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President & CEO, ARCSys

Understanding Collateral Dependent Loans

and Converting Impaired Loans at Adoption of CECL

Concept of Impaired Loans Today

- Impaired loans currently have two methods for calculation
  - DCF and Collateral
- Impaired loans as defined are gone under CECL including TDR's
- CECL has two similar concepts but the are not applied the same
  - All loans are in-home risk pools
  - Collateral Dependent
    - Foreclosure
    - Borrower experiencing financial difficulties
  - Individual CECL evaluation for loans that do not fit into a homogeneous risk pool.

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Why did FASB Change Impairment Process

- Forecasting changes everything
- Hard to individually forecast a loan without pool statistics
- Discounted Cash Flow is now a method for CECL
- Forecasting collateral is difficult
- CECL Pool Concept drives risk assessments, forecasting and modeling

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- First, loans are collectively evaluated in pools with loss forecasted over the contractual term of the pool. Loans within the same pool should have similar risk characteristics.
- Pool analysis includes, charge-off historical data, prepayment data, probability of default data, and loss given default data.
- Correlating external factor analysis
- Documentation and support required

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Measuring CECL – Step 2

- Second, if a loan does not fit any risk profiles, the entity may develop a borrower specific risk profile and forecast losses over the contractual term of the loan using any CECL method. However, using the current value of collateral is not acceptable.
- Need borrower specific risk and forecasts

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Measuring CECL – Step 3

- Third, loans can be determined to be collateral dependent if:
- Foreclosure of the loan's underlying collateral is probable (requirement)
- A practical expedient (not a requirement)
  - if the borrower is experiencing financial difficulties and (requirement)
  - the repayment is to be provided ***substantially*** through
    - The operation of the collateral or
    - Sale of the collateral.

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Breaking Down Collateral Dependent - Foreclosure

- Foreclosure is probable (or in foreclosure)
  - This is a MUST!
  - Requirement because fair value (minus selling costs) is best measure of cash flow for loans with collateral in foreclosure
  - Similar to today's model but foreclosure required

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Breaking Down Collateral Dependent – Borrower Financial Difficulty

Step One – Borrower must be experiencing financial difficulty → Continuous assessment → Not the same as impaired, higher assessment and more documentation → Can not use practical expedient if this is not met! → Can past due be the only indicator? → How to document?

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Breaking Down Collateral Dependent – Substantially

- First, FASB does not define "substantially", however the dictionary defines substantially as "considerable in quantity".
- Each institution will have to consider how they evaluate this subjective definition. Why is this important? Sometimes, the collateral's value has diminished, and the repayment may have to come from the guarantor. The deterioration of the collateral's value can also affect the guarantor's ability to fund the guaranty.
- Accepting payments over a longer period may show that the threshold of substantiality will not be met.
- The ARCSys team believes the concept of "substantially" here is critical because if the loan is not repaid substantially through the sale or operation of the collateral, it would not fit the definition.
- In the community bank environment, it is not unusual for loans to stay on nonaccrual for longer periods. Leaving a loan in collateral dependent status for a long period of time is in stark contrast to the concept behind the inclusion of collateral dependent loans within the CECL standard. Why? Because the calculation is based on current collateral value and collateral value can change significantly over time. In addition, the longer you hold a loan in this status it calls into question whether the borrower is having financial difficulties and why the institution has not taken action to sell the asset.

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Breaking Down Collateral Dependent – Through the Operation Of

- FASB does not define "through the operation of". In general, this indicates that the revenue generated by the asset would cover the repayment of the loan.
- However, when can this happen if the borrower is experiencing financial difficulties and does the institution need to take over possession of the asset?
- For most community banks, the asset is directly tied to either the business of the borrower (i.e. the borrower's business operates out of or uses the collateral), or the collateral is the business such as a hotel or rental property.
- In addition, for most community institutions, the collateral as well as the revenue of the associated business were used to underwrite the loan. So, if the borrower is experiencing financial difficulties due to poor business performance is it reasonable to expect that it would not continue to have financial difficulties if operated by the lender?
- Determining and documenting how to operate the asset without taking over control of it may be difficult. Also, determining cashflows from the business operations may be time consuming especially if the institution does not take control of the collateral and constantly updating and monitoring the cashflows through time would be costly.
- Probably requires cash flow calculation and forecasting of cashflows

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Breaking Down Collateral Dependent – Sale of Collateral

- Fair Value minus selling costs
- Selling costs includes similar costs to todays calculation
- Must be updated periodically
- Documented support needed
- The longer a loan stays in this status, the easier it will be for auditors to question the collateral dependent status.

