MEMO

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Project	**Transition Resource Group for Credit Losses**		
Project Stage	**Post-Issuance**		
Issue(s)	**Transition Guidance for Pools of Financial Assets Accounted for under Subtopic 310-30**		

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Memo Purpose

1. Stakeholders have informed the staff of questions on the guidance in Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, on the transition provisions for pools of assets accounted for under Subtopic 310-30, Receivables—Loans and Debt Securities Acquired with Deteriorated Credit Quality. This memo summarizes implementation questions in this area and provides staff analysis of the issues. The staff will seek input from members of the Transition Resource Group for Credit Losses (TRG) on these implementation questions.

Question for TRG Members
1. Do the TRG members agree with the staff analysis in this memo?

Issue Background

2. The scope of purchased credit impaired (PCI) assets is described in paragraph 310-30-15-2 as follows:

> The guidance in this Subtopic applies to all loans with evidence of deterioration of credit quality since origination acquired by **completion of a transfer** for which it is **probable**, at acquisition, that the investor will be unable to collect all **contractually required payments receivable**.[1]

3. For PCI assets, Subtopic 310-30 requires the excess of cash flows expected to be collected over the investor's initial investment to be accreted into interest income on a level yield basis. This approach prevents any credit-related purchase discount from being accreted into interest income. After initial measurement, favorable changes in cash flows are recognized as a yield adjustment, and unfavorable changes in cash flows may trigger an impairment analysis under the other-than-temporary impairment model for debt securities (Subtopic 320-10, Investments—Debt and Equity Securities—Overall) or the guidance for impaired loans (Subtopic 310-10, Receivables—Overall). For PCI loans, expected losses that are incurred by an investor after acquisition are accounted for through a valuation allowance.

4. Subtopic 310-30 permits accounting on either a pool basis or an individual loan basis. Paragraph 310-30-15-6 describes the factors entities must consider when aggregating PCI assets within the scope of Subtopic 310-30:

> **310-30-15-6** For purposes of applying the recognition, measurement, and disclosure provisions of this Subtopic for loans that are not accounted for as debt securities, investors *may aggregate loans acquired in the same fiscal quarter that have **common risk characteristics** and thereby use a composite interest rate and expectation of cash flows expected to be collected for the pool*. It is not intended for this aggregation to be analogized for purposes other than this Subtopic. To be eligible for aggregation, each loan first should be determined individually to meet the scope criteria of paragraph 310-30-15-2. After determining that certain acquired loans are within the

[1] Certain items are excluded, including:

(a) Loans that are measured at fair value if all changes in fair value are included in earnings or, for a not-for-profit (NFP) entity, loans that are measured at fair value if all changes in fair value are included in the statement of activities and included in the performance indicator if a performance indicator is presented
(b) Mortgage loans classified as held for sale under paragraph 948-310-35-1
(c) Leases as defined in Topic 840, Leases
(d) Loans acquired in a business combination accounted for at historical cost, including:
   (i) Business combinations of two or more NFPs
   (ii) The acquisition of a for-profit business entity by a NFP
   (iii) Combinations of two or more mutual entities
(e) Loans held by liquidating banks and revolving credit agreements, such as credit cards and home equity loans, if at the acquisition date the borrower has revolving privileges
(f) Loans that are a transferor's interests.

> scope as defined in that paragraph, the investor may evaluate whether such loans have common risk characteristics, thus permitting the aggregation of such loans into one or more pools. *The aggregation shall be based on common risk characteristics that include similar credit risk or risk ratings, and one or more predominant risk characteristics.* A portion of the total cost of acquired assets shall be assigned to each unit of accounting acquired on the basis of its relative fair value at the date of acquisition. The excess of the contractually required payments receivable over the investor's **initial investment** (whether **accretable yield** or **nonaccretable difference**) for a specific loan or a pool of loans with one set of common risk characteristics shall not be considered available to offset changes in cash flows expected to be collected from a different loan or an assembled pool of loans with another set of common risk characteristics. [Emphasis added.]

5. If an entity elects to account for PCI loans on a pool basis, there is guidance addressing how the pools must be accounted for in paragraph 310-30-40-1, which states the following:

> **310-30-40-1** Once a pool of loans is assembled, the integrity of the pool shall be maintained. A **loan** shall be removed from a pool of loans only if either of the following conditions is met:
>
> a. The investor sells, forecloses, or otherwise receives assets in satisfaction of the loan.
> b. The loan is written off.
>
> A refinancing or restructuring of a loan shall not result in the removal of a loan from a pool.

