USD to EUR is 1:1. At 12/31/X1, the fair value of the security is €900,000 or US$945,000, and the foreign-exchange rate is 1.05:1. Entity A estimates a credit loss of €50,000 at 12/31/X1.

To translate the credit loss to its reporting currency, Entity A takes the following steps:

- *Step 1 – Estimate the credit loss in the foreign currency:* First, Entity A estimates the credit loss in euros. The fair value at 12/31/X1 is €900,000 and therefore the total impairment is €100,000. Entity A estimates the credit loss is €50,000 and establishes an ACL for €50,000. If Entity A had estimated a credit loss in excess of €100,000, it would have limited the estimate of credit losses to €100,000 because of the fair-value floor in ASC 326-30.

- *Step 2 – Translate the credit loss to the reporting currency:* Next, Entity A translates the €50,000 ACL to USD using the foreign-exchange rate at the measurement date, which is 1.05:1, resulting in an ACL of US$52,500.
- *Step 3 – Determine remaining impairment to be recognized in OCI:* The fair value of the debt security at 12/31/X1 is US$945,000, resulting in a total impairment of US$55,000 (an amortized cost of US$1 million compared to a fair value of US$945,000 at 12/31/X1). As a result, Entity A would recognize an ACL and related credit loss of US$52,500, as determined in Step 2, and then recognize the remaining impairment of US$2,500 as a component of OCI.

Beneficial interests classified as trading

Certain beneficial interests, typically those of lower credit quality, are within the scope of subtopic ASC 325-40. The guidance in ASC 325-40 features an integrated accounting model that, leveraging a discounted cash flow approach, provides guidance on interest income as well as initial and subsequent measurement for beneficial interests classified either as held-to-maturity or as available-for-sale. ASC 325-40 also applies to beneficial interests classified as trading, although it does not include detailed subsequent measurement guidance for these beneficial interests.

ASU 2016-13 amended the subsequent measurement guidance for beneficial interests classified as held-to-maturity or available-for-sale within the scope of ASC 325-40. The amended guidance requires entities to determine whether beneficial interests classified as held-to-maturity have a credit loss under ASC 326-20, or whether beneficial interests classified as available-for-sale have a credit loss under ASC 326-30. If a credit loss is determined in either case, the entity should recognize that credit loss. Any remaining change in expected cash flows would then result in a prospective adjustment to the effective interest rate of the beneficial interest. However, beneficial interests classified as trading are not within the scope of either ASC 326-20 or ASC 326-30.

Some stakeholders questioned whether beneficial interests classified as trading should still be within the scope of ASC 325-40. Although ASC 325-40 lacks detailed subsequent measurement guidance for beneficial interests classified as trading, the FASB staff said that ASC 325-40 clearly includes such beneficial interests within its scope, while ASC 326-20 and 326-30 clearly exclude such beneficial interests from their scopes. The FASB staff further indicated that changes to the scope of ASC 325-40 are beyond the remit of the TRG. The TRG generally agreed with the FASB staff's analysis.

Issues submitted by stakeholders to the TRG

Extensions of the contractual term

Background

The guidance in ASC 326-20 states that expected credit losses on financial assets should be estimated over the contractual life of the financial asset and that the contractual life should be extended only for reasonably expected troubled debt restructurings (TDRs) with a borrower.

Questions

Question 1

Stakeholders questioned whether an entity could consider expected contractual extensions in certain situations other than an expected TDR and identified four potential scenarios:

1. The financial asset does not contain an explicit extension option, but it is the lender's practice to renew such financial assets.
2. The financial asset contains a contractual extension option controlled by the lender.
3. The financial asset contains an unconditional contractual extension option controlled by the borrower.
4. The financial asset contains a conditional contractual extension option controlled by the borrower.

Question 2

Stakeholders also questioned whether an entity may consider forecasted economic conditions and other information beyond the contractual term of a financial asset when estimating expected credit losses.

TRG views

Question 1

The TRG generally agreed that an entity should consider contractual extension options controlled by the borrower, whether conditionally or unconditionally, when estimating the contractual life of a financial asset. The FASB staff noted that the Board's intent was for the "contractual term" to capture the term over which the lender is exposed to credit risk under the existing contractual arrangement. The TRG generally agreed that extension options controlled by the borrower, whether conditional or unconditional, that are part of the current contractual arrangement represent a present legal obligation to extend credit to the borrower.

Estimating contractual life when borrower-controlled extensions exist

The TRG generally agreed that an entity may estimate the contractual life of a financial asset when a borrower-controlled extension option is present using one of two methods:

- *Method 1 – Estimate the likelihood of extension:* Under the first method, an entity would estimate the likelihood of the extension option being exercised. An entity would then estimate the expected credit losses over the extended contractual period, considering the likelihood of an extension. This process would be virtually identical to the process described in ASC 326-20-30-11 for off-balance-sheet exposures on lines-of-credit that are not unconditionally cancellable by the lender.
- *Method 2 – Estimate prepayments:* Under the second method, an entity may assume that all contractual extensions will be exercised to determine the maximum contractual life, and then consider expected prepayments in a manner consistent with the guidance in ASC 326-20-30-6.

