FASB FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO

Memo No.	**5**
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Project	**Transition Resource Group for Credit Losses**		
Project Stage	**Post-Issuance**		
Issue(s)	**Determining the "Estimated Life" of a Credit Card Receivable**		

Memo Purpose

1. Some stakeholders informed the staff that there are two views about how to determine the "estimated life" of a credit card receivable[1] for purposes of assessing credit losses under the guidance in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments,* and have asked the staff whether both views are appropriate.

2. This memo summarizes the views and provides staff analyses of the issues. The staff will seek input from members of the Transition Resource Group for credit losses (TRG).

3. The staff also has included as an appendix, a set of illustrative examples prepared by a group of financial institutions that illustrate both views expressed in this memo. The staff notes that the illustrations are simplified in nature and are meant to contrast the differences in estimating the life of a credit card receivable in which the fundamental question is focused on whether future expected

[1] While the discussion is in the context of credit cards, the staff notes that some of the concepts discussed in this memo also are applicable to other forms of unsecured revolving credit for which unused amounts are unconditionally cancellable.

payments should be allocated to the measurement date balance or the measurement date balance and potential future funding. Readers should not assume that the specific payment amounts allocated to each year are representative of what an entity would determine the actual amounts to be under either scenario as part of its credit loss assessment process. That is:

(a) The amounts illustrated are assumed to be more than the minimum payment.

(b) Interest and fees are accrued and paid in each period to isolate changes in principal amounts owed.

(c) The individual account holder is assumed to continue to actively use the credit card.

(d) Payments are held constant over time.

(e) The loss calculated is illustrated on an individual account.

None of the items above are meant to represent an actual fact pattern or, for that matter, a realistic process, but are simply being used to isolate the issue raised.

Questions for the TRG Members
1. Which view do the TRG members agree with? 2. Do the TRG members have a view on whether either approach should be prohibited?

Background Information

4. Paragraph 326-20-30-6 states the following:

> An entity shall estimate expected credit losses over the **contractual term of the financial asset(s)** when using the methods in accordance with paragraph 326-20-30-5. An entity shall consider prepayments as a separate input in the method or prepayments may be embedded in the credit loss information in accordance with paragraph 326-20-30-5. An entity shall consider estimated prepayments in the future principal and interest cash flows when utilizing a method in accordance with paragraph 326-20-30-4. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless it has a reasonable expectation at the reporting date that it will execute a troubled debt restructuring with the borrower. [Emphasis added.]

5. Stakeholders have noted that observing payment behaviors over time on closed-end loans like mortgages, auto loans, student loans, and other term loan products enables lenders to identify an estimated life for those loans, and such observations are expected to be integrated into the lifetime loss estimation methods applied to similar loans under the amendments in Update 2016-13. In addition, vintages of closed-end loans can be observed over time to determine an estimated life and lifetime loss experience. However, these approaches are not directly available for a credit card receivable balance

given the revolving nature of the lending arrangement. Credit card vintages are viewed as relating to the age of the account relationship and not to specific receivables generated by that relationship. Furthermore, the life of a revolving credit card receivable within an actively used account is not clear because quite often the balance of an actively used credit card account is never reduced to zero.[2]

6. Another factor further complicating the evaluation of the life of a credit card receivable is that often it comprises various components of balance (COBs) that are subject to different annual percentage rates (APRs). For example, the portion of a credit card receivable created through a cash advance will typically bear a higher rate of interest than one created through a purchase. Although the distinction between the rate components does not create separate legal obligations out of the different COBs, it is relevant under legal and bank regulatory guidance for purposes of determining the amount of interest that may be assessed on an outstanding balance that is paid off over time; therefore, questions have been raised concerning the effect, if any, this has on the life of a credit card receivable for accounting purposes.

7. Estimating the remaining life of a credit card receivable balance is dependent on estimating the amount and timing of the payments expected to be collected on it. When estimating the expected payments over the remaining life of a closed-end loan receivable, such as a mortgage loan or a student loan, there is no question that all remaining principal payments from the borrower are associated with the measurement date balance of the closed-end loan. A similar evaluation for an actively used credit card account with a revolving balance is significantly more complex because in addition to future expected payments there also will be new borrowing activity over the remaining life of the measurement date balance.