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CPE Polling Question #1

Collateral Dependent is now defined to included the following?

- All impaired loans
- One of several methods to apply to loan pools
- Loan in foreclosure
- Where the borrower is having financial difficulties

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PCI to PCD Conversion for Collateral Dependent and Other loans

Purchase Credit Impaired

- Historically PCI occurs when one institution purchases another or part of another such as a branch.
- All loans are added to acquiring institutions balance sheet at fair value
- No Allowance is recorded
- PCI vs Non-PCI at purchase
  - PCI loans are generally impaired at time of purchase
  - Non-PCI loans are generally all other loans purchased
- All loans generally have a credit risk and interest rate risk adjustment for fair value. This includes premiums/discounts and credit marks for FV allowance loss estimate
- These marks may be separate or combined

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Purchase Credit Deteriorated

Affects all purchases of Loans and investments

Purchased Financial Assets with Credit Deterioration - PCD

- Acquired individual financial assets or acquired groups of financial assets with similar risk characteristics that as of the date of acquisition have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment.

*Source: ASU 216-13

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PCD Assets Affects

- Purchased Loans or Loan Pools
- Purchased HTM and AFS Investments
- Business Combinations

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Initial Measurement

Initial Measurement

- An entity shall record the allowance for credit losses for **purchased financial assets with credit deterioration** by the acquirer using any CECL method the acquirer deems appropriate.
- AFS securities would have the AFS DCF method applied.

*Source: ASU 216-13

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PCD Gross Up Approach

The amortized cost of the PCD asset at initial recognition would be the sum of the purchase price and the associated expected credit loss at the date of purchase.

*Source: ASU 216-13

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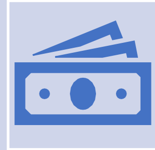
Initial Measurement



An entity shall account for purchased financial assets that **do not have** a more-than-insignificant deterioration in credit quality since origination in a manner consistent with originated financial assets.

At purchase, Non PCD financial assets will have an allowance on the acquirer's books at purchase with the effect of the allowance through income

*Source: ASU 216-13

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Example PCD

- Assume 50 million loan purchase
- Assume 25 million is determined to be PCD and 25 million Non-PCD
- Assume CECL Allowance on PCD is 750,000 and and Non-PCD is 500,000
- At purchase
  - $750,000 is added to purchase price and allowance – no P&L effect
  - $500,000 is added to provision on acquirer's books and allowance – reduction of income
  - Allowance is created for 1.25 million on acquirer's balance sheet

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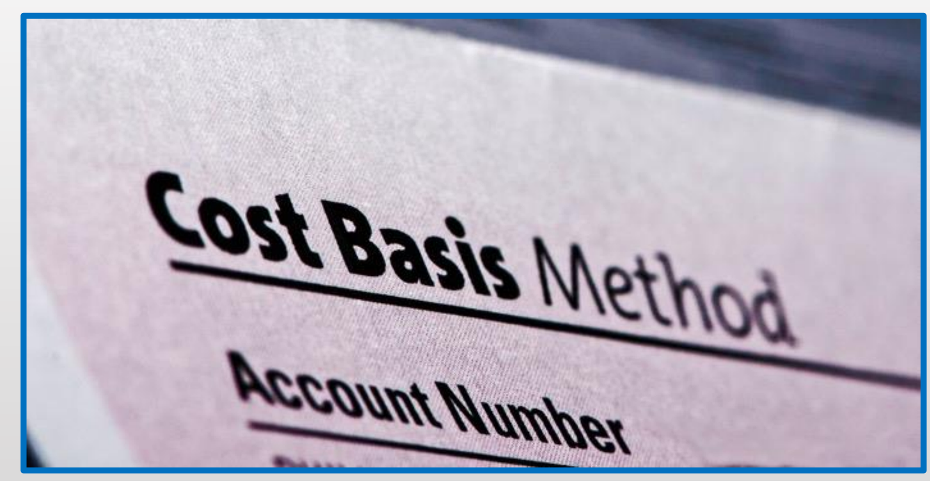
Initial Measurement



An entity shall add the allowance for credit losses at the date of acquisition to the purchase price to determine the initial **amortized cost basis** for purchased financial assets with credit deterioration.

