Current Expected Credit Losses: Preparing for the New Standard

Specialty Finance Overview and an Introduction to CECL

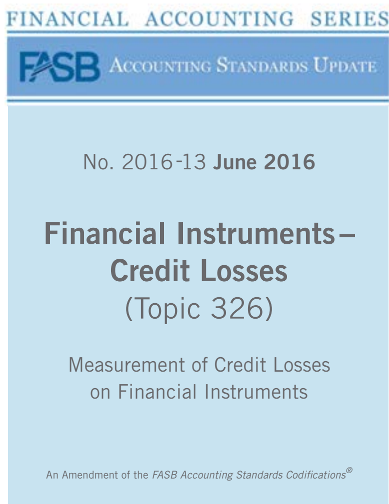
What You Need to Know

Current Expected Credit Losses (CECL) will be effective for public business entities that are SEC filers for fiscal years after December 15, 2019, including interim periods. Non-public business entities will have two additional years for interim period adoption, but will be required to adopt annual reporting in fiscal years beginning on or after January 1, 2022. Early adoption has been permitted for all entities for fiscal year beginning after December 15, 2018.

- Companies that proactively implement the CECL model will have a jumpstart not only to address questions from auditors and regulators, but also those of management, the board, and shareholders that may factor into capital allocation planning and decisions.
- Companies that begin the process and estimates early will have greater flexibility to adapt to interpretations of the new standard and ample time to analyze data and the implications on earnings; especially important for companies making current or future lending and origination decisions.
- In addition to the accounting considerations for implementing CECL, preparers should also evidence and document their governance and internal control framework used to support their estimates. This will further reduce the opportunities for audit or regulatory findings.

Background

For firms with special lending platforms, there is a new accounting standard being introduced by the Financial Accounting Standard Board (FASB) that is expected to drastically change the way loans and other similar types of financial instruments are accounted for. Observers of the Great Recession often point to insufficient capital requirements to absorb credit losses as a leading preventable cause of the financial crisis. Thus, in June 2016, the FASB introduced a new standard for credit loss reserves for lenders, which is expected to result in improved transparency of losses on loans, earlier in the lending process. This new standard, which will be required for all public companies beginning in December 2019, is being referred to as the CECL model.



The CECL model is a result of the FASB's release of Accounting Standards Update (ASU) 2016-13, Financial Instruments—Credit Losses (Topic 326). Under current generally accepted accounting principles (GAAP), the model requires an "incurred loss" methodology for recognizing credit losses that delay recognition until it is probable a loss has been incurred. This model has been criticized for restricting an organization's ability to record credit losses that are expected, but do not yet meet the "probable" threshold. Under the new standard, CECL requires recognition to be made when losses could have been reasonably expected for the lifetime of the exposure. This treatment applies to all financial assets recorded at amortized cost (as further explained below) and not marked-to-market through fair value accounting. The changes prescribed by CECL are expected to have a notable impact on the following for financial institutions: loss provisioning, operational processes, technology requirements, financial reporting, and communications. The CECL changes will also impact loss recognition for several other instruments on the balance sheet, including leases, investments, certain receivables, and repurchase and securities lending agreements.

CECL requires recognition to be made when losses could have been reasonably expected for the lifetime of the exposure.

Focus on Specialty Finance

- The specialty finance industry is comprised of bank and non-bank financial and credit-related businesses that participate in a wide range of asset class lending. Participants include strategic acquirers seeking entry to the market, traditional depository institutions, private equity firms, financial technology companies, and other private institutions.
- The specialty finance industry grew out of the Great Recession as large banks began to limit their lending activities with consumers and small businesses. As a result of this trend, a hole was left in the financing markets and new players started to enter the scene to fill the underserved consumer and small- to middle-sized business loan markets. Entrants into the market were attracted by the possibility of high rates of returns on capital given the limited sources of capital for these types of borrowers and lower levels of regulation relative to traditional banks.
- As the industry took off after the Great Recession, natural consolidation occurred as specialty lenders saw synergistic opportunities through acquisitions. By increasing size, businesses were able to lower their cost of borrowing in order to increase margins on their lending activities. In addition, through the use of technology, specialty finance companies were able to drastically cut down on the time and expense required to underwrite these loans. Technology was also able to analyze the riskiness of borrowers more precisely in order to cut down on loan loss levels.
- Specialty finance companies are especially exposed to the tenets of CECL and future impacts it will have on their financial reporting, earnings smoothness, and future operational, modeling, and technological requirements. Companies both public and private, financial or non-financial, need to begin evaluating and implementing new systems and understandings to prepare for the increased complexity involved in reporting, communicating, accounting for, and disclosing the instruments which are exposed to credit losses.

What Is Changing?

