Working Draft:
Allowance for Credit Losses Implementation Issue
(with a focus on Lending Institutions and Insurance Companies)

Issue #21: Advances of Taxes and Insurance

Wording to be Included in the Allowance for Credit Losses- Audit and Accounting Guide (with a focus on Lending Institutions and Insurance Companies):

Background:

1. Oftentimes, lenders require mortgagors to deposit funds for property taxes and insurance on mortgaged properties into escrow accounts concurrent with monthly loan payments. Adequate property insurance protects the lenders' interests in the mortgaged properties against damage or destruction. Similarly, lenders ensure that borrowers deposit adequate funds into the escrow accounts for property taxes to avoid tax liens that encumber the lenders' liens on the mortgaged properties. To the extent that borrowers fail to fund escrow accounts adequately (or fail to pay these amounts directly), lenders may pay taxes and insurance on the properties using their own funds to protect their interests in the mortgaged properties.

2. In many cases, payments made by the lender for property taxes, insurance or other costs are recoverable from the borrower and are either capitalized in the loan receivable balances as permitted by the loan agreements or recorded as other receivables from the borrower. Capitalized tax and insurance payments increase the financial asset receivable from the borrower, as they are capitalized to principal. Once such amounts are paid by the lender, if they are capitalized into principal, they increase the amortized cost basis of the financial asset receivable.

3. There may be other costs that a lender incurs as a result of its collection efforts that they may have the legal right to reimbursement from the borrower. For example, the lender may incur legal costs associated with foreclosing on a property.

4. The objective of the credit losses standard is to present the net amount expected to be collected on the financial asset.

Issue:

5. Should lenders' expectations of future losses on payments of tax, insurance premiums, and other "costs" (i.e., payments made by lenders that may not be recovered from borrowers) be included in the estimate of expected lifetime credit losses prior to the lender advancing the funds or incurring the costs?

Accounting guidance:

6. The FASB Master Glossary (subsequent to the adoption of the credit losses guidance) defines *amortized cost basis* as "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, write-offs, foreign exchange, and fair value hedge accounting adjustments."

7. FASB ASC 326-20-30-11 indicates an entity shall estimate expected credit losses for off-balance sheet credit exposures over the contractual period over which the entity is exposed to a credit risk via a contractual obligation to extend credit, unless that obligation is unconditionally cancelable by the issuer. This guidance goes on to state that for such a period of exposure to a credit risk, the entity shall consider both the likelihood that the funding will occur and estimate the expected credit loss on that commitment expected to be funded over its estimated life.

8. FASB ASC 326-20-35-4 through 35-5 provides guidance on the collateral dependent practical expedient and a requirement to use the fair value of collateral when foreclosure is probable and states:

   "Regardless of the initial measurement method, an entity shall measure expected credit losses based on the fair value of the collateral at the reporting date when the entity determines that foreclosure is probable. The entity shall adjust the fair value of the collateral for the estimated costs to sell if it intends to sell rather than operate the collateral. When an entity determines that foreclosure is probable, the entity shall remeasure the financial asset at the fair value of the collateral at the reporting date (less costs to sell, if applicable) so that the reporting of a credit loss is not delayed until actual foreclosure. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326- 20-30-12 that are applicable to the financial asset when recording the allowance for credit losses. An allowance for credit losses that is added to the amortized costs basis of the financial asset(s) shall not exceed amounts previously written off.

   An entity may use, as a practical expedient, the fair value of the collateral at the reporting date when recording the net carrying amount of the asset and determining the allowance for credit losses for a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty based on the entity's assessment as of the reporting date (collateral-dependent financial asset). If an entity uses the practical expedient on a collateral-dependent financial asset and repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral shall be adjusted for estimated costs to sell. However, the entity shall not incorporate in the net carrying amount of the financial asset the estimated costs to sell the collateral if repayment or satisfaction of the financial asset depends only on the operation, rather than on the sale, of the collateral. When the fair value (less costs to sell, if applicable) of the collateral at the reporting date exceeds the amortized cost basis of the financial asset, an entity shall adjust the allowance for credit losses to present the net amount expected to be collected on the financial asset equal to the fair value (less costs to sell, if applicable) of the collateral as long as the allowance that is added to the amortized cost basis of the financial asset(s) does not exceed amounts previously written off. If the fair value of the collateral is less than the amortized cost basis of the financial asset for which the practical expedient has been elected, an entity shall recognize an allowance for credit losses on the collateral-dependent financial asset, which is measured as the difference between the fair value of the collateral, less costs to sell (if applicable), at the reporting date and the amortized cost basis of the financial asset. An entity also shall consider any credit enhancements that meet the criteria in paragraph 326-20-30-12 that are applicable to the financial asset when recording the allowance for credit losses."

