

Southeast Bankers Outreach Forum

Accounting Policy Update

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TOPICS

- **Proposed rule on accounting for credit losses**
- **Mortgage loan purchase programs**
- **Loans Held for Sale**
- **New rules on revenue recognition**

NEW RULES: ACCOUNTING FOR CREDIT LOSSES

- **Change in rules for accounting for credit losses**
 - Current accounting model considered inadequate
- **Delayed recognition of losses due to “probable” and “incurred” thresholds**
- **Inability to consider forward-looking information**

KEY ELEMENTS OF THE PROPOSED STANDARD

- Allowances to be based on estimate of lifetime current expected credit losses
- Expected credit losses defined as “current estimate of all contractual cash flows not expected to be collected”
 - No triggers, no thresholds
- Aims at quicker recognition of losses
 - Changes in allowance balances reflect changes in credit quality and flow through bank earnings

TRANSITION IMPACT ON THE ALLOWANCE

- **Allowance levels will most likely increase upon transition from current incurred loss model to CECL**
- **Actual impact upon transition will depend on:**
 - **Level of allowance**
 - **Portfolio composition**
 - **Economic conditions expected**
- **Allowances should not be built in anticipation of transitioning to CECL (beyond those appropriate under existing GAAP)**

IMPLEMENTATION CHALLENGES

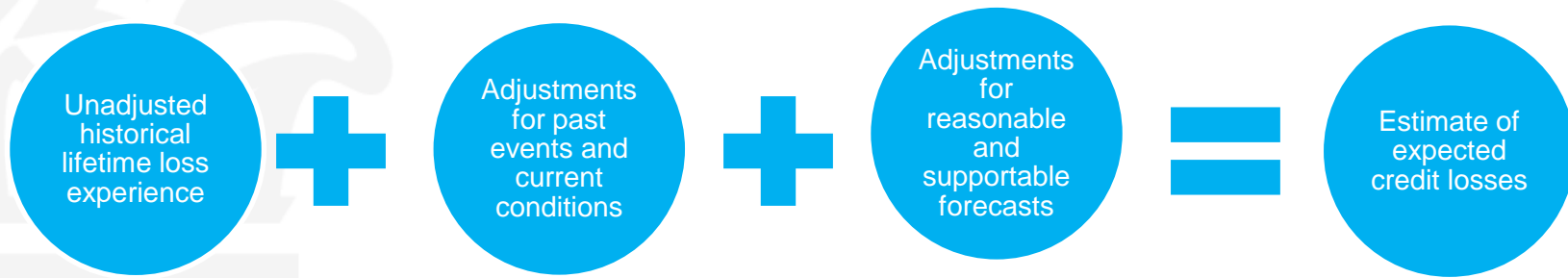
- **Banks DO NOT need complex models**
 - However, banks may need to make changes for data collection and analysis

MEASUREMENT OF EXPECTED CREDIT LOSSES

- **Choice of methods available include:**
 - Loss-rate methods
 - Roll-rate methods
 - Probability of default methods
 - Discounted cash flow methods
 - Provision matrix method using loss factors
- **Will likely need to change inputs and assumptions**
 - Moving from annual → lifetime loss rates
- **Any reasonable approach may be used**
 - Zero ALLL should be rare

MEASUREMENT (CONT.)

- A current estimate of all contractual cash flows not expected to be collected should incorporate:
 - Internally and externally available information
 - Information about past events, current conditions, and reasonable and supportable forecasts
 - Quantitative and qualitative factors specific to borrowers and the economic environment including underwriting standards



UNADJUSTED HISTORICAL LIFETIME LOSS DATA

- **Most banks currently are collecting annual charge-off data**
- **Banks will need to collect lifetime loss data**
 - Loss rates
 - Delinquency data
 - Risk rating transition data

EXAMPLE: APPLICATION OF LOSS RATE METHOD

- **Assume a portfolio of 4-year amortizing, retail finance loans:**

The following pattern of credit loss experience has been developed based on the ratio of the amortized cost basis in each vintage that was written off because of credit loss and the original amortized cost basis, shown as a percentage.

