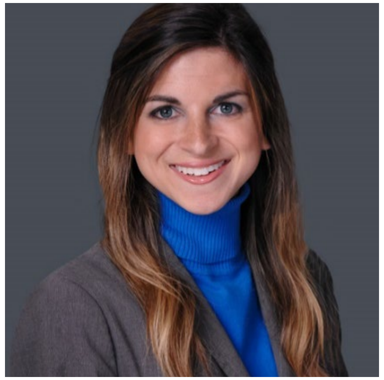
# ASC 326-20 (CECL) AND THE FAIR VALUE OPTION

May 26, 2022

# Today's speakers

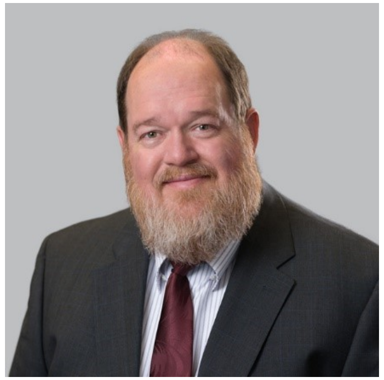



**Amber Sarb**

Senior Manager, National Professional Standards Group, RSM US LLP

Schaumburg, IL

+1 847 413 6453


**Kenton Thompson**

Senior Director, Valuation Services, RSM US LLP

Charlotte, NC

+1 407 581 3587

# Agenda

| Topic | Minutes |
|---|---|
| Overview of the credit losses standard | 15 |
| Fair value option | 30 |
| Observations | 10 |
| Questions and answers | 5 |

# Objectives

By the end of this course, you will be able to:

- Consider the implications of the new standard on credit losses (ASC 326-20) at your institution
- Evaluate the fair value option as an alternative for your institution

# Polling question #1

- Did you attend our webcast, ASC 326-20 (CECL) for specialty finance companies, originally held on May 19?
  A. Yes
  B. No





RSM

You may access a recording of our webcast, *ASC 326-20 (CECL) for specialty finance companies*, originally held on May 19 at https://rsmus.com/events/2022-events/cecl-webcast-series-for-specialty-finance-companies.html





RSM

# OVERVIEW OF THE CREDIT LOSSES STANDARD

# ASU 2016-13

- ASU 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, was issued in June 2016
- Includes significant changes to the determination of the allowance for credit losses on financial assets held at amortized cost basis (focus of this presentation)
  - Supersedes many of the provisions in ASC 310 and 450

# Revised effective dates (based on calendar year-end)

## 2022**

- PBEs that are SEC filers, except SRCs as defined by the SEC
- All interim periods within the calendar year

## 2023

- All others (PBEs that are SEC filers and SRCs, PBEs that are not SEC filers, Non-PBEs)
- All interim periods within the calendar year

***The CARES Act and Consolidated Appropriations Act deferred the original implementation dates for certain regulated financial institutions; however, regulators still allowed entities to adopt as of 1/1/2020, 1/1/2021, 12/31/2021 or 1/1/2022, if desired*

# Applicability of CECL

- The following are in-scope:
  - Financial assets measured at amortized cost basis
    - Financing receivables (e.g., loans and net investments in leases recognized by the lessor in accordance with ASC 842 that are held for investment)
      - Net investment in leases includes direct financing and sales-type; does not apply to operating leases
    - Held-to-maturity debt securities
    - Receivables resulting from revenue transactions in the scope of Topic 606 (revenue from contracts with customers) or Topic 610 (other income)
    - Reinsurance receivables resulting from insurance transactions in the scope of Topic 944
    - Receivables related to repurchase agreements and securities lending transactions in the scope of Topic 860
  - Off-balance-sheet credit exposures not accounted for as insurance (e.g., loan commitments, standby letters of credit, financial guarantees not accounted for as insurance and similar instruments other than those in the scope of Topic 815 on derivatives and hedging)

# Applicability of CECL (cont.)

- The following are generally NOT in-scope:
  - Loans held for sale
  - ***Financial assets measured at fair value or for which the fair value election has been taken***
  - Available-for-sale debt securities
    - ASU 2016-13 did amend certain guidance relating to measurement of credit losses on AFS debt securities (formerly OTTI) - refer to the ASU and ASC 326-30 as not captured in this presentation
  - Equity securities (measured at fair value in accordance with ASC 321)
  - Loans between entities under common control
  - Options and futures contracts