Any noncredit discount or premium resulting from acquiring a pool of purchased financial assets with credit deterioration shall be allocated to each individual asset.

At the acquisition date, the initial allowance for credit losses determined on a collective basis shall be allocated to individual assets to appropriately allocate any noncredit discount or premium.

*Source: ASU 216-13

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PCD Methods

- If an entity estimates expected credit losses using a discounted cash flow method, the entity shall discount expected credit losses at the rate that equates the present value of the purchaser’s estimate of the asset’s future cash flows with the purchase price of the asset.
- If an entity estimates expected credit losses using a method other than a discounted cash flow method, the entity shall estimate expected credit losses on the basis of the unpaid principal balance (face value) of the financial asset(s).
- Collateral Dependent Calculation

*Source: ASU 216-13

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PCD Investments New CECL Methodology

- All purchases will be reviewed for PCD
- Allowance may be booked at purchase if PCD
- If not PCD, Allowance may be booked in a subsequent period when FV becomes less than Amortized cost basis – technically impaired

*Source: ASU 216-13

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CPE Polling Question #2

Adopting PCD process and policies will require institutions to:

- Develop policies for what comprises more than insignificant
- Create process to apply CECL losses to pool before purchase
- Slow down the purchase process
- Break loan purchases into PCD and Non-PCD Pools
- All the Above

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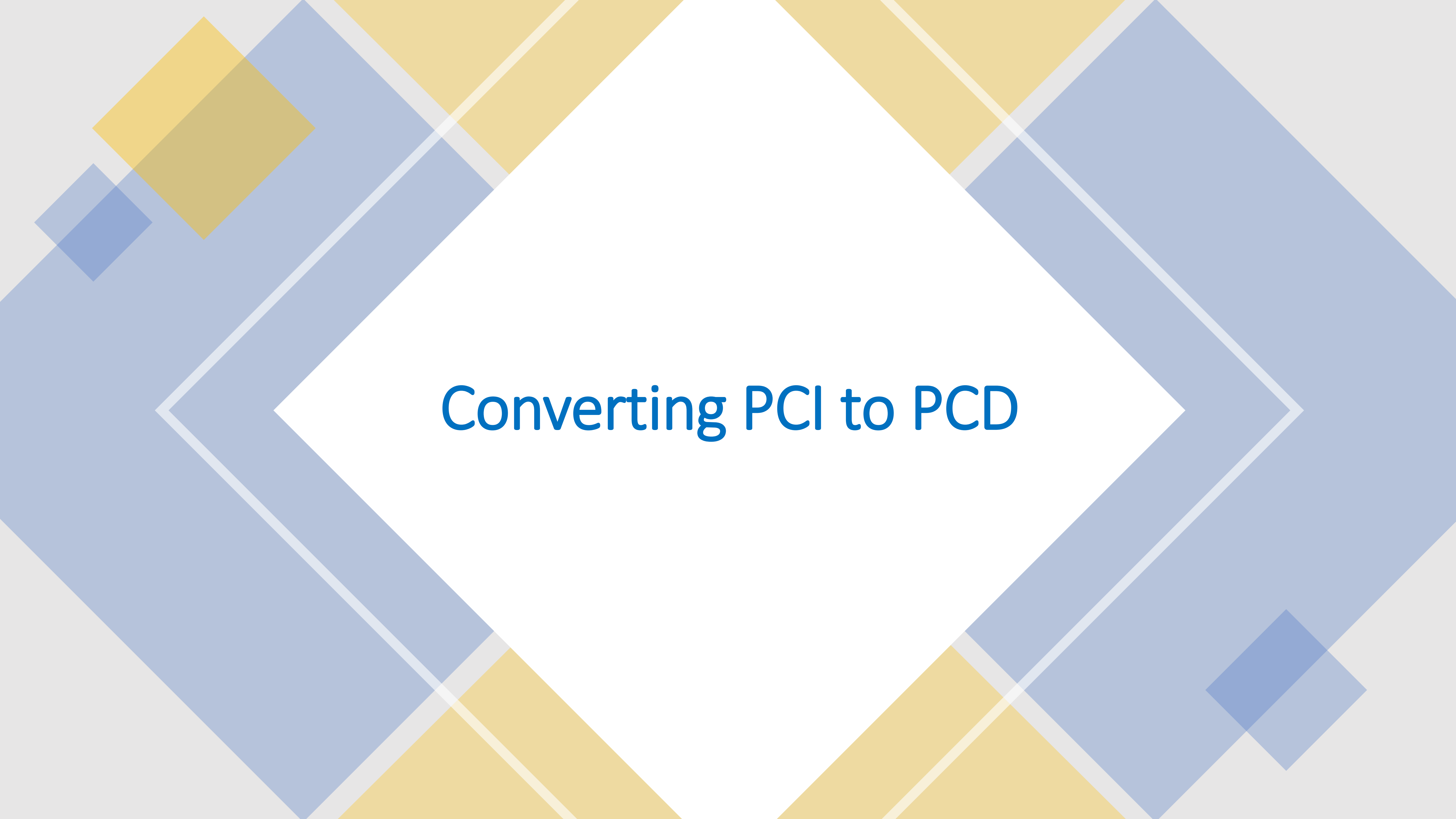
Converting PCI to PCD