Old Approach vs. New Approach

Factor	Old Approach (ASC 310-20 and 310-30)	New Approach (ASU 2016-13)
Loss Model	• Loss to be recorded as incurred or once it is probable of occurring	• Expected credit losses recorded on day one and adjusted through earnings each reporting period based on extensive models, which include subjective evaluations
Individual or Pooling	• Individual asset evaluation or pooling of assets allowed as a policy choice	• Pooling of assets with similar risk characteristics is required
PCD Assets (Purchased With Credit Deterioration)—Initial Acquisition	• No allowance for credit losses is recorded under ASC 310-30	• Record an allowance for expected credit losses at time of acquisition and INCREASE amortized cost (this will result in a gross up of the balance sheet from fair value purchase price required under ASC 805)
PCD Assets—Subsequent Evaluation	• Subsequent impairment recognized as incurred and subsequent improvement in cash flows are recognized as a yield adjustment	• Favorable and unfavorable changes in cash flows are recognized IMMEDIATLEY through credit loss expense
Amortized Cost	• Includes unpaid principal, discounts, premiums, fees, foreign exchange, and hedge adjustments without separation of components under ASC 310-20	• Allows an entity to separately measure the loss expected by separately measuring unpaid principal balance and other amortized cost items (premiums, discounts, fees, etc.)
Disclosures	**Existing disclosure requirements include the following:** • Policies of recognizing interest income and the treatment of costs and losses • For credit impaired loans, disclose the outstanding balance, accretable yield, and reconciliation for additions, accretion, disposal, and reclassifications • Disclosures for any loans that are not classified as debt securities	**Beyond the previous requirements, also requires the below, among others:** • Amortized cost by credit quality indicator, security type, and by vintage year (table on following page ASC 326-20-55-79) • Reasonable and supportable forecasts and reversion methodology beyond that period

Basic Tenets of CECL

1. Requires entities to pool financial assets with similar risk characteristics. If they do not share similar risk characteristics, the assets should be evaluated individually.

2. Requires the allowance for credit losses to be deducted from amortized cost to present the net amount expected to be collected. Amortized cost is defined as the amount at which the asset was originated or acquired adjusted for accrued interest, accretion of discounts or amortization of premiums, net deferred fees, cash collections, write-offs foreign exchange, or hedge accounting adjustments.

3. Loss estimates are to be made over the expected life of an exposure (or pool of exposures), using the following:

   a. Historical information

   b. Current information

   c. Reasonable and supportable forecasts (including estimated prepayments) as follows:

      i. Beyond the point at which forecasts can be made, an entity is required to have a reversion to historical loss averages

      ii. Several models are permitted for use in determining allowance for credit losses, including discounted cash flows, roll-rate, loss-rate, probability of default, and loss given default among others. There are significant amounts of judgement and complexities associated with accurately recording and supporting loss forecasts for various assets—the likes of which were not previously required under a "record losses as incurred model."

   d. Fair market value of collateral

4. Financial assets are required to be written-off in the period in which a determination is made that they are uncollectible. This can occur when all reasonable means of seeking collection have been exhausted. A company may also consider significant changes in debtor's finances or whether the collateral is sufficiently marketable to pay the asset.

5. CECL disclosure requirements can be extensive. Among other requirements, a reporting entity must disclose by portfolio segment and major security type all of the following: a description of how loss estimates are developed, accounting policies and methodology for recording losses, risk characteristics for each segment, factors that influenced changes in estimates during the period, and any significant write-offs, purchases, or sales. For each class of financial asset, a reporting entity should disclose quantitative and qualitative data about credit quality. Credit quality indicators can include consumer credit risk scores, rating agency reports or internally developed measures, among others. The following example from the FASB pronouncement partially illustrates the presentation of credit quality disclosures for a financial institution with a narrow range of loan products offered to local customers—both consumer and commercial. Depending on the size and complexity of an entity's portfolio of financing receivables, the entity may present disclosures that are more or less detailed than the following example.

	Term Loans Amortized Cost Basis by Origination Year							
As of December 31, 20X5	**20X5**	**20X4**	**20X3**	**20X2**	**20X1**	**Prior**	**Revolving Loans Amortized Cost Basis**	**Total**
Residential mortgage:								
Risk rating:								
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-
Total residential mortgage loans	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Residential mortgage loans:								
Current-period gross writeoffs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Current-period recoveries	-	-	-	-	-	-	-	-
Current-period net write-offs	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
Consumer:								
Risk rating:								
1–2 internal grade	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -
3–4 internal grade	-	-	-	-	-	-	-	-
5 internal grade	-	-	-	-	-	-	-	-
6 internal grade	-	-	-	-	-	-	-	-
7 internal grade	-	-	-	-	-	-	-	-
Total consumer	$ -	$ -	$ -	$ -	$ -	$ -	$ -	$ -

Source: ASU 2016-13

In general, upon adopting CECL, companies will see an immediate decrease in earnings as life time expected credit losses (not just those "probable of having been incurred") are required to be recognized on assets held as of each reporting date. Assuming no impact on a company's underlying valuation, this will result in higher price-to-earnings multiples after CECL is implemented. It should further be noted that for those purchased financial assets with credit deterioration (or PCD Assets) acquired after CECL adoption, an allowance for loss reserve will be established simultaneously with initial asset recognition. Only those losses in excess of the initially established loss reserve will impact earnings.