# Major provisions of CECL

- Pre-adoption guidance – recognize incurred credit losses when probable and estimable
- CECL - Recognize lifetime expected credit losses at the time of origination/purchase of the financial asset
  - Through allowance for recognized financial assets
  - Results in day 1, life of asset expected loss recognition for recorded financial assets and off-balance-sheet exposures
  - Changes in the allowance (plus and minus) are recorded immediately through provision for credit losses





RSM

# Amortized cost basis

| DEFINITION |
| --- |
| The amortized cost basis is the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, writeoffs, foreign exchange, and fair value hedge accounting adjustments. |
| **KEY ASPECTS OF THE DEFINITION** |
| Inclusion of accrued interest, premium, discount and net deferred fees or costs.<br><br>*For accrued interest, refer to the Practical Expedients and Policy Elections section that may allow for a policy election to not record an allowance for accrued interest.* |
| **WHAT WILL THIS MEAN FOR YOUR ALLOWANCE?** |
| The allowance for credit losses cannot be computed in a manner that only factors in unpaid principal balance. For example, if historical losses do not include losses on accrued interest, premiums, discounts and net deferred fees/costs, management must arrive at separate estimated losses for those components of amortized cost.<br><br>*For accrued interest, refer to the Practical Expedients and Policy Elections section that may allow for a policy election to not record an allowance for accrued interest.* |

# Reserve + unamortized purchase discount ≠ allowance for credit losses

"…In addition, when an entity expects to accrete a discount into interest income, the discount should not offset the entity's expectation of credit losses…"

ASC 326-20-30-5

**Rationale is that expected lifetime losses are required to be recognized as of day one under CECL - waiting to "use up" the unamortized discount and then start recording required reserves would not be reflective of an appropriate day one allowance**

# Reserve + unamortized purchase discount ≠ allowance for credit losses (cont.)

- Entities should have a rational, systematic and documented methodology for computing the allowance, independent of any consideration of the unamortized discount
- If the entity has historically combined the unamortized purchase discount and a calculated reserve to reflect an overall estimate of the allowance, this is no longer allowed
  - Compliance cannot be achieved by merely reducing the unamortized discount and adding that balance into the allowance day one; need to consider each independently
  - Unamortized discount is to be recognized over life of the loan using the interest method, whereas allowance is to be recognized day one (and adjusted as needed throughout the life)

# Qualitative factors and adjustments

- Consider relevant, reliable, and available information (internal and/or external) when estimating expected losses
- Should not rely solely on past events (i.e., historical loss calculation)
- Required to adjust historical loss information or the initially calculated allowance for:
  - Current conditions
    - Differences in risk characteristics (loss drivers) as compared to the period upon which historical losses were calculated
    - No change from previous standard
  - Asset-specific risk characteristics
- Required to incorporate adjustments for reasonable and supportable forecasted conditions
    - Significant change from previous standard





RSM

# FAIR VALUE OPTION

# ASU 2019-05

ASU 2019-05, *Financial Instruments – Credit Losses (Topic 326): Targeted Transition Relief*, was issued in May 2019

Provides an option for entities with certain financial instruments to ***irrevocably*** elect the fair value option (ASC 825-10) upon adoption of CECL)

- Can be elected on an instrument-by-instrument basis
- Must be applied at adoption date and applied to financial assets previously held at amortized cost
- Cannot be applied to held-to-maturity debt securities

**Prospectively, could elect fair value option on new originations or measure under CECL model; this relief is for existing financial assets**





RSM

# Polling question #2

- Do you currently elect the fair value option for any assets or liabilities held at your institution?
  A. Yes
  B. No
  C. Unsure
  D. Not applicable, I am an auditor or other party to which this does not apply




RSM

# Fair value option

- Applied on a modified-retrospective basis by means of a cumulative-effect adjustment to the opening balance of retained earnings as of the adoption date
- Most interest in this approach has been from those with short duration products, those that commonly lend to subprime borrowers, those in the auto finance industry, and those that purchase contracts at a significant discount
- Entities need to weigh the cost/benefit of this approach
- Management should evaluate various methodologies/models under ASC 326-20 and the fair value option to determine which may be best based on nature of the entity and its financial assets as well as the needs of financial statement users

