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CECL: What's on Tap for the Future of Credit Loss Accounting?

A new model for expected credit losses is supposed to fix flaws in the accounting system and protect against future financial crises. But the so-called CECL model comes with its own set of challenges that will dramatically change firms' accounting practices for impaired loans.

The Financial Accounting Standard Board's (FASB) recently issued current expected credit loss (CECL) model attempts to align measurement of credit losses for all financial assets held at amortized cost, and specifically calls out potential improvements to the accounting for purchased credit impaired (PCI) assets.

Indeed, this new model changes the entire approach to credit loss accounting by increasing the scope to focus on purchased credit deteriorated (PCD) financial assets and by making the computation of the allowance for credit losses (and the recognition of interest income for PCDs) more comparable with the originated assets.

However, despite the expected benefits of CECL, potential complexities exist. In this article, we explore those complexities and discuss how this new model changes accounting for loans with evidence of deterioration of credit quality since origination.

First, though, let us take a quick look at how we have arrived at this stage. Historically, accounting standard setters such as FASB have recognized that collectability of the contractual amount is one of the key types of financial information investors would consider when making decisions about providing resources to a financial institution.

FASB also acknowledged that some loans cause more problems than others. For example, loans that have experienced deterioration of credit quality since origination present certain challenges in financial reporting, as their expectation of collectability is reflected in both purchase price and future expectations of cash flows.

Consequently, in December of 2003, PCI accounting — which required entities to implement complex accounting treatment of income and impairment recognition for PCI assets — was introduced. From its adoption, however, entities struggled with operational challenges, income volatility, and the comparability of PCI versus originated-assets accounting.

Today, to address impairment accounting by creditors, concepts of contractually required payments receivable, initial investment and cash flows expected to be collected are consistently used across current Generally Accepted Accounting Principles (GAAP) in the US. But CECL, which is expected to take effect for financial institutions in January 2020, requires significant changes to firms' credit loss accounting approach.

Definitions and Scope

To explore how CECL revises the accounting for purchased loans, it is important to start with definitions. According to current GAAP, PCI loans are loans that (1) are acquired by completion of a transfer; (2) exhibit evidence of deterioration of credit quality since origination; and (3) make it improbable, at acquisition, for the investor to collect all contractually required payments receivable.

After a loan is accounted for as a PCI, it continues to be considered a PCI, regardless of its performance (unless it is modified as a troubled debt restructuring). In the past, accurately defining which acquired loans should be considered PCI presented a challenge.

Given the conservative nature of GAAP accounting and the often inadequate amounts of data available (at the time of acquisition) to the acquirer of financial assets, it is no real surprise that financial institutions often scope into PCI population those assets that, after acquisition, significantly outperform expectations over their remaining life. For these assets, PCI accounting often results in unusually high effective yields and — when a decrease in expected cash flows triggers discounting with such yields — unreasonable impairment amounts thus causing income statement volatility.

Furthermore, PCI accounting allows loans that have common risk characteristics that are not accounted for as debt securities — and that are acquired in the same fiscal quarter — to be aggregated into an accounting pool that is considered one unit of account. After a pool is assembled, it accrues income based on a composite interest rate and its integrity is maintained for purposes of applying the recognition, measurement and disclosure provisions of PCI accounting.

This pooling concept was designed to allow the investor to offset "winners against losers" within one pool and potentially achieve less income statement volatility, period-over-period. However, pool accounting presented dramatic challenges operationally, as core banking systems are not set up to manage it.

Incidentally, CECL does not provide for PCD pool accounting, due to individual allocation of the non-credit related discount, but does allow the holder of the assets to maintain existing pools at the time of transition from PCI to PCD upon CECL adoption.

While CECL completely supersedes Subtopic 310-30, it continues to require different accounting for purchased loans with evidence of deterioration of credit quality. However, it also changes the definition for such loans and expands the scope, as follows: PCD assets must be treated as acquired individual financial assets (or acquired groups of financial assets with similar characteristics) that, as of the date of acquisition, have experienced more-than-insignificant deterioration in credit quality since origination (as determined by an acquirer's assessment).

Note the removal of the probability threshold from the definition, and the addition of more-than-insignificant criteria compared to the PCI definition. Identifying PCD assets could therefore present an operational challenge when defining what is "significant," because FASB suggests considering multiple qualitative factors.

The ability to consume systematically large amounts of data points, apply data rules and appropriately tag the acquired assets would be key in accurate designation of PCD assets. But how does PCD designation affect the financials at acquisition and beyond? To demonstrate, we will use the following table (see below) that summarizes the basis of accounting for the acquired loans under current and future GAAP:

Table: Accounting for Acquired Loans under Current and Future GAAP

	GAAP Reference	Loan Type	Increase in Expected Cash Flows	Decrease in Expected Cash Flows	Interest Income Recognition
Current GAAP	ASC 310-20, Receivables – Non-Refundable fees and Other Costs	Acquired loan where an investor expects to collect all contractual cash flows due	Reduce the Allowance amount. No impact to the Effective Interest Rate	Increase the Allowance amount. No impact to the Effective Interest Rate. At acquisition, book at fair value/ purchase price, no Day 1 Allowance	Based on Contractual Cash Flows. Effective Interest Rate is the Contractual rate adjusted for deferred premiums and discounts existing at acquisition
Current GAAP	ASC 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality	Acquired loan where it is probable at acquisition that an investor is unable to collect all contractual cash flows due	Reduce or reverse in full the Allowance amount first. Increase the Effective Interest Rate	Increase the Allowance amount. Use the current Effective Interest Rate to discount expected cash flows and calculate the impairment amount. At acquisition, book at fair value/ purchase price	Based on Expected Cash Flows. Recalculate the accretable yield amount as the excess over revised expected cash flows and the loan's recorded investment
Future GAAP/CECL	ASC 326, Financial Instruments – Credit Losses	Acquired loan that at acquisition experienced a more-than-insignificant deterioration in credit quality since origination	Reduce the Allowance amount. No impact to the Effective Interest Rate	Increase the Allowance amount. At acquisition, recognize credit-related discount as an Allowance against the loan's amortized cost balance	Based on Contractual Cash Flows. Accrete to income only the non-credit-related discount existing at origination
Future GAAP/CECL		Acquired loan that at acquisition did not experience a more-than-insignificant deterioration in credit quality since origination	Reduce the Allowance amount. No impact to the Effective Interest Rate	Increase the Allowance amount. At acquisition, recognize the lifetime expected loss through Allowance and Income Statement	Based on Contractual Cash Flows. Accrete to income the full difference between contractual cash flow and purchase price