9. FASB ASC 360-10-35-38 states:

   > "Costs to sell are the incremental direct costs to transact a sale, that is, the costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made. Those costs include broker commissions, legal and title transfer fees, and closing costs that must be incurred before legal title can be transferred. Those costs exclude expected future losses associated with the operations of a long-lived asset (disposal group) while it is classified as held for sale. Expected future operating losses that marketplace participants would not similarly consider in their estimates of the fair value less cost to sell of a long-lived asset (disposal group) classified as held for sale shall not be indirectly recognized as part of an expected loss on the sale by reducing the carrying amount of the asset (disposal group) to an amount less than its current fair value less cost to sell. If the sale is expected to occur beyond one year as permitted in limited situations by paragraph 360-10-45-11 the cost to sell shall be discounted."

10. At the June 11, 2018 Transition Resource Group (TRG) meeting, the TRG discussed capitalized interest and whether interest amounts that will be earned, but are not contractually required to be paid on a current basis

and are capitalized into the principal balance of the loan, should be included in the measurement of expected credit losses prior to being earned. The FASB staff expressed a view that capitalized interest should not be included in an estimate of expected credit losses (not using a discounted cash flow approach) until earned. Memo Number 13, June 2018 Meeting – Summary of Issues Discussed and Next Steps states:

> "The staff believes that it is inappropriate to measure and record an allowance on an asset that is not recorded on the balance sheet and for which there is no contractual obligation to repay at default, which is the case with future unearned interest."

11. At the August 29, 2018 FASB Board meeting, the Board concurred with the staff's position and concluded that no amendments to the standard were required.

12. There is no legal or contractual requirement for lenders to pay taxes and insurance when borrowers have a shortfall in their escrow accounts or fail to make such payments directly to the taxing authority or insurance company. While lenders may have an economic motivation to make such payments to avoid encumbrances on their lien and ensure the collateral is insured, there is no legal requirement to do so. The guidance in FASB ASC 326-20-30-11, which states that entities should only develop an expected credit loss for periods over which they are contractually obligated to provide credit, should be applied to these scenarios. In addition, the FASB has also concluded it is inappropriate to measure and record an allowance on an asset that is not recorded on the balance sheet and for which there is not a contractual obligation to repay at default.

13. Tax and insurance payments are paid to mitigate the lender's losses, and similar to the cost of other loss mitigation activities (for example servicing), FinREC believes these payments should not be considered in the expected credit loss estimate until such amounts are advanced and the borrower has a legal obligation to pay them. In addition, FinREC believes other costs that a lender is not legally obligated to incur should be treated in the same manner.

14. FinREC also considered whether lender payments should be considered costs to sell when the collateral dependency practical expedient in FASB ASC 326-20-35-5 is used. Depending on the type of the loan and legal jurisdiction, a lender may be required to pay tax liens prior to selling an asset, pay tax liens from the proceeds of selling the asset, or may be permitted to transfer a tax lien with the property. Under that practical expedient, when repayment or satisfaction of the asset depends on the sale of the collateral, the fair value of the collateral should be adjusted for costs to sell. As the standard does not define costs to sell, FinREC believes that one should look to ASC 360-10-35-38, which defines costs as "costs that result directly from and are essential to a sale transaction and that would not have been incurred by the entity had the decision to sell not been made." In applying that guidance, it is important to note that lenders' payments of tax and insurance are not directly connected to selling the underlying collateral. These costs would be incurred even if the bank decided not to sell the underlying collateral (for example, if the bank intended to hold the seized collateral as an investment or operate it if a commercial property). As a result, FinREC does not believe that payments of taxes and insurance would be a cost to sell.

15. However, FinREC notes that the existence of tax or other senior liens related to amounts currently due, but unpaid would be incorporated into the allowance calculation under the collateral dependent practical expedient. In these situations, FinREC believes the amount due at the reporting date under the tax lien should be subtracted from the fair value of the collateral, and the resulting amount compared to the amortized cost of the loan to determine the allowance under the practical expedient.

Comments should be received by October 15, 2019, and sent by electronic mail to Jason Brodmerkel at Jason.Brodmerkel@aicpa-cima.com, or you can send them by mail to attention: Jason Brodmerkel, 1455 Pennsylvania Avenue NW, 10th Floor, Washington D.C., 20004.