# Cost / benefit considerations

Both require regular re-evaluation/calculation

Generally involves loan-by-loan analysis, while certain other models derive allowance balances on a pooled basis

The needs and sophistication of users and what may be most relevant and understandable to them (i.e., how transparent about the model can the entity be)

Fair value accounting in accordance with ASC 825 can be just as challenging as establishing an allowance under ASC 326-20

Expected to need to involve a valuation specialist to assist with the fair value option

May be able to leverage existing processes and controls for those that are already acquisitive in nature or that disclose fair value in the financial statements

# Cost / benefit considerations (cont.)

Assets under FVO can be marked up (i.e., FV may be greater than amortized cost); very limited circumstances under CECL where here will be a “negative allowance”

Whether there is an actively traded market where inputs may be more readily available (e.g., securitization transactions)

In the absence of an actively traded market, determination of the exit price for receivables is a complex exercise

Exit price can be a volatile measure, depending on the nature of the asset and the economy, which may lead to significant income statement and asset volatility

Loan origination fees and costs are recognized as charged/incurred under the FVO and do not require deferral under ASC 310-20

# Polling question #3

- Based on the cost / benefit considerations discussed, do you believe that the one-time, irrevocable fair value election would be advantageous for your institution?
    A. Yes, for all product types
    B. Yes, for some product types
    C. No
    D. Unsure, I need more information

# Exit price

- 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
- Exit price incorporates potential risks facing the lender that a buyer would take into consideration, such as:
  - Interest rates risk (e.g., rising rates generally decrease fair value)
  - Liquidity risk
  - Reputational risk
  - Credit risk
  - Counterparty risk
  - Policy and political risk
- Exit price may be difficult to establish for financial assets such as loans, especially when there is not an actively traded market
- Fair value is based on market participant expectations, whereas CECL is established using management's best estimates

# Valuation techniques / options (ASC 820)

## Market approach

- Uses prices and other relevant information generated by market transactions involving identical or comparable assets, liabilities, or a group of assets and liabilities
- Quoted prices can include actual prices at which a sale occurred, or quotes provided by brokers or other third parties

## Income approach

- Converts future amounts (e.g., cash flows) into a single, discounted current amount based on current market expectations about those future amounts
- Commonly referred to as “present value” or “discounted cash flow” technique
- Discount rate is a significant input that will require judgment and should be based on market assumptions, not entity-specific assumptions

## Cost approach (not applicable for receivables)





RSM

# Market approach

- More commonly used for homogeneous type loans such as residential mortgages that frequently trade on the secondary market or other loan types (e.g., auto loans) for which there is an active securitization market
- Transaction price is not always representative of fair value
  - Main considerations include whether related parties are involved, if the transaction takes place under duress/pressure, similarity of the unit(s) of account and principal or most advantageous market
- Primary assumptions
  - Adjustments to quoted prices due to differences in credit risk and security-specific features
  - Adjustments for transformation costs and profit margin (if using securitization pricing as a starting point)

# Income approach

- Observable data can and should be used to the extent possible, including peer and industry data
- Primary assumptions
  - Prepayment speed (rate) for amortizing loans
    - Curtailment speed (rate) for revolving loans
  - Probability and timing of default
  - Expected loss given default
  - Recovery rate and period (time between default event and resolution)
  - Discount rate

# Income approach – discount rate

- Rate that would be required by a ***market participant***
  - Most recent origination rates are not necessarily representative of a market participant / exit price perspective (i.e., cost to sell/expected return of the market participant is the main consideration, not necessarily the pricing that originating party would accept)
  - Some use the yield on bonds with comparable risk (however, need to consider and adjust for similarities and differences as noted below)
- Consideration should be given to duration of the contract, risk profile, illiquidity and other relevant factors (economic and asset specific)
  - One method for establishing a liquidity discount is to examine average spreads between certain rated securities and treasury securities at the valuation date
  - Factor in presence of credit enhancements, relative risk of/appetite for loss to market participant vs. originator, origination fees received
- Risks inherent in the cash flows must be considered either in the expected cash flows or the discount rate
  - If incorporated through the expected cash flows, then discount rate should be a “risk-free” rate

