Current Expected Credit Losses

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FASB finalized guidance related to the impairment of financial instruments. The following white paper provides information related to the guidance update and its impact on mortgage banking companies.

Current Expected Credit Losses

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Overview

In the aftermath of the global economic crisis, the overstatement of assets caused by the delayed recognition of credit losses related to mortgage and other loans was identified as a weakness by the Financial Accounting Standards Board (FASB). In November 2015, FASB issued the *Accounting Standards Update of ASC 825-15 Financial Instruments – Credit Losses* (ASC 825-15). This standard modifies the existing "incurred loss" model for credit losses on financial instruments and creates a more forward-looking model that is likely to result in the need for companies to increase loan loss reserves.

The main objective of the ASC 825-15 is to provide the readers of financial statements with more useful information about the expected losses related to financial assets at each reporting date. In order to achieve this objective, the current impairment model, which reflects *incurred* credit events, will be replaced by an impairment model that recognizes *expected* credit risks and requires more consideration of a broader range of reasonable and supportable information to inform credit losses. All financial institutions that are exposed to potential credit risk and that hold financial assets being measured at amortized cost will be affected by ASC 825-15. Loans, debt securities not classified as available-for-sale, trade receivables, lease receivables, loan commitments, and reinsurance receivables (within the scope of ASC 944) will all be affected by ASC 825-15.

Debt securities classified as available-for-sale are excluded from the scope of the CECL model and will continue to fall under Topic 320. However, the CECL model does include two significant changes to how credit losses related to available-for-sale securities are measured. Namely, 1) the removal of the requirement to consider the length of time that the fair value of an available-for-sale security has been less than its amortized cost basis when estimating whether a credit loss exists, and 2) the removal of the requirement to consider changes that occur in the fair value of available-for-sale securities after the balance sheet date. Under current GAAP, an entity considers past events and current conditions in measuring credit losses. ASC 825-15 would require that estimates be based not only on relevant information about past events and current conditions, but also reasonable and supportable forecasts that affect the expected collectability of remaining contractual cash flows.

What Will Change?

Mortgage banking companies will be required to impair existing financial assets or commitments to extend credit based on the "current estimate" of contractual cash flows not expected to be collected at each reporting date. This impairment would be reflected as an allowance for expected credit losses. Currently, mortgage banking companies are allowed to delay recognition of credit losses until a qualified event occurs and the loss becomes probable. For example, loan loss reserves are typically not posted until loans reach a certain delinquency threshold (i.e. number of days delinquent). However, this method neglects to include any type of forecasting model that estimates future losses before a qualifying event occurs.

The CECL model would eliminate delayed recognition and would assist mortgage banking companies in estimating and developing a provision for credit losses throughout the contractual term of an asset. Estimates of expected credit losses will also be required to reflect the time value of money either explicitly or implicitly. If a financial institution decides to estimate its current losses based on a discounted cash flow model, the discount rate utilized must be the effective interest rate of the financial assets.

Accounting for CECL

Under the CECL model, the expected credit loss estimated by a company's management would represent cash flows that the company does not expect to collect. The expected loss should not be estimated based on the most likely outcome (that is, the statistical mode), but rather on collectability of the assets over the remaining contractual term. This will pose a significant challenge for mortgage banking companies, as they will be required to estimate losses on loans over their contractual term, beginning on the day they are originated or purchased. When determining the contractual term of an asset, mortgage companies would need to consider many factors, such as prepayment speeds, but would not be allowed to consider expected borrower extensions unless management can reasonably expect to execute a loan modification with the borrower. As the length of time included in a forecast increases, there is considerably more judgement involved and estimating the expected loss becomes more challenging.

In estimating losses under the CECL model, there are three integral factors to consider:

1. Expected credit losses based on relevant information about past events, including historical experience with similar assets.
2. Expected credit losses based on current conditions.
3. Expected credit losses based on supportable forecasts that would affect future collectability.

Mortgage companies would need to consider both quantitative and qualitative factors specific to each borrower, including evaluation of the borrower's creditworthiness. They would also need to evaluate current economic conditions and any forecasted economic changes (e.g. changes to issuer or investor guidelines or to government representation and warranty frameworks).

In addition, when determining a company's expected credit losses, management will need to assess the company's financial assets on either an individual basis or on a collective basis (pool) depending on similar loan characteristics, such as credit risk indicators. As a result, the method used to estimate expected credit losses for financial assets may change over time. For example, a company may initially use a loss-rate method for a pool of similar loans, then later use a discounted cash flow model on individual loans as the credit quality of individual loans in the pool declines.

Effective Date

We expect FASB to allow ample time to implement the standard (e.g. fiscal years beginning after December 15, 2019 for privately held enterprises). Mortgage companies would apply the changes as a cumulative-effect adjustment to the statement of financial position as of the beginning of the first reporting period for which the guidance is effective.

How Can You Prepare Now?

We recommend that mortgage companies begin evaluating the effects of implementation of CECL immediately, as this standard update can potentially be costly and time consuming. Below is a list of items that should be considered prior to implementation:

1. Do you have the resources to capture historical data in order to estimate current losses over the remaining contractual term of financial assets?
2. Can you easily access this data?
3. Can you develop models that evaluate the average contractual term and loss rate of a loan such as Discounted Cash Flow, Regression Analysis, Static Pool or Provision Matrices? Will these models evaluate sound credit quality indicators that assist in evaluating the financial and operating metrics used?
4. Will your current loan origination and accounting software assist you in estimating losses or prevent you from successfully implementing CECL?
5. Begin developing internal control policies and procedures that include your CECL models, indicating which financial assets can be evaluated individually or as a collective group (pool).

6. Begin evaluating which CECL model and forecasting methods makes sense for your company based on historical and current data.

The impact of the CECL change will likely result in an increase of credit loss allowances over those required by existing methodologies. Companies will have to modify or significantly enhance their existing financial reporting and risk systems to include a larger asset population and additional inputs, resulting in a more expensive and time-consuming process.

Tax Considerations

The timing and eligibility of a tax deduction are determined by the general rule of deductibility under § 461. In order for a liability to be deductible under § 461, it must qualify under the "all events test." According to the all events test, a loss can be recognized only when all the following criteria have been met:

1. The fact of the liability has been established,
2. The amount of the liability can be determined with reasonable accuracy, and
3. Economic performance has occurred under § 461(h).

An exception to the general rule related to economic performance exists when the first two prongs of the all events test have been satisfied and where economic performance occurs before the tax return is filed, the item is recurring in nature, and the item is not material or the accrual of the item in the taxable year results in a better matching with income recognition.

The facts and circumstances of each taxpayer's situation should be considered closely and the taxpayer should consult a tax advisor familiar with the complex rules and regulations involved in this area.

Notice to Reader:

The information contained herein is of a general nature and based on authoritative guidance that is subject to change. The descriptive and summary statements in this document are not intended to be a substitute for FASB or IRS guidance or requirements, or any other applicable accounting literature. Companies applying U.S. GAAP should apply the texts of relevant laws, regulations, and accounting requirements, considering their particular circumstances, and consult their accounting and legal advisors. The applicability of the tax information to specific situations should be determined through consultation with tax advisors.