Working Draft:

Allowance for Credit Losses Implementation Issue

(with a focus on Lending Institutions and Insurance Companies)

Issue #23: Zero Expected Credit Losses Factors for Financial Assets Secured by Collateral

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. The FASB ASC 326-20-30-10 provides that "an entity is not required to measure expected credit losses on a financial asset (or group of financial assets) in which historical credit loss information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that nonpayment of the amortized cost basis is zero."

2. Consistent with Example 8 in the ASU, FinREC believes that the analysis of whether no measure of expected credit loss is required focuses on an asset's loss given default (LGD). The ASU explicitly contemplates the probability that an asset could default, but the lender would not experience any loss in such an event. While ASU uses a US Treasury security as an example of an instrument where an entity may conclude that the expectation of nonpayment is zero, the guidance notes that it is not intended to be applicable only to US Treasury securities.

3. The remainder of this analysis addresses when financial assets secured by collateral may have no expected credit losses. The analysis does not include financial assets secured by collateral maintenance provisions where the practical expedient in FASB ASC 326-20-35-6 is being applied. This paper also does not address collateral-dependent financial assets when either: (a) the entity determines that foreclosure is probable, or (b) the entity is applying the practical expedient in FASB ASC 326-20-35-5 because repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower is experiencing financial difficulty.

Other Collateralized Financial Assets

4. An allowance may not be necessary for certain secured financial assets such as those secured by collateral maintenance provisions or other well-secured financial assets whereby there is no history of loss and based on current and projected economic conditions, there is no expectation of loss (e.g., financial assets with very low loan-to-value ratios). Except for financial assets secured by collateral maintenance provisions and certain collateral-dependent financial assets, ASC 326-20-30-10 states that "an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral."

5. When the use of the collateral maintenance provision practical expedient or the collateral dependent practical expedient is not applied and when foreclosure is not probable, that does not mean the fair value of collateral is not relevant. FASB ASC 326-20-30-10 states, in part:

> "Except for the circumstances described in paragraphs 326-20-35-4 through 35-6, an entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss information for financial assets secured with similar collateral."

6. Accordingly, when the collateral maintenance provision and collateral-dependent financial asset guidance in paragraphs 35-4 through 35-6 of FASB ASC 326-20 is not applied, FinREC believes an entity should consider how the fair value of collateral may impact the estimation of expected credit losses over the contractual life of the financial asset (or group of financial assets)[1]. In absence of applying the collateral-dependent financial asset practical expedient, an entity cannot measure the allowance for credit losses solely on the basis of the reporting date fair value of the collateral or avoid recognizing an allowance for credit losses solely on the basis that the reporting date fair value of the collateral (less selling costs, if applicable) equals or exceeds the amortized cost basis of the financial asset (or group of financial assets). Nevertheless, it would be expected that the collateral security on a financial asset would impact an entity's estimation of expected credit losses. In this regard, as discussed in FASB ASC 326-20-30-10, an entity should consider the nature of the collateral (including the nature of the security and the seniority thereon), potential reasonably possible future changes in the fair value of the collateral, and historical losses (adjusted for current conditions and reasonable and supportable forecasts) for financial assets secured with similar collateral[2]. FASB ASC 326-20-55-15 further indicates that debt-to-value ratios and collateral impact the credit quality indicators pertinent to financial assets. As such, the collateral securing a financial asset will likely have an impact on both the probability of default and loss given default on the financial asset.

7. Although not typical, there could be situations where, in absence of the application of the collateral-dependent financial asset practical expedient, no allowance for credit losses is provided on financial assets, based on an entity's assessment. BC63 of FASB ASU 2016-13 states:

> "BC63. The Board decided that an entity should consider the expected risk of loss, even if that risk is remote, and that an entity need not measure an expected credit loss when historical information adjusted for current conditions and reasonable and supportable forecasts results in an expectation that the risk of nonpayment of the amortized cost basis is zero. The Board decided not to explicitly state which financial assets are appropriate to have a zero allowance for expected credit losses. The Board understands that an expectation of zero loss is entirely based on the nature and characteristics of a financial asset, which may change over time. As a result, the Board concluded that a "bright-line" approach would be inappropriate for all facts and circumstances and decided not to provide explicit guidance on what specific assets are appropriate for zero expected credit losses. The Board decided that an entity should determine at the reporting date an estimate of credit loss that best reflects its expectations (or its best estimate of expected credit loss)."

8. For example, it may be appropriate to not recognize an allowance for credit losses on certain secured financial assets that have such a low loan-to-value ratio as to reduce the expected credit losses to zero. In order to reach such conclusion, FinREC believes an entity should appropriately consider the relevant facts and circumstances, including, but not limited to the following:

   - The remaining contractual term of the financial asset (and if relevant, an entity's ability to call the financial asset upon a decline in the fair value of the collateral).
   - The nature of the collateral. [3]
   - Potential future changes in the collateral values.[3]
   - The nature and terms of the security (including any subordination provided by other interests in the collateral).
   - Past experience with similar collateralized financial assets. [3]
   - Current conditions and reasonable and supportable forecasts that may impact the prior historical loss information (for example, potential reasonable and supportable declines in the fair value of the collateral that have not occurred

[1] Other factors that may impact an entity's estimation of expected credit losses may include estimated prepayments on the financial asset (or group of financial assets) and expected repayments that may be received from sources other than the collateral (e.g., general recourse to the borrower or an embedded credit enhancement provided by a third-party guarantor).

[2] See ASC 326-20-55-4(g).

[3] See ASC 326-20-30-10.

in the past). An entity is not required to consider every possible scenario but should consider reasonably possible scenarios.

9. However, if an entity is aware of a historical default that resulted in a loss on a particular asset or asset with similar risk characteristics, whether the asset is held by the entity or another entity, FinREC believes it would be difficult for an entity to conclude that it is not required to recognize an allowance for credit losses for that asset or asset class.

10. Additionally, BC71 of ASU 2016-13 indicates that "it would be inappropriate to measure credit losses for financial assets on an individual basis to arrive at a zero expected credit loss when a pool of financial assets with similar risk characteristics exists that would indicate otherwise."

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.