# Income approach – prepayment speed (rate)

- Constant prepayment rate (CPR) represents percentage of outstanding principal balance paid in each period, often evaluated on a monthly basis
  - CPR curve may be used when prepayment rates expected to vary due to variable rate terms, seasonality, borrower characteristics, or other factors
- May be established through historical experience, prepayment expectation models, and (or) third-party analysis
- Peer or external data may be available for certain loan types, but for others may need to be modeled or individually estimated
  - Make sure that peer or external data used is for comparable entities or products and, if not, make appropriate adjustments and document rationale/method

# Income approach – default and recovery timing and rates

- Existing expected credit loss models may be used in arriving at this estimate
- Often impacted by historical default experience, credit metrics of the portfolio, and market data
- Consider “loss drivers” in establishing default rates (e.g., credit score, LTV, DSCR, vintage, product type)
- Recovery period (i.e., difference in timing between charge-off and recovery) may need to be taken into consideration and incorporated into the assumptions





RSM

# Comparison of DCF inputs and assumptions – fair value option and CECL

## Fair value option

- Use renewal and extension assumptions (limited application in CECL)
- Only known or knowable inputs and assumptions used (no forecasts)
- Discount rate = market participant approach to establish rate

## Common

- Contractual loan terms (orig. date, interest rate, maturity, payment frequency, etc.)
- Borrower credit data (LTV, DSCR, credit score, risk rating, etc.)
- Default and recovery timing/rate
- Prepayment/curtailment rate
- Loss given default

## CECL

- Adjustments for current conditions and asset-specific risk characteristics
- Adjustments for reasonable and supportable forecasts
- Discount rate = effective interest rate of asset

# Presentation

Balance sheet - separate those reported fair values from the carrying amounts of similar assets and liabilities measured using another measurement attribute

1. Present the aggregate of fair value and non-fair-value amounts in the same line item in the balance sheet and parenthetically disclose the amount measured at fair value included in the aggregate amount; or
2. Present two separate line items to display the fair value and non-fair-value carrying amounts.

Income statement - should disclose, by line item, the amounts of gains and losses included in earnings during each period and in which line item in the income statement those gains and losses are reported

Election available to disclose interest income and change in fair value separately or combined in the income statement.

# Select disclosure requirements related to the fair value option (ASC 825)

- Reasons for electing the fair value option for each eligible item or group of eligible items
  - If the fair value option is not elected for all eligible items within a group, a description of the items and the reason for partial election
- Difference between the aggregate fair value and the aggregate unpaid principal balance of loans and long-term receivables
- Certain disclosures related to past due status (greater than 90  days past due) and interest income recognized
- Estimated amount of gains or losses included in current earnings attributable to instrument-specific credit risk, and the manner in which such gains and losses were determined
- Methods and significant assumptions used to estimate fair values of items for which the fair value option has been elected (relates to ASC 820 requirements)

# Disclosure requirements related to fair value (ASC 820)

- Note that fair value disclosures under ASC 820 are still required
- In most cases, loans and other finance receivables carried at fair value will be classified as Level 3 due to the use of unobservable inputs in arriving at fair value
  - Several additional quantitative and qualitative disclosures exist for Level 3 financial instruments (as compared to Levels 1 and 2)

# OBSERVATIONS

# Lessons learned – public company adoption

- Very common to employ a valuation specialist (management specialist) to derive fair value as a result of complexities involved in deriving fair value estimates
- Data availability and modeling capability
  - Having the data available to run a financial model is a significant part of adoption
  - Includes ability to support the inputs used and to update on a periodic basis
  - May need to consider employing a third-party for initial and (or) ongoing modeling capability if do not have the resources or capability to execute in-house
- Just as an entity should parallel run a CECL model for calculating the allowance for credit losses for a period before adoption, may also be wise to parallel run the fair value option for a few periods to see how it works on an ongoing basis
- Consider the disclosure requirements for Level 3 inputs

# Polling question #4

- What do you think would be the most difficult assumption to derive when using a DCF approach under the FVO?
  A. Discount rate
  B. Prepayment / curtailment speed (rate)
  C. Probability and timing of default
  D. Estimated loss given default
  E. Recovery rate / period
  F. Other




RSM

# QUESTIONS AND ANSWERS

# THANK YOU FOR YOUR TIME AND ATTENTION

RSM

**RSM US LLP**

Address
City
Phone

+1 800 274 3978
rsmus.com



RSM