KEY RECENT FASB COMMUNICATIONS

In April 2019, the FASB concluded on additional transition relief guidance. Upon adopting ASU 2016-13, a reporting entity can elect the fair value option under ASC 825 for all loans in the entity's portfolio—not just those originated or purchased after adopting. This differs from current ASC 825 guidance, which typically requires the fair value election to be made at the time the entity first recognizes the items on its balance sheet. This fair value election may be made on an asset-by-asset basis. It is important to note that this expanded ASC 825 application to loans was not extended to debt securities of an entity's balance sheet.

Houlihan Lokey has an integrated team across accounting and financial reporting, valuation, banking, and restructuring to help you.

In addition, in their July 2019 meeting, the FASB has proposed to allow certain small public entities and private entities an additional year to adopt, beginning for fiscal years after December 15, 2022.

How Should Management Prepare?

Management should be taking stock of their performing and non-performing loan portfolio now in order to begin assessing the impact it will have on their balance sheet, earnings, and financial ratios. Forecasting the impacts to its key stakeholders will be highly beneficial ahead of the planned adoption date in order to manage expectations. We strongly advise taking a fresh look at your models, inputs, and assumptions and to design a roadmap for implementation. Despite the proposed deferral for those other than large public institutions, it is well documented how much effort and analysis adopting CECL will take, so better to get ahead of the issues sooner rather than later.

How Houlihan Lokey Clients Have Benefited From the Firm's Specialty Finance Insight

An integrated team to help clients work through CECL

Houlihan Lokey's Transaction Advisory Services practice has a dedicated team—Accounting and Financial Reporting Advisory—that helps its clients navigate today's uncertain and complex accounting and reporting transactions. We partner with our valuation, banking and restructuring, and data and analytics teams to bring our clients an integrated approach so they can quickly respond to opportunities, issues, and new transaction-driven accounting standards such as CECL.

It was a challenging time frame, but the integrated Houlihan Lokey team rolled-up their sleeves and worked with us to make it happen. The level of collaboration was excellent.

- Controller, Large Public Company

Our integrated team can help guide the process of implementing and evaluating the impacts of adopting the CECL standard. We can provide confidence to management and stakeholders by developing reasonable and supportable forecasts for the vast array of financial instruments impacted by this standard as well as navigating the options available for reporting results to your stakeholders.

Our dedicated Financial Institutions Group provides real-world transaction experience and can tailor to your individual portfolio.

CASE STUDY

Company XYZ purchased loans from Company ABC. These loans included a basket of performing and a basket of non-performing (credit deteriorated) loans. For the sake of an example, purchase price = $10,000,000 for performing loans, with an UPB of $12,000,000. Purchase price = $8,000,000 for non-performing loans with a UPB of $15,000,000.

In the case of Company XYZ, the implementation and requirements of CECL would have accelerated the loss provisioning on their income statement versus the old GAAP methods. A comparison between performing and non-performing loans under historical guidance and CECL is shown below.

Performing Loans

- **Current: ASC 310-20**
    - Day 1: Recorded at unpaid principal balance of $12,000,000 with a $2,000,000 discount.
    - Ongoing: Record losses once they are probable of having occurred or having been incurred when compared to the unamortized cost basis for the loans at each reporting date.
- **CECL**
    - Day 1: Recorded at unpaid principal balance of $12,000,000 less discount of $2,000,000 AND record a provision for expected loan loss for the lifetime of exposure based on historical experience at the first reporting/measurement date.

- ASC 326 would characterize these loans as not having a "more than insignificant deterioration in credit since origination" and therefore, would not be accounted for as PCD assets. An allowance for loan losses would not be established at acquisition but instead, would be reserved for as "reasonable and supportable forecasting" indicate credit deterioration and the likely existence of a lifetime credit loss exposure.
- Ongoing: Updated continuously for changing economic and asset specific factors.

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Non-Performing Loans

- **Current: ASC 310-30**
  - Day 1: Record on the books at $8,000,000 cost.
  - Ongoing: Because these loans are non-performing, the loans can be accounted for under one of three methods—collateral, cost recovery, or expected cash flows. Assuming the expected cash flow method is chosen, a loan loss provision would be taken only when cash collections differ from expectations established at acquisition.
- **CECL**
  - Day 1: Record at the net purchase price, but establish accounts for the gross UPB loan balance, an allowance for expected credit losses and any discount or premium determined by differences in interest rates. If actual credit losses are less than the allowance for credit losses initially established, no further provision charges to earnings will need to be recognized and if lifetime losses become less than initially forecasted, the allowance for credit losses will reverse into earnings as contra expenses.

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