6. If an entity elects to account for PCI loans on an individual basis, there is specific guidance on subsequent modifications of loans. Paragraph 310-30-35-13 states that if a modification of a loan occurs and it is not a troubled debt restructuring (TDR), then the modified loan must not be accounted for as a new loan. One key difference between loans accounted for in pools compared with loans accounted for individually is that when a TDR occurs, Subtopic 310-30 continues to apply to a loan accounted for within a pool, but TDR accounting applies to a loan accounted for individually.

7. The amendments in Update 2016-13 superseded Subtopic 310-30 in its entirety, and replaced it with a purchased credit deteriorated (PCD) accounting methodology for financial assets within the scope of Subtopic 326-20, Financial Instruments—Credit Losses—Measured at Amortized Cost, and available-for-sale securities within the scope of Subtopic 326-30, Financial Instruments—Credit Losses—Available-for-Sale Debt Securities. The PCD model retains the concept from Subtopic 310-30 that for certain assets it is not appropriate to accrete income on the basis of the entire difference between the purchase price of an asset and the contractual cash flows. Therefore, similar to Subtopic 310-30, the PCD methodology excludes the credit discount from the amount accreted to interest income. However, the PCD methodology is different from Subtopic 310-30 because it does not require asymmetrical accounting for subsequent changes in expected cash flows due to credit. PCD assets, instead, have an allowance for credit losses that is calculated on the basis of the guidance in either Subtopic 326-20 or Subtopic 326-30, which is adjusted each period for changes in expectations of credit losses. Upon the purchase of an asset, or a group of assets, the allowance for credit losses

is added to the purchase price to determine the initial amortized cost basis that is used for interest income recognition. This approach results in PCD assets being more comparable to other purchased or originated assets and prevents the accretion of the credit discount into interest income.

8. Unlike Subtopic 310-30, the PCD accounting methodology does not permit a pool unit of account for any purpose other than measuring credit losses. Paragraph 326-20-30-13 requires any noncredit discount or premium resulting from acquiring a pool of PCD assets to be allocated to each individual asset. Therefore, upon adoption of the amendments in Update 2016-13, there may be several practical changes to how pooled PCI assets would have previously been accounted for, including the following:

   (a) Interest income will be based on the unit of account at an individual asset level.

   (b) Writeoffs of financial assets will be determined at an individual asset level, whereas under Subtopic 310-30 entities may not have applied their writeoff policies[2] to pooled PCI assets and, instead, reflected amounts deemed uncollectible in the expected cash flows of the pool.

   (c) A modification of a PCD asset that is a TDR will be accounted for as such, whereas under Subtopic 310-30 TDR accounting is not required to be applied when assets are accounted for in a pool.

9. The PCD accounting methodology requires collective evaluation of credit losses that is generally consistent with the pool unit of account concept under Subtopic 310-30; however, the requirements for how to collectively evaluate credit losses in paragraph 326-20-30-2 are not the same. Paragraph 326-20-30-2 states that "an entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist…." In applying this guidance, credit loss measurement pools must be reassessed each period whereas under Subtopic 310-30, periodic reassessment of the pool is not required.

Issue Description

10. The transition guidance in Update 2016-13 contains the following guidance for PCI and PCD assets within paragraph 326-10-65-1:

    d. An entity shall apply prospectively the pending content that links to this paragraph for **purchased financial assets with credit deterioration** to **financial assets** for

[2] In many cases, entities' accounting policies in this area are influenced by regulatory guidance that requires assets to be written off depending on certain factors such as a certain period of delinquency. One example of this guidance is the Uniform Retail Credit Classification and Account Management Policy issued by the Federal Financial Institutions Examination Council.

> which Subtopic 310-30 was previously applied. The prospective application will result in an adjustment to the **amortized cost basis** of the financial asset to reflect the addition of the allowance for credit losses at the date of adoption. An entity shall not reassess whether recognized financial assets meet the criteria of a purchased financial asset with credit deterioration as of the date of adoption. *An entity may elect to maintain pools of **loans** accounted for under Subtopic 310-30 at adoption.* An entity shall not reassess whether modifications to individual acquired financial assets accounted for in pools are **troubled debt restructurings** as of the date of adoption. The noncredit discount or premium, after the adjustment for the allowance for credit losses, shall be accreted to interest income using the interest method based on the **effective interest rate** determined after the adjustment for credit losses at the adoption date. The same transition requirements should be applied to beneficial interests for which Subtopic 310-30 was applied previously or for which there is a significant difference between the contractual cash flows and expected cash flows at the date of recognition. [Emphasis added.]