8. When considering how to determine the life of a credit card receivable, it is important to understand the role of legal and regulatory requirements that affect the way credit card finance charges are computed, payments are applied, and minimum payment amounts are determined.

The CARD Act

9. The stated objective of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (the CARD Act) is to establish fair and transparent practices for open-end credit.[3] Among other things, the CARD Act requires the application of a credit card holder's payments on the basis of a hierarchy under

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[2] Credit card issuers have not historically evaluated credit card receivables to estimate the remaining life of a measurement date receivable balance, and, thus, lifetime loss rates have not historically been measured.

[3] The Credit Card Accountability Responsibility and Disclosure Act of 2009 was signed into law in May 2009 and was implemented by the Board of Governors of the Federal Reserve as part of Regulation Z (the Truth in Lending Act or "TIL") in February 2010. The consequential amendments to the TIL (12 CFR Part 226) as published in the Federal Register can be found at https://www.gpo.gov/fdsys/pkg/FR-2010-02-22/pdf/2010-624.pdf.

which components of the card holder's balance to which higher APRs apply are generally paid off before components with lower APRs.[4]

10. Section 104 of the CARD Act requires a credit card issuer, upon receipt of a cardholder's payment, to apply amounts in excess of the minimum payment first to the component of the cardholder's balance bearing the highest rate of interest and then to each successive component bearing the next highest rate of interest until the payment is exhausted.

11. The purpose of the payment provision of the CARD Act is to prevent lenders from engaging in potentially abusive practices by which interest charges could be maximized while the benefit borrowers get from lower-rate promotional offers might be unfairly minimized. While the CARD Act does not directly regulate interest rates on credit cards, the payment allocation rule and certain other CARD Act provisions do affect the finance charges assessed on credit cards. As noted by the Consumer Financial Protection Bureau, in situations in which an account has different components of balance with different rates, the order in which payments are applied to these various components will affect the effective interest rate over time.[5] It is important to note that although the CARD Act provides the payment allocation rule, it neither creates separate legal obligations of the various components of an account balance nor results in any component of a balance becoming subordinate to any other.

Issue Description

12. When applying expected payments to a revolving credit card receivable to determine the life of that credit card receivable, a fundamental question arises:

    (a) Should all principal payments expected to be received after the measurement date (that is, payments after finance charges and fees assessed have been paid) be applied to the credit card receivable balance existing at the measurement date until that balance is exhausted, or should those payments be allocated in some manner between the measurement date balance and future credit card receivables expected to be originated through subsequent usage of the unconditionally cancellable loan commitment associated with the credit card account?

13. The answer to this question could have a significant effect on the estimated life of the credit card receivable and could thus have a material effect on the measurement of the allowance for loan losses

[4] A credit card balance often comprises various components of balance to which different annual percentage rates apply (for example, a cardholder's statement balance might comprise purchases at 14.99 percent, a cash advance at 24.99 percent, and a balance transfer at 0 percent).

[5] *CARD Act Report: A Review of the Impact of the CARD Act on the Consumer Credit Card Market*, October 1, 2013, located at http://files.consumerfinance.gov/f/201309_cfpb_card-act-report.pdf.

on credit card receivables.[6] Additionally, depending on one's view, the answer to the above question could lead to (or prevent) the unnecessary introduction of significant additional complexity in the allowance estimation process for revolving credit card portfolios.

Stakeholder Feedback

14. Stakeholders have presented the staff with two views on how an entity should consider the application of expected principal payments received after the measurement date:

    (a) **View A**: When evaluating the estimated life of a credit card receivable balance, all expected principal payments (that is, payments after finance charges and fees assessed have been paid) should be applied to the measurement date balance until that balance is extinguished using a first-in, first-out (FIFO) method (or, in the absence of payments, charged off).[7] Separating expected losses on a credit card receivable from losses related to future uses of available credit associated with the account requires, in essence, evaluating the measurement date receivable balance as if it were a closed-end loan. The CARD Act would still dictate the application of payments for purposes of determining the amount of the cardholder's exposure to each APR (that is, to the extent that the balance comprises multiple COBs subject to different APRs), but it would do so only with respect to the measurement date balance. Any future payments will continue to be applied as received using the CARD Act payment hierarchy until the measurement date balance is exhausted.