Both approaches are acceptable and entities should select the method they can best support given their data limitations and modelling capabilities.

On November 19, the FASB issued a proposed ASU, *Codification Improvements – Financial Instruments*, which includes amendments that reflect the TRG's views on this issue.

Question 2

The TRG generally agreed that entities may consider information, including forecasts of future economic conditions, beyond the financial asset's contractual term when estimating credit losses, provided that this information is relevant to the entity's estimate of credit losses under the asset's current contractual terms.

The TRG generally agreed that considering such information does not, in and of itself, constitute a de facto contractual extension of a financial asset.

Considering information beyond the contractual term of a financial asset

Lender A has provided a two-year construction loan to Entity B. The term of the construction loan includes principal and interest payments based on a 20-year amortization period and features a balloon payment at the end of year two.

Lender A may consider information, such as Entity B’s probability of default and forecasts of future economic conditions, beyond the two-year term of construction loan when estimating credit losses on the loan’s payment terms. For example, based on this information, Lender A may consider the likelihood that an unrelated, third-party lender might refinance Entity B’s obligation under the two-year construction loan when estimating credit losses on loan.

‘Vintage’ disclosures for revolving loans

Background

ASC 326 requires PBEs to disclose in the footnotes to the financial statements the amortized cost basis of financial assets by class of financing receivable or major security type, credit quality indicator, and year of origination. However, lines-of-credit are not distinguished by year of origination. Example 15 in ASC 326-20-55-79, which illustrates one way in which PBEs might comply with this requirement, includes lines-of-credit in a unique column that is separate from the columns indicating the years of origination (years of origination are commonly referred to as “vintages”). The guidance in ASC 326, however, does not specifically address how to treat lines-of-credit that convert to term loans with regard to the “vintage” disclosure requirement.

Question

Certain stakeholders questioned in what “vintage” they should present lines-of-credit that convert to term loans.

TRG views

The TRG generally agreed that the most meaningful “vintage” information for lines-of-credit that convert to term loans is the period in which the last credit decision was made with regard to converting the line-of-credit to a term loan. Accordingly, the amortized cost of the new term loan should be included in the vintage column that aligns with the last underwriting after the original underwriting when a line-of-credit is converted to a term loan. For lines-of-credit that either convert into term loans without an additional credit decision or that convert to term loans pursuant to a TDR, the amortized cost of the new term loan should be included in a separate column. Additionally, the TRG generally agreed that entities should disclose each reporting period, by class of financing receivable or major security type and by the amount of lines-of-credit arrangements converted to term loans.

The FASB included amendments to ASC 326 to reflect the TRG’s views on this issue in a proposed ASU issued on November 19, 2018.

Recoveries

Background

Under ASC 326-20-35-8, an entity should write off all or a portion of the amortized cost basis of a financial asset that is deemed uncollectible against the ACL. The guidance further states that subsequent recoveries of amounts previously written off should be recorded when received. This guidance on recoveries is consistent with the existing guidance in ASC 310, which considers recoveries to be gain contingencies.

Question

Stakeholders questioned whether an entity should consider expected cash flows related to amounts that were previously written off (called "expected recoveries") when estimating the ACL. Because ASC 326-20-30-1 states that the allowance is a valuation account that reduces the amortized cost balance, some stakeholders believe that it is inappropriate to consider expected recoveries in this situation because recoveries inherently relate to amounts that are no longer included in the amortized cost basis of financial assets.

On the other hand, other stakeholders believe that excluding expected recoveries from the estimate of the ACL would result in presenting financial assets on the balance sheet in an amount other than "the net amount expected to be collected," which is the purpose of the ACL under ASC 326-20-30-1.

TRG views

The TRG generally agreed that the measurement principle in ASC 326 is to present the net amount of an entity's financial assets that it expects to collect. Accordingly, entities should consider expected recoveries when estimating the ACL, even if recognizing such recoveries would cause the ACL to be negative (that is, adding expected recoveries to the asset's amortized cost basis). The TRG also generally agreed that any negative allowances should not be presented as a separate asset apart from the ACL.

The TRG also generally agreed that the following sources of recoveries should be considered:

- Cash flows from the borrower
- Cash flows from the operation or sale of collateral securing a financial asset
- Proceeds from the sale of nonperforming financial assets
- Payments from guarantors of financial assets, provided that the guarantee is integral to the financial asset and not freestanding

Additionally, the TRG generally agreed that recoveries should be limited to amounts previously written off, regardless of whether or not the financial assets is collateral-dependent.

Grant Thornton insights: Estimating recoveries

Based on the TRG's views, we believe that a reasonable and supportable estimate of expected credit losses must include an estimate of expected recoveries. Accordingly, entities must have a disciplined, controlled process for estimating expected recoveries based on their historical experience, adjusted for current conditions and reasonable and supportable forecasts of future conditions.

Additionally, the TRG's views mean that write-offs, in and of themselves, may not impact the net carrying amount of a financial asset. However, as write-offs frequently serve as the basis used to determine their historical loss experience, we believe entities must still have a robust system of controls around write-offs to the extent they are a key input to the estimate of the ACL.

The FASB included amendments to ASC 326 reflecting the TRG's views on this issue in a proposed ASU issued November 19, 2018.