11. Stakeholders have questioned the intent of the sentence above in italics that allows entities to elect to maintain pools of loans accounted for under Subtopic 310-30 at adoption. The primary issue underlying stakeholder questions is:

    (a) Can entities apply the election to maintain pools accounted for under Subtopic 310-30 at the time of adoption only, or both at the time of adoption and on an ongoing basis?

Stakeholder Feedback

12. Stakeholder questions focus on whether the election to maintain pools accounted for under Subtopic 310-30 at adoption provides an exemption from the requirement to collectively evaluate assets with similar risk characteristics in paragraph 326-20-30-2 (as described in paragraph 9 above) at adoption only or both at adoption and on an ongoing basis. These questions arise in part because of the placement of the election to maintain pools in the transition section of Update 2016-13, which may imply that it only applies at transition. Additionally, Subtopic 310-30 was superseded in its entirety; therefore, once the amendments in Update 2016-13 are adopted, the guidance in paragraph 326-20-30-2 would be the only applicable guidance on pooling of assets for purposes of measuring credit losses.

13. If the election to maintain pools applies both at adoption and on an ongoing basis, stakeholders have also asked for clarity on whether the pool unit of account would continue to apply as it does under Subtopic 310-30, which means a pool unit of account may apply for purposes of writeoff determination or TDR identification in addition to credit loss measurement.

14. This issue affects the extent to which entities may need to modify their current systems and processes for pooled PCI assets. The Board included this transition provision to provide relief to entities transitioning to the amendments in Update 2016-13, and stakeholders are seeking clarity on the extent of relief that was intended—specifically, the period of time over which the election should be

applied and whether the pool unit of account may be extended to areas outside of credit loss measurement.

15. The staff has identified two views for the TRG members to consider:

(a) View A: Maintain the Subtopic 310-30 pool at the time of adoption only. Under this view, after adoption entities may only continue to maintain the pools for credit loss measurement purposes to the extent the risk characteristics of the underlying assets are similar in accordance with paragraph 326-20-30-2.

(b) View B: Maintain the Subtopic 310-30 pool both at the time of adoption and on an ongoing basis. Under this view, an entity would maintain the integrity of the pool consistent with the guidance in Subtopic 310-30 for all applicable areas of accounting which may include credit loss measurement, interest income recognition, writeoff determination, and TDR identification. Regarding interest income recognition, the prospective transition approach for PCD assets (that is, the "gross-up approach") would be applied at a pool level which would freeze the effective interest rate of the pool. Under this view, entities that elect to maintain pools would not be able to remove assets from the pool until they are paid off, written off, or sold.

16. Supporters of View A place weight on the fact that the guidance on the election to maintain pools is in the transition section of the standard. After transition, entities would no longer apply the transition guidance but would apply the general guidance on collective evaluation in paragraph 326-20-30-2 (described in paragraph 9 above).

17. Additionally, the transition guidance in paragraph 326-10-65-1(d) does not provide any explicit exemption from the requirement in paragraph 326-20-30-13, which states:

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

Supporters of View A argue that continuing to account for noncredit discounts or premiums at a pool level would not comply with this guidance.

18. Supporters of View A add that the following sentences in the transition guidance reinforce the view that the Board's intent was for the noncredit discount to be accreted to interest income at the individual asset level because of the reference to adjusting the amortized cost basis at the individual financial asset level. From paragraph 326-10-65-1(d):

> The prospective application will result in an adjustment to the **amortized cost basis** of the financial asset to reflect the addition of the allowance for credit losses at the date of adoption….The noncredit discount or premium, after the adjustment for the allowance for credit losses, shall be accreted to interest income using the interest method based on the **effective interest rate** determined after the adjustment for credit losses at the adoption date. [Emphasis added.]

19. Supporters of View A also point to the sentence in paragraph 326-10-65-1(d) immediately following the guidance on the election to maintain pools that addresses TDR identification for pools of Subtopic 310-30 assets existing as of the date of adoption. From paragraph 326-10-65-1(d):

> An entity shall not reassess whether modifications to individual acquired financial assets accounted for in pools are **troubled debt restructurings** as of the date of adoption.

This sentence allows relief for identification of TDRs in existing PCI pools for modifications that occurred before the date of adoption. By not addressing relief for modifications that occur after the date of adoption, this sentence may imply that a pool unit of account is not acceptable for TDR identification purposes after the date of adoption.