    (b) **View B**: When evaluating the estimated life of a credit card receivable balance, all expected principal payments (that is, payments after finance charges and fees assessed have been paid) should be applied to the measurement date balance and anticipated future COBs in a way that reflects how the CARD Act payment allocation hierarchy is expected to affect the application of a cardholder's payments over time; that is, inclusive of the effect of future draws (and, thus, the composition of future statement balances).

15. It should be noted that both View A and View B recognize that the CARD Act will dictate how each month's payment will be credited against different rate components of a cardholder's credit card receivable balance. That allocation criteria, together with a cardholder's purchase, balance transfer, and cash advance activity during the next statement period, will determine the COBs that make up the new closing balance on the cardholder's next statement. Those COBs will in turn affect the computation

[6] Inherent in this assertion is the expectation that the longer the estimated life of a receivable associated with a credit card account, the greater the expectation that some future default event on that account will be reflected presently in the allowance. This is demonstrated by the application of View B in the illustrations provided with this memo.

[7] The methods described here are meant to illustrate how payments would theoretically be applied at the individual account level. For the avoidance of doubt, when evaluating the life of receivables at a portfolio level payments from any individual borrower could only be applied until that borrower's measurement date balance is exhausted.

of finance charges at the next statement date. Under both View A and View B it is assumed that each customer payment is first applied to finance charges and fees assessed, and then the remaining portion will reduce the principal portion of the receivable.

16. The sole difference between View A and View B pertains to whether projected future cardholder draws should be considered in applying forecasted expected payments. The choice to exclude (View A) or include (View B) such draws will result in different conclusions about the estimated life of the measurement date balance. It is important, however, to emphasize that the amount and timing of the forecasted expected payments under View A and View B are the same in the examples for simplicity purposes. Under both View A and View B, forecasted payments are assumed to be derived considering such things as expectations about borrower behavior and propensity to pay and incorporating such key factors as anticipated macroeconomic considerations.

17. Supporters of View A note that determining whether an estimated future loss on the account relates to the measurement date credit card receivable balance or to one that has not yet been originated as of the measurement date is dependent on establishing a common conceptual understanding of how future expected principal payments relate to an existing credit card receivable and how they should be applied in evaluating the remaining life of the measurement date credit card receivable.

18. Supporters of View A stated that the approach is consistent with the Board's decision that unconditionally cancellable unfunded amounts do not reflect a present obligation. Therefore, an unfunded amount that is not deemed to be a present obligation at the balance sheet date should not be considered a future obligation that could be funded when determining future cash flows related to the measurement date balance. Consequently, a lender should not record an allowance for unfunded credit lines that are unconditionally cancellable. They note that the guidance in paragraphs 326-20-30-11 and 326-30-55-56 are clear on this point.

> **326-20-30-11** In estimating expected credit losses for off-balance-sheet credit exposures, an entity shall estimate expected credit losses on the basis of the guidance in this Subtopic over the contractual period in which the entity is exposed to credit risk via a **present contractual obligation to extend credit, unless that obligation is unconditionally cancellable by the issuer.** At the reporting date, an entity shall record a liability for credit losses on off-balance-sheet credit exposures within the scope of this Subtopic. An entity shall report in net income (as a credit loss expense) the amount necessary to adjust the liability for credit losses for management's current estimate of expected credit losses on off-balance-sheet credit exposures. For that period of exposure, the estimate of expected credit losses should consider both the likelihood that funding will occur (which may be affected by, for example, a material adverse change clause) and an estimate of expected credit losses on commitments expected to be funded over its estimated life. If an entity uses a discounted cash flow method to estimate expected credit losses on off-balance-sheet credit

> exposures, the discount rate used should be consistent with the guidance in Section 310-20-35. [Emphasis added.]
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> **326-20-55-56** When determining the allowance for credit losses, Bank M estimates the expected credit losses over the remaining lives of the **funded credit card loans**. Bank M **does not record an allowance for unfunded commitments on the unfunded credit cards** because it has the ability to unconditionally cancel the available lines of credit. Even though Bank M has had a past practice of extending credit on credit cards before it has detected a borrower's default event, it does not have a present contractual obligation to extend credit. Therefore, an allowance for unfunded commitments should not be established because credit risk on commitments that are unconditionally cancellable by the issuer are not considered to be a liability. [Emphasis added.]

