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November 2018 TRG Meeting on Credit Losses

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In June 2016, the FASB issued ASU 2016-13,[1] which adds to U.S. GAAP an impairment model — known as the current expected credit losses (CECL) model — that is based on expected losses rather than incurred losses. Once effective, the new guidance will significantly change the accounting for credit impairment under ASC 326.[2] See Deloitte's June 17, 2016, *Heads Up* for more information about the new guidance.

This *TRG Snapshot* summarizes the November 1, 2018, public meeting of the FASB's credit losses transition resource group (TRG), which was the third such meeting attended by the FASB since it issued the CECL guidance. See Deloitte's June 2017 *TRG Snapshot* and June 2018 *TRG Snapshot* for summaries of the public TRG meetings held on June 12, 2017, and June 11, 2018, respectively.

The purpose of the credit losses TRG is similar to that of the TRG established by the FASB and International Accounting Standards Board (IASB®) to discuss their joint revenue recognition standard. That is, the TRG does not issue guidance but provides feedback on potential issues related to the implementation of the CECL model. By analyzing and discussing potential implementation issues, the TRG helps the FASB determine whether it needs to clarify or issue

[1] FASB Accounting Standards Update (ASU) No. 2016-13, *Measurement of Credit Losses on Financial Instruments*.

[2] For titles of *FASB Accounting Standards Codification* (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the *FASB Accounting Standards Codification*." ASC 326 represents a new ASC Topic that includes both legacy impairment guidance moved from other ASC paragraphs as well as new credit losses guidance introduced by ASU 2016-13. Some of the guidance moved from other ASC paragraphs was also amended by ASU 2016-13.

additional guidance. The TRG comprises financial statement preparers, auditors, and users. Board members of the FASB also attend the TRG's meetings. In addition, representatives from the SEC, PCAOB, Federal Reserve, Office of the Comptroller of the Currency, FDIC, National Credit Union Administration, and Federal Housing Finance Agency are invited to observe the meetings.

The following topics were discussed at the November 1, 2018, meeting and are summarized below:

- *Topic 1* — Contractual term: extensions and measurement inputs.
- *Topic 2* — Vintage disclosures for revolving loans.
- *Topic 3* — Recoveries.

The appendix of this publication discusses other matters submitted to the credit losses TRG and recent technical inquiries submitted to the FASB staff related to ASU 2016-13.

Before the TRG began discussing topics at the November 1, 2018, meeting, FASB Board Member Hal Schroeder indicated that the FASB is expected to receive a document drafted by various financial institutions that proposes an alternative to the CECL model. Mr. Schroeder provided a high-level description of the proposal, stating that it would require an entity to estimate an allowance for expected credit losses in the same manner it would do so under the CECL model. However, the entity would recognize in its income statement only the credit losses expected to occur in the 12 months after the reporting date. The entity would recognize in accumulated other comprehensive income the remaining expected credit losses estimated under the CECL model.

Mr. Schroeder stated that the FASB had considered this type of approach to estimating and recognizing expected credit losses during the development of ASU 2016-13 but ultimately rejected it after performing a cost-benefit analysis. However, Mr. Schroeder indicated that the FASB would consider the proposal at a future public board meeting.

Topic 1 — Contractual Term: Extensions and Measurement Inputs

Background: The TRG discussed the following two questions that have been raised by stakeholders regarding the contractual term:

- *Question 1* — Is it appropriate for an entity to consider expected extensions in determining the contractual term when estimating expected credit losses in accordance with ASC 326-20?
- *Question 2* — Is an entity precluded from considering future economic and other conditions (referred to as "measurement inputs") beyond the contractual term of a financial asset for short-term lending arrangements under ASC 326-20?

ASC 326-20-30-6 requires entities to estimate expected credit losses over the contractual term of the financial asset. The guidance does not define contractual term; however, it specifies certain elements that should be considered in the determination of the contractual term. ASC 326-20-30-6 states, in part:

> An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless it has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower.

Question 1

ASC 326-20-30-6 indicates that entities must consider prepayments but cannot consider expected extensions except in limited circumstances. However, stakeholders believe that in certain circumstances, the consideration of extensions in the determination of the contractual term aligns with the overall objective of ASC 326. As outlined in TRG Memo 15, stakeholders questioned how an entity should determine the contractual term of a financial asset in the following scenarios:

- *Scenario A* — The arrangement does not contain an explicit extension option; however, the lender may have a history of renewing or extending the term of the loan.
- *Scenario B* — The arrangement contains a contractual extension option that gives the borrower the unilateral ability to extend the arrangement's term.
- *Scenario C* — The arrangement contains a contractual extension option that gives the borrower the conditional ability to extend the term. Satisfying the condition may or may not be within the borrower's control.
- *Scenario D* — The arrangement contains a contractual extension option that is solely within the lender's control.