Changes to Day 1 Accounting

On Day 1 (at acquisition or origination), CECL requires measurement of the credit losses for newly-recognized financial assets. Moreover, for the purpose of presenting the net amount expected to be collected on the balance sheet, it also requires the recording of the allowance for credit losses.

For non-PCD assets, credit loss expense must be recorded through the income statement to establish the allowance. For PCD assets, there is no income statement impact on Day 1: the initial allowance for credit losses is added to the purchase price and considered to be part of the PCD loan's amortized cost basis.

CECL also calls for a loan-level, non-credit-related discount to be calculated as a derived value from the difference between the receivable and amortized cost and to be recorded into income over the remaining life of the PCD asset.

Thus, CECL presents an interesting misalignment between originated and acquired PCD assets where origination results in the recording of a lifetime loss through expense for assets that are less risky than PCD assets by definition.

Under the current GAAP, it is not appropriate to record a loss allowance at acquisition, and the acquired loan must be recorded at its purchase price. For loans acquired in a business combination, the initial recognition of those loans are based on the present value of amounts expected to be received. Moreover, the allowance for credit losses for the PCI loans must reflect only those losses that are incurred by the investor after acquisition.

The difference between gross expected cash flows and contractual cash flows over the life of the loan represents a non-accretable difference that must be disclosed at acquisition in the financial statement footnotes (but not on the balance sheet). The difference between PCI loan purchase price and gross expected cash flows is accreted to income over the life of the loan using effective interest rate (that is the accretable yield amount).

Given the CECL requirement to calculate, track, and amortize loan-level (non-credit-related) discounts, it seems that PCD accounting will continue to present an operational challenge to financial institutions.

Changes to Day 2 Accounting

After acquisition, recognition of income and expected losses under current and future GAAP also differ.

CECL accounting for interest income recognition is consistent with non-PCD accounting, except for the non-amortization of the Day 1 discount attributable to credit losses, which is achieved through incorporation of the credit-related discount into the Day 1 amortized cost.

Interest income for PCD loans is recognized similar to originated assets, using a level yield methodology where the non-credit related discount is amortized over the remaining loan life. This is consistent with existing GAAP for amortization of deferred fees, costs, acquisition premiums, and discounts.

FASB decided that, under CECL, purchased assets and originated assets follow the same accounting model approach — to as large an extent as possible. Consequently, other than applying a "gross-up approach" for the PCD assets (including a Day 1 allowance on an amortized cost basis), estimation of the expected credit losses for PCD assets must follow the same methodology as originated assets.

An allowance method is not prescribed under CECL, so the discounted cash flow approach is not required for PCD loans. Rather, an investor must estimate credit losses over the contractual term of the financial asset (considering even the remote probability of a loss) and incorporate information on past events, current conditions and reasonable and supportable forecasts.

Current GAAP states that, a loan would be considered impaired, if, based on current information and events, it is probable that the investor is unable to collect all cash flows expected at acquisition (plus extra cash flows arising from changes in estimate after acquisition). Entities are required to use discounted cash flow methodology to estimate expected credit losses on the PCI loans.

Based on these outlined requirements, it is clear that the loss estimate would change for the same loan, even if the same methodology (that is the discounted cash flow approach) is used.

PCI accounting for interest income recognition is not only complex but also based on the expected cash flow changes over time. It requires effective interest rate recalculations, as the cash flow expectations improve over time.

To calculate PCI interest income, the investor must adjust the amount of accretable yield by reclassification from non-accretable difference, and the resulting yield must be used as the effective interest rate in any subsequent application — including the calculation of the future impairment amount. The amount of accretion is tied to the future expectations of cash flows, while contractual cash flows are ignored.

CECL's requirement to incorporate reasonable and supportable forecasts into the credit loss estimate for all instruments (including PCDs) measured at amortized cost presents a new challenge. However, potential competitive advantages can be derived from the use of appropriate modeling approaches for various segments; the ability to apply systematically qualitative factors; and the incorporation of forward-looking information.

Parting Thoughts

As financial institutions transition to CECL, they will not be required to reassess retrospectively whether their existing PCI assets meet the definition of PCD upon CECL adoption. Rather, they will adjust the amortized cost basis of their PCI assets to reflect the addition of the allowance. Moreover, subsequently, they will begin accreting into income the non-credit related discount, after adjusting the amortized cost.

We expect that certain PCD accounting operational difficulties shall continue to exist, because of the allocation and amortization of the non-credit related discount at the individual asset level.

While CECL closely aligns credit loss measurement methodologies across originated and purchased portfolios, and provides for consistent income recognition models based on contractual cash flows, the introduction of the lifetime loss estimate — including the incorporation of forward-looking information — demands significant improvements in financial institutions' data collection, accessibility and retention capabilities.

What is more, firms need to implement expanded analytics and reporting and to adopt more granular — and potentially more sophisticated — loss measurement methodologies.