19. Consequently, absent a present legal obligation to extend credit, the loan loss allowance under the amendments in Update 2016-13 should be determined only on the credit card receivable balance existing at the measurement date because unused credit card lines are generally cancellable. Losses related to future borrowings expected to be made on a credit card with an unconditionally cancellable credit line should not be included in the loss estimate under the amendments.

20. Additionally, supporters note that View A is a reasonable and practical approach for evaluating the repayment of a credit card receivable in a manner consistent with viewing the measurement date balance as a closed-end loan and for determining which expected losses relate to the measurement date balance and which relate to future borrowings.

21. Supporters of View B highlight that legal requirements affecting the application of expected payments against different rate components of the cardholder's outstanding credit card receivable balance raise the question of what effect, if any, those requirements have on the life of a measurement date credit card receivable for purposes of applying the amendments in Update 2016-13.

22. View B would require forecasting the application of expected payments at each billing cycle to the forecasted components of a cardholder's credit card receivable balance (as of the future statement date) without regard to when the COBs were originated to determine the portion of the expected payment applicable to the measurement date balance. The approach makes no distinction between pre- and post-measurement date draws. Because this allocation approach will suggest a longer repayment period for the measurement date balance, under certain conditions it can result in an expected loss on the account being associated with the measurement date balance even if principal collections in excess of that balance are forecasted to be received before the future loss being realized.

23. However, supporters of View A note that under those circumstances, the net result may be the accrual of a credit loss associated with an unfunded loan commitment when the measurement of credit losses should be on funded amounts as of the balance sheet date. That amount should not be affected by an

expectation of amounts that may or may not occur in the future because the potential existence of those amounts is within the sole control of the lender.

Staff Analysis

24. The staff believes, on the basis of stakeholder feedback and discussions held with financial institutions, that either view could be considered compatible with the amendments in Update 2016-13. View A appears to be a reasonable and straight-forward approach for determining the life of a credit card receivable balance, and View B appears to do the same, although at a much more granular level. Consequently, the staff sees no reason why either approach would be prohibited.

25. The staff bases the conclusions in paragraph 24 on the fact that stakeholders have noted that in both views the forecasted payments are assumed to be derived considering such things as expectations regarding borrower behavior and propensity to pay and incorporate such key factors as anticipated macroeconomic considerations. Therefore, both views appear to contemplate historical information and management's expectations of the effect that current conditions and reasonable and supportable forecasts will have on that historical information.

26. It appears the only difference between View A and View B is whether projected future cardholder draws should be considered in applying forecasted expected payments, which appears to the staff to be more of a debate about precision of the estimate rather than the misapplication of the new amendments in Update 2016-13. The staff would highlight that the Board acknowledged in paragraph BC50 of the Update that there will be differences in estimates from entity to entity depending upon several factors. Paragraph BC50 states the following:

> The Board acknowledges that any approach to estimating the collectibility of financial assets is subjective. The Board has permitted entities to estimate expected credit losses using various methods because the Board believes entities manage credit risk differently and should have flexibility to best report their expectations. The Board recognizes that different methods may result in a range of acceptable outcomes. Given the subjective nature of this estimate and certain fact patterns, one methodology's consideration of time value may have a more direct impact on the estimate of expected credit losses than other methods. Some entities may be able to forecast over the entire estimated life of an asset, while other entities may forecast over a shorter period. The complexity of the portfolio, size of the entity, access to information, and management of the portfolio may result in approaches with varying degrees of sophistication. Because entities may have different levels of sophistication, the Board did not prescribe one type of methodology for measuring expected credit losses for financial assets measured at amortized cost. The Board concluded that different outcomes for expected credit losses due to these and other factors are acceptable under the amendments in this Update. Furthermore, using terms such as *reasonable* and

> *supportable* does not imply a single conclusion or methodology upon which an entity must base its estimate. Different parties using different methodologies do not make a particular estimate unreasonable. While the range of reasonable outcomes is not unlimited, the Board concluded that it is rare that there will only be one acceptable choice in estimating credit losses. Estimates of credit losses may not precisely predict actual future events and, therefore, subsequent events may not be indicative of the reasonableness of those estimates.