The FASB staff believes that the contractual term of the arrangements in Scenario B would include the extension options described because in that scenario, the ability to exercise the extension options are outside the lender's control. As a result, the lender has a present obligation to extend credit. By contrast, the staff believes that the contractual term of the arrangements in Scenarios A and D would not be affected by a history of renewing or extending an arrangement or an extension option that is solely in the control of the lender. In both of those scenarios, the lender has the ability to limit its current obligation to extend credit. The FASB staff sought feedback from the TRG members regarding Scenario C.

Summary: The TRG members agreed with the FASB staff's views regarding Scenarios A, B, and D. Concluding that Scenarios B and C were similar, they reached a consensus that the contractual term of an arrangement would include the extension options described in Scenario C. However, certain members expressed concerns that Scenario C might present operational challenges related to an entity's estimation of the probability that the specified condition would be met and the borrower would extend the arrangement. As a result, the TRG indicated that an entity could use the following methods to determine which extension options to include in the contractual term:

- *Method 1* — Assume that the extension will be exercised and consider prepayments when estimating expected credit losses.
- *Method 2* — Estimate the probability of an extension.

Question 2

Question 2 addresses whether a lender should consider information beyond the contractual term of a loan when estimating expected credit losses. TRG Memo 15 provides an example related to a one-year construction loan made to an entity that is working on a real estate development that is expected to take three years to complete. Upon the loan's maturity, the borrower agrees to do one of the following:

- Pay off the loan by refinancing it with the current lender.
- Pay off the loan by refinancing it with another lender.
- Pay off the loan with funds generated by the project.
- Sell the underlying development and use the funds to pay off the loan.
- Default on the loan and allow the lender to foreclose on the underlying collateral.

The TRG discussed the following views regarding whether and, if so, how an entity should consider information beyond the contractual term of a financial asset:

- *View A* — Consider only the probability that the borrower will default within the contractual term of the loan.
- *View B* — Consider the probability that the borrower will default throughout the life of the project (for instance, in this example, consider the three years even though the loan matures in one year).
- *View C* — Consider only the probability that the borrower will default beyond the loan's contractual term relative to the probability that the borrower will refinance with another lender.

Summary: Although TRG Memo 15 presented Question 2 within the context of the example in TRG Memo 15 and Views A through C outlined above, the discussion broadly referred to whether an entity's consideration of information must be limited to the contractual term as determined under Question 1. The staff believes that ASC 326-20-30-7, which states the following, does not limit measurement inputs to the contractual term of the financial asset:

> When developing an estimate of expected credit losses on financial asset(s), an entity shall consider available information relevant to assessing the collectibility of cash flows. This information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts. An entity shall consider relevant qualitative and quantitative factors that relate to the environment in which the entity operates and are specific to the borrower(s). When financial assets are evaluated on a collective or individual basis, an entity is not required to search all possible information that is not reasonably available without undue cost and effort. Furthermore, an entity is not required to develop a hypothetical pool of financial assets. An entity may find that using its internal information is sufficient in determining collectibility.

TRG members generally agreed that an entity's consideration of measurement inputs should not be limited to the contractual term of the asset.

Topic 2 — Vintage Disclosures for Revolving Loans

Background: ASC 326-20-50 requires entities to disclose credit quality information regarding their financial instruments. That is, ASC 326-20-50-6 requires an entity to present the amortized cost basis within each credit quality indicator by year of origination. However, ASC 326 specifically exempts "funded or unfunded amounts of line-of-credit arrangements, such as credit cards" from that requirement because the timing of the underwriting decisions related to those arrangements may not align with the borrower's use of funds. Instead, entities may aggregate such revolving loan balances and report them in a separate single column, without regard to when the initial underwriting decisions were made.

However, for loans that are modified, ASC 326-20-50-7 requires an entity to apply the guidance in ASC 310-20 to determine whether the loan would be considered new. If a modified loan would be considered a new loan, an entity would report the loan as a current-year origination in the year of the restructuring to comply with the vintage disclosure requirements in ASC 326-20-50-6. However, stakeholders have questioned how an entity would present, in its vintage disclosures, revolving loans that convert to term loans.

TRG Memo 16 discusses the implementation question raised by stakeholders regarding the vintage disclosure requirements for revolving arrangements that later convert to term loans.