- **Projected loss rates based upon the following:**

Table 1: Loss Experience in Years Following Origination						
Origination @EOY	Year 1	Year 2	Year 3	Year 4	Total	Projected
2001	0.50%	1.20%	1.40%	0.30%	3.40%	
2002	0.60%	1.20%	1.60%	0.50%	3.90%	
2003	0.40%	1.10%	1.50%	0.30%	3.30%	
2004	0.60%	1.10%	1.50%	0.40%	3.60%	
2005	0.50%	1.30%	1.70%	0.50%	4.00%	
2006	0.70%	1.50%	1.80%			4.60%
2007	0.80%	1.40%				4.80%
2008	0.70%					5.00%
2009						5.10%

BANKS

Banks are encouraged to:

- **Become familiar with the proposed accounting standard**
- **Discuss the proposed accounting changes with external auditors, industry peers and regulators**
- **Review current ALLL and credit risk management practices to identify processes that might be leveraged**
- **Begin collecting data that might be used in a lifetime expected credit loss model**
- **Begin drafting an initial, high-level plan for CECL implementation**

EFFECTIVE DATE

- **FASB expects to issue the standard by 12/31/15**
- **Implementation date not yet determined**
 - Likely no earlier than 1/1/2019
- **Public vs. private; asset size**

MORTGAGE PURCHASE PROGRAMS

- **Under a mortgage purchase program, a bank provides funding to a mortgage loan originator and simultaneously obtains an interest in the mortgage loans from the originator, subject to a takeout commitment from a third-party investor.**
- **Interagency view on mortgage purchase programs**
- **Issues to consider:**
 - **Does the accounting by the originator qualify as a sale of the loans or as a secured borrowing?**
 - **Risk-based capital treatment and potential legal lending limits**

ACCOUNTING CONSIDERATION

- For the transaction to qualify as a sale by the originator to the acquiring institution, certain conditions must be met:
 - If the sale is structured using a loan participation agreement, the transferred ownership interest must meet the definition of a participating interest.
 - The transfer must meet all three conditions set forth in [ASC 860-10-40-5](#) to demonstrate that the originator has surrendered control over the transferred financial assets:
 - Legal isolation
 - Ability to pledge or exchange the assets
 - Effective control

REGULATORY CAPITAL TREATMENT

If the transaction under the mortgage purchase programs does not qualify for sale treatment, the funds advanced by the bank should be accounted for as a warehouse line of credit and assigned a 100 percent risk weight.

Call Report treatment:

See [March 2013 Federal Financial Institutions Examination Council Call Report Supplemental Instructions](#)

(<http://www.fdic.gov/news/news/financial/2013/fil13015a.pdf>)

LOANS HELD FOR SALE

- **When a decision is made to sell a loan, the loan should be clearly identified and transferred to the held-for-sale (HFS) account.**
 - Identifying when a decision is made to sell is judgmental
- **Criteria in interagency guidance and GAAP**
 - Scope of interagency guidance and GAAP is narrow, however, can be used by analogy
- **2001 Interagency Guidance**
 - At the time the decision is made, a formal marketing strategy or plan of sale is typically developed.
 - A plan of sale may include, for example, identification of the loans to be sold, the expected method of sale, the time period expected for completion of the sale, and an active program to find a buyer.
- **Implications for allowance if a price is discovered but no sale occurs.**

REVENUE RECOGNITION

- **Core Principle**
 - Revenue is recognized at the amount reflecting the consideration to which the entity expects to be entitled in exchange for the goods and services
- **Requires use of greater judgment and estimates**
- **Generally included in the scope of the standard**
 - Seller-financed sales of other real estate owned (OREO)
 - Trust and custody services
 - Cash management and payment processing services
 - Deposit account fees
 - Credit card interchange fees
 - Credit card rewards programs

REVENUE RECOGNITION

Seller-financed sales of OREO

- **Current model constrains full profit recognition**
- **New model recognizes revenue when control of OREO transfers**
 - Collectability must first be “probable” to apply model
 - Buyer must be “committed” to perform
 - Recognize as revenue the amount of which the bank expects to be entitled
 - Record provision expense for any amounts not expected to be collected

ACCOUNTING UPDATE

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Questions?