27. On the one hand, View B could be considered “conceptually flawed” in that it has the *potential* to apply expected payments to future unfunded amounts, which would suggest a loss could potentially be recorded for these unfunded amounts. For example, if the total payments expected to be received exceed the measurement date balance but the CARD Act suggests application of those payments to future unfunded amounts, thereby leaving a measurement date balance that exceeds expected payments, one could argue that the recorded credit loss would be attributable to the future balance because the measurement date balance would have otherwise been paid off. However, others would suggest this is accurate because the measurement date balance would still be outstanding if the projected future draws actually came to fruition.

28. On the other hand, one could view the application of future expected payments to future expected draws as a consideration that one would make in determining the life of the measurement date credit card receivable. In this instance, the staff observes that the result could be driven purely by the composition of the future draw balance. For example, as illustrated in examples 8 and 9 in the attached appendix, if the future draw were assumed to be a balance transfer, Views A and B would provide for the same result. This would suggest to the staff that perhaps View B is attempting to reach a level of precision that (a) doesn’t exist and (b) goes beyond what the Board intended when developing the standard.

29. Additionally, the staff has discussed View B with larger financial institutions, and they have stated that applying this approach would be unnecessarily complex and would require information that currently is not available and that could not be derived without significant cost and effort. Institutions have noted that to apply a lifetime loss estimation model to a measurement date credit card receivable using the approach detailed in View B, it would be necessary to understand not only the components of the credit card receivable balance at the measurement date but also to forecast the amount and type of components expected to exist at each date in the future when a payment is expected to be received, recognizing that COBs are increased by future borrowing activity and reduced on the basis of the payment allocation hierarchy applied to the borrower’s aggregate balance at each statement date. The institutions add that projecting the effect of future borrowing activity for this purpose would necessitate highly subjective assumptions about future purchase activity, future promotional rate offers (and the extent to which those offers would be accepted), and future cash advance activity. Furthermore, given the significant subjectivity and complexity involved in attempting to build this level of granularity, they

are concerned whether it would be possible to achieve a reliable and supportable estimate. The staff is concerned that if larger financial institutions find View B difficult to operationalize, it is likely that smaller institutions would find the approach incrementally more difficult to operationalize. This would seem to be counter to the Board's intention of making the standard scalable.

Staff Recommendation

30. The staff does not object to either view and sees no reason why either approach would be prohibited. However, the staff prefers View A for the following reasons:

    (a) The staff does not think the Board was expecting companies to make assessments related to the unfunded balance because of the Board's decisions regarding unconditionally cancellable amounts. Specifically, the Board decided that unconditionally cancellable amounts result in no liability at the balance sheet date because there is no present obligation; therefore, the staff would question why the Board would expect entities to perform an analysis for potential future amounts that do not exist at the balance sheet date.

    (b) The staff thinks that the calculation of credit losses is a measurement of the credit card receivable at the balance sheet date. The staff does not think this measurement was intended to be affected by the fluctuation of unfunded amounts potentially becoming funded. At the balance sheet date the assumption is that the unfunded amount is zero and, therefore, should be assumed to remain zero in the future.

    (c) The staff thinks that the Board intended for the amendments in Update 2016-13 to be scalable. The staff is concerned that if it is perceived that View B is more precise and therefore more appropriate, View A potentially risks becoming prohibited. The staff thinks this could be a significant operational burden for financial institutions, particularly those that are smaller in size and scale of operations.

    (d) The staff thinks that View B could *potentially* lead to a result of recording losses for amounts not recognized at the balance sheet date. For example, if the total payments expected to be received exceed the measurement date balance but the CARD Act suggests application of those payments to future unfunded amounts, thereby leaving a measurement date balance that exceeds expected payments, there is a potential that a recorded credit loss would be attributable to the future balance because the measurement date balance would have otherwise been paid off.