Summary: The TRG discussed the following views related to this question:

- *View A* — The loans should always be included in the revolving loan totals, even after conversion to a term loan.
- *View B* — The loans should be presented in the vintage year that corresponds with the start date of the term loan (the conversion date).
- *View C* — The loans should be presented in the vintage year that corresponds with the origination date of the original revolving credit agreement.
- *View D* — Lenders should make and disclose a policy election by class of receivable and apply View A, B, or C.
- *View E* — Term loans should be presented in the vintage year that corresponds with the lender's most recent credit decision.

The FASB staff dismissed View A because of its belief that it (1) would not provide financial statement users with decision-useful information and (2) could be misleading if these loans were still presented as revolving arrangements after they had been converted to term loans. The staff also emphasized that the Board intended to align the guidance in ASU 2016-13 with the underwriting decisions made by an entity, as described further in paragraph BC11 of that ASU. The FASB staff asked TRG members to discuss the views and determine which of them they support (other than View A).

At the TRG meeting, members discussed the above views and offered a new option, View F, under which an entity would be required to present an additional column in the vintage disclosure table that would include loans that were converted from revolving loans to term loans.

TRG members generally agreed that a "hybrid" approach that combined Views E and F would be appropriate. That is, if an entity made a new credit decision and considered the loan to be a "new loan" under ASC 310-20-35-9 as a result of a related modification, the entity should reflect the loan in the origination year it made the credit decision when converting it from a revolving loan to a term loan. However, if the conversion from a revolving to a term loan was contractually specified in the original loan, or if, as a result of the conversion, the loan was not considered a "new loan" (e.g., it was a troubled debt restructuring), the loan should be reflected in a new column that shows loans that were converted from revolving to term loans. In addition, TRG members suggested that the Board consider whether the scope of the hybrid view should be expanded to include all instruments that are subject to ASU 2016-13 and for which a revised credit decision is made.

Topic 3 — Recoveries

Background: At the June 2018 TRG meeting, the FASB staff stated its belief that the Board's intention when developing the CECL model was for companies to estimate and include expected financial asset recoveries in the CECL calculation because they represent "amount[s] expected to be collected." After the June 2018 TRG meeting, the staff received feedback from several stakeholders that entities were interpreting the term "recoveries" differently.

On the basis of that feedback, the staff described in TRG Memo 17 two possible alternatives on how to clarify the guidance:

- *Alternative 1 — "Allow for All Types of Recoveries to Be Considered Except Sales of Performing Financial Assets* . . . This alternative would have to amend the guidance to limit recoveries to only those amounts expected to be received on nonperforming financial assets."
- *Alternative 2 — "Allow for All Types of Recoveries to Be Considered* . . . [N]o further amendments are recommended for Update 2016-13."

Summary: TRG members discussed the two alternatives at length but did not select either of them. They generally agreed that recoveries should include cash flows from borrowers (i.e., principal and interest), collateral, or the sale proceeds of a financial asset to a third party. A substantial portion of the discussion was devoted to recoveries, and some TRG members suggested that the FASB amend ASU 2016-13 to provide more guidance on the definition of a recovery. The FASB staff will continue to evaluate the two alternatives and will incorporate any amendments to the guidance in a future proposed ASU.

In addition to considering whether and, if so, how to clarify the guidance on recoveries, the FASB staff discussed whether an entity should be permitted to record a negative allowance when measuring the expected credit losses for financial asset(s) subject to a cap. The cap would preclude entities from recording an amount that exceeds the aggregate sum of previous write-offs of the financial asset. The TRG generally agreed with the staff's views on a negative allowance. The staff indicated that the guidance in ASC 326 would need to be amended to indicate that a negative allowance is permitted.

Appendix

Other TRG Submissions

In addition to the three topics discussed above, the FASB staff received from stakeholders the three TRG submissions outlined below. As indicated in TRG Memo 14, these submissions are not addressed in separate TRG memos because "(a) the [FASB] staff believes the current guidance is clear and no amendments are needed or (b) the submission is beyond the scope of the TRG."

Discounting Inputs When Using a Method Other Than a DCF

Stakeholders questioned "whether discounting certain inputs in estimating credit losses would be permitted when an entity uses a method other than a [discounted cash flow (DCF)] method, such as a probability-of-default credit loss method. These stakeholders questioned whether discounting certain inputs to a date other than the reporting date also would be permitted."

