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Electing the Fair Value Option Instead of CECL? Know the Risks

Introduction

Some recent public disclosures by institutions indicate that some lenders are evaluating electing fair value accounting, also known as the fair value option, or FVO, in lieu of applying the Current Expected Credit Losses standard. What is the FVO and how does it compare with CECL?

Electing the Fair Value Option Instead of CECL? Know the Risks

BY SOHINI CHOWDHURY

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CECL, the Financial Accounting Standards Board's 2016 guidelines on loss accounting, requires institutions to book losses expected over the entire life of the scoped-in financial instruments, including loans they hold, as soon as those instruments are originated or acquired. Assuming all else equal, loans made to borrowers with poor credit have a higher propensity to default. This means that higher reserves are to be recorded against such loans under CECL on day one—the day these loans are originated. Therefore, some in the industry feel that CECL will penalize subprime lenders disproportionately. So, it comes as no surprise that lenders who cater primarily to less pristine borrowers are evaluating an alternative accounting measure—the FVO.

Why are lenders considering the FVO?

Under the FVO, assets within the scope of CECL will be allowed an irrevocable election, at the date of transition to CECL, to be measured at their fair value on the balance sheet with periodic adjustments being immediately recognized into income. The fair value of assets is based on the notion of an exit price, defined as the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date. In the absence of an actively traded market, determining the exit price for loans is a complex exercise. Therefore, it is less common to use the FVO for loans. Despite this, some lenders, especially those in the subprime space, started to seriously evaluate the FVO as an alternative to CECL after the FASB issued the Accounting Standard Update 2019-05 called Targeted Transition Relief. The May 2019 update gives lenders the option to irrevocably elect the FVO on an instrument-by-instrument basis for eligible financial assets measured at amortized cost basis upon adoption of the credit losses standard. This allows lenders to elect the FVO not only for newly originated or purchased loans, but also for existing loans that were historically measured at amortized cost at the time of CECL adoption.

It is not hard to see why the FVO is an enticing option for subprime lenders. One of the most common complaints about CECL is that it forces a lender to book a reserve for the losses expected over the entire life of the asset immediately on day one, while any returns (interest income) are recognized gradually over the life of the asset. This inherent timing mismatch becomes exacerbated in the subprime market where the riskier assets will likely require a greater reserve number. In some cases, the large initial expense will outweigh the benefit of the potential higher returns. Lenders worry that since the loss reserves under CECL will not necessarily align with the actual cashflows, financial results presented to investors will project an inaccurate picture of their businesses' health. This leaves lenders with three options: accept the challenge and move forward under CECL, choose to not underwrite the loan, or utilize the FVO. Those considering the third option should know that, unfortunately, the FVO too has its own set of challenges.

Look beyond day one

Neither the CECL allowance calculation nor the fair value determination is a onetime exercise. Regardless of which method is chosen, it must be repeated every quarter, with the changes recorded in the income statement. This is where the FVO, with its potential for higher earnings volatility, feels less attractive than CECL. The main sources of volatility over the next two years are the risk of an economic downturn and the risk of rising interest rates.

Risks abound with the FVO

With major economies around the world struggling with slowing growth and facing numerous downside risks, an economic downturn over the next two years is highly probable. That, and the associated uncer-

1 http://www.ir.creditacceptance.com/static-files/34a6700b-4cc0-4608-b936-2b9a412646e2
https://investor.oportun.com/static-files/6f2b7d28-56f7-4f94-b0ab-2760a96f0e9f
http://ir.consumerportfolio.com/static-files/57c3f896-d4d6-45ea-802e-f8acdd2b85f1

tainty, will likely have an adverse impact on portfolios measured using either CECL estimates or fair value. When it comes to the subprime market, assets at fair value will likely see increased volatility because the exit price used in fair value calculations, unlike the transaction price or entry price, incorporates the entire gamut of possible risks facing the lender, including interest rate, liquidity, reputational, credit, counterparty, policy, geopolitical, process, political, cyber, operational, etc. Adverse events in any one of these can dent the valuation of a company's loan book. For example, the reputational risk for lenders electing the FVO is particularly significant. Subprime portfolios have earned a hard-to-shake-off ugly reputation after the 2008-2009 financial crisis. With the first signs of stress in the economy, subprime loans likely will find no takers, puncturing their valuations. The ensuing liquidity crunch will force the central banks of the world to intervene. A liquidity shortage can also strike in an economy running at full employment with well-capitalized banks—the brief episode of panic in the U.S. repo market in mid-September was a stark reminder.

Interest rates have a direct impact on the market valuation of portfolios. All else equal, rising interest rates can erode the portfolio's value and the FVO election irrevocability clause will leave the lender with no exit route. This is a real concern because in the current historic low interest rate environment, it is just a matter of time before growing wage and inflation pressures eventually push up rates.

In contrast, CECL incorporates only credit risk, that is, the risk of a borrower defaulting. That is not to say that CECL will not result in volatile quarter-over-quarter earnings, but the primary driver of that volatility will be economists' inability to precisely predict the future economy. Estimating CECL reserves based on multiple scenarios is a way to dampen the noise in economic forecasts and, in the process, also in the loss estimates, as explained here.

The takeaway

Electing the FVO in lieu of CECL might save subprime lenders from having to book large reserves on the new accounting standard adoption date. However, the risks associated over time with the FVO irrevocable election are significant. The greatest risk is the potential for high quarter-over-quarter volatility in valuations, especially in the current uncertain economic environment. Lenders should evaluate this trade-off carefully when deciding whether to elect CECL or the FVO under the new accounting rule.

About the Author

Sohini Chowdhury is a director and senior economist with Moody's Analytics. She specializes in macroeconomic modeling and forecasting, scenario design and market risk research, with a special focus on stress-testing and CECL applications. Previously, she led the global team responsible for the Moody's Analytics market risk forecasts and modeling services while managing custom scenarios projects for major financial institutions worldwide. An experienced speaker, Sohini often presents at client meetings and industry conferences on macroeconomic models, scenarios and CECL solutions. Sohini holds a PhD and a master's degree in economics from Purdue University, and a master's degree in applied statistics from West Chester University in Pennsylvania. Before joining Moody's Analytics in 2011, she taught economics at the University of Cincinnati.

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