Converting PCI to PCD at Adoption

- For all PCI assets
  - An entity does not reassess whether any existing assets meet the definition of PCD assets at adoption. Instead, an entity applies the new PCD asset gross-up approach at transition to all PCI assets, including beneficial interests, that were accounted for as PCI under ASC 310-30 prior to adoption. Any change in the allowance for credit losses for these assets as a result of applying the new guidance is accounted for as an adjustment to the asset's amortized cost basis and not as a cumulative-effect adjustment to beginning retained earnings.

*Source: ASU 216-13

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Example Conversion PCD Loans

- Assume PCI loan of 1,000,000 par
- Remaining Unamortized Discount of 50,000
- Credit Mark of 50,000
- Basis of 900,000
- CECL allowance calculated using DCF is 75,000

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Conversion Result PCD Loan

- Current Basis 900,000 plus CECL allowance of 75,000 = 975,000
- Adjusted basis 975,000 less par value of 1,000,000 = 25,000 remaining balance
- Adjusted Discount = 25,000
- No affect on cumulative adjustment

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Example Conversion Non-PCD Loans

- Assume PCI loan of 100,000 par
- Remaining Unamortized Discount of 5,000
- Remaining Credit Mark of 1,000
- Basis of 94,000
- CECL allowance calculated using DCF is 2,000

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Conversion Result NON-PCD Loans

- Current Basis 94,000 plus CECL allowance of 2,000 = 96,000
- Adjusted basis plus remaining discount of 5,000 = 101,000
- Cumulative effect adjustment – 1,000 (par minus new basis)
- Allowance of 2,000 and capital effect 1,000
- What if you can not breakout the credit mark and discount if treated as one number?

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PCD and TDR’s

- An entity also does not reassess on the adoption date whether prior modifications of individual PCI loans accounted for as ASC 310-30 pools were TDRs at the time of their modification. However, once an entity adopts the new guidance, it must evaluate modifications of PCD assets to determine whether they constitute TDRs.

*Source: ASU 216-13

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Converting PCI to PCD at CECL adoption will include which the following?

- Changes in the calculation will be seen in retained capital
- PCI loans will be turned to PCD loans using any CECL model
- All PCI loans will use collateral dependent method
- Discounts/premiums on PCI loans are worked into allowance

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Amortization at NEW EIR

- Upon transition, the EIR of a PCD asset will be determined after the gross-up for expected losses at adoption. That EIR is calculated at the level of the individual asset and will be used to accrete any noncredit discount that exists at the date of adoption.

*Source: ASU 216-13

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Questions

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President & CEO, ARCSys

- Mike has been providing accounting, consulting and auditing services to financial institutions for over 30 years.
- Mike was selected by the AICPA to create and deliver their 8-hour CPE course on CECL. He is a past member of the Auditing Standards Board and a published author on Accounting and Auditing for Financial Institutions.
- Mike runs multiple CECL webinar series and is the subject expert speaker at numerous national and CECL conferences each year including AICPA National Banking Conference, AICPA National Credit Union Conference, NCUA Examiner Workshop, FFIEC Accounting and Auditing Conference, FMS CECL Workshop, and the Public Company Accounting Oversight Board Internal Controls Roundtable.
- Mike is the President and CEO of ARCSys, a consulting firm that specializes in Allowance for Credit Loss software and CECL.
- ARCSys was started in 2009 with the sole purpose of building a solution for CECL and it's challenges.

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