The FASB staff stated that it "believes the guidance is clear that if an entity were to discount cash flows or inputs used to measure the allowance for credit losses, the effect of discounting would have to be measured as of the reporting date, not an arbitrary default date." Furthermore, the staff expressed its belief that:

> [P]artial discounting would not provide users with decision-useful information, as it would create additional complexity in understanding the accounting model. In addition, it would not be possible for the staff to determine which inputs should or should not be discounted because the guidance does not provide specificity on which inputs should be considered when measuring the allowance for credit losses. . . . For these reasons, the staff believes partial discounting is prohibited and believes that if an entity wants to discount the inputs used to measure the allowance for credit losses, the entity should discount all the inputs used in the measurement.

TRG members discussed the discounting of inputs in the estimation of credit losses in situations in which a method other than a DCF method is used. Many TRG members expressed the view that discounting certain inputs, specifically recoveries, is better than other methods for reflecting the overall estimated credit losses. However, some TRG members indicated that if a method other than a DCF method is used to estimate credit losses, an entity should be precluded from discounting any inputs. The TRG generally agreed that the guidance is not clear and asked the FASB staff to explain whether an entity would be permitted to discount inputs in estimating credit losses when it uses a method other than a DCF method.

Accounting for Changes in Foreign Exchange Rates for Foreign-Currency-Denominated Available-for-Sale Debt Securities

Stakeholders questioned "the timing of when unrealized losses related to changes in foreign exchange rates from an investment in a foreign-currency-denominated available-for-sale (AFS) debt security should be recognized in earnings." The FASB staff acknowledged concerns raised by stakeholders that the amendments in ASU 2016-13 will delay loss recognition since unrealized losses related to foreign exchange rates are reported in other comprehensive income and recognized in earnings "(a) at the maturity of the security, (b) upon the sale of the security, (c) when an entity intends to sell, or (d) when an entity is more likely than not required to sell the security before recovery of its amortize cost basis." However, the staff noted that:

> [T]he guidance is clear that unrealized losses related to changes in foreign exchange rates from an investment in a foreign currency denominated AFS debt security reported in OCI are recognized in earnings (a) at the maturity of the security, (b) upon the sale of the security, (c) when an entity intends to sell, or (d) when an entity is more likely than not required to sell the security before recovery of its amortize cost basis.

Furthermore, the FASB staff stated "that this topic is beyond the scope of the Credit Losses TRG because the topic relates to reporting changes in fair value related to foreign exchange rates."

TRG members agreed with the FASB staff that this topic is beyond the TRG's scope; however, they asked the FASB staff to clarify the mechanics of the relationship between ASC 830 and ASC 450 regarding the timing of unrealized losses related to changes in foreign exchange rates from an investment in a foreign-currency-denominated AFS debt security.

Beneficial Interest Classified as Trading

Stakeholders questioned "whether an entity should maintain an allowance for credit losses for a beneficial interest in the scope of Subtopic 325-40 that is classified as trading." The FASB staff responded that "the scope of Subtopic 326-20 clearly excludes financial assets measured at fair value through net income. Therefore, the [FASB] staff believes the guidance is clear that an entity is not required to maintain an allowance for credit losses for beneficial interest classified as trading."

In addition, FASB staff acknowledged that:

> [ASU] 2016-13 does not include specific guidance for determining the subsequent measurement of the accretable yield for beneficial interests classified as trading similar to the guidance for HTM and AFS beneficial interests as noted in [ASC 325-40]. However, the [FASB] believes that the guidance on recognition of interest income for beneficial interests in the scope of Subtopic 325-40 classified as trading is beyond the scope of the TRG. The staff believes that entities will need to apply reasonable judgment in determining the amount of accretable yield for beneficial interests classified as trading.

The FASB staff does not intend to continue working on this issue.

Recent Technical Inquiry (Related to ASU 2016-13)

In TRG Memo 14, the FASB staff discusses a recent technical inquiry (and outcome) regarding credit quality disclosures, noting that ASU 2016-13 requires "public business entities 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 to meet the disclosure objective in paragraph 326-20-50-4."

A stakeholder asked the FASB staff whether gross write-offs and recoveries must be "included in the credit quality disclosure, similar to Example 15, because the requirement is not dictated by the guidance contained within paragraphs 326-20-50-5 through 50-6." The FASB staff responded that it believes that "the Board intended to include these amounts to comply with the disclosure requirements . . . in paragraphs 326-20-50-5 and 50-6."

The TRG stated that the examples in ASC 326-20 are not authoritative and recommended that the FASB amend the guidance in ASU 2016-13 to require an entity to disclose gross write-offs and recoveries. The FASB staff intends to make improvements to ASC 360-20 to address the concerns raised by the TRG.

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