20. Supporters of View B note that the Board intended to allow an entity to elect to maintain PCI pools on an ongoing basis based on cost-benefit considerations. These stakeholders argue that the election to maintain pools would only significantly reduce costs if the pool unit of account concept applied both at the time of adoption and prospectively. This would allow entities that use a specialized system of accounting under Subtopic 310-30 to continue using such a system on an ongoing basis with few, if any, modifications, which would reduce costs for these entities.

21. Supporters of View B also argue that the transition guidance allowing an election to maintain Subtopic 310-30 pools does not only apply to credit loss measurement; rather, it applies more broadly to other aspects of accounting addressed by Subtopic 310-30. These stakeholders note that the guidance in Subtopic 310-30 addresses the pooling of loans and specific areas in which a pool unit of account applies, such as TDR identification. Therefore, they add that a pool unit of account concept should continue to apply consistent with the current application of Subtopic 310-30, which may affect the areas of credit loss measurement, allocation of noncredit premiums of discounts, writeoff determination, and TDR identification. These stakeholders argue that if the PCI pool is required to be broken up for any of these areas, the usefulness of the election to maintain pools is diminished because more substantial system and process modifications would be necessary.

22. The staff is aware of another view in which the full Subtopic 310-30 model is applied. However, the staff note that this view is flawed and should not be discussed by the TRG members. If the Subtopic 310-30 interest income model is applied, it would result in a direct conflict with the transition guidance in paragraph 326-10-65-1(d) that provides specific guidance on prospective interest income recognition for former PCI assets. Additionally, Subtopic 310-30 was superseded in its entirety by Update 2016-13, which means that under this view entities would be applying a superseded accounting model in its entirety on an ongoing basis. The staff adds that this view was clearly not the intent of the Board and that View B may provide a similar level of relief by continuing application of only the pool unit of account concept from Subtopic 310-30.

Staff Analysis of Alternatives

23. The staff agrees with stakeholders that the intent of the "election to maintain pools" is not entirely clear. The staff notes that outside of the excerpts from the guidance noted in paragraphs 17–19, there is no further clarification in Update 2016-13, including in the basis for conclusions. Therefore, the staff has analyzed the benefits and drawbacks of each view in the following paragraphs.

24. The staff notes that the primary benefit of View A is that it prevents assets with different risk characteristics from being pooled together after adoption, which, if allowed, may result in noncompliance with the objective of the amendments in Update 2016-13, as described in paragraph 326-20-30-1.[3] Under View A, assets would be removed from pools when risk characteristics have changed significantly, and for areas outside of credit loss measurement, the unit of account would be the individual asset. This application would align with the guidance in paragraph 326-20-30-2, which requires collective evaluation for assets that have similar risk characteristics, and paragraph 326-20-30-13, which requires noncredit premiums and discounts to be allocated to each individual PCD asset. Additionally, View A would result in consistency with other assets accounted for under the amendments in Update 2016-13 in that the postadoption accounting for PCI loans held at transition would be the same as PCD assets acquired after the adoption date. Therefore, View A would result in better comparability in the years after adoption when evaluating a single entity's portfolio that includes former PCI assets and across entities that hold former PCI assets.

25. The staff adds that the main drawback of View A is that it would not provide as much cost relief as View B. The staff notes that under View A entities may incur incremental costs to evaluate pools of assets for credit loss measurement purposes and to transition PCI pools to an individual unit of account. The staff also notes that application of View A may have the following immediate effects for entities currently accounting for pools of assets under Subtopic 310-30:

    (a) Allocation of noncredit premium or discount—At transition, any noncredit premium or discount would need to be allocated at the individual asset level in accordance with paragraph 326-10-65-1(d).

    (b) Evaluation of pools for credit loss measurement purposes—Entities would need to evaluate whether assets in PCI pools have similar risk characteristics in accordance with paragraph 326-20-30-2 in the first reporting period after adoption.

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[3] Paragraph 326-20-30-1 states that "the allowance for credit losses is a valuation account that is deducted from the **amortized cost basis** of the **financial asset(s)** to present the net amount expected to be collected on the financial asset."

(c) Application of writeoff guidance—Entities may not currently apply writeoff policies to PCI assets accounted for in a pool; however, under the amendments in Update 2016-13 when the unit of account is an individual asset, entities may need to consider whether writeoffs are needed immediately after adoption. For example, assume an entity's policy for writing off a certain type of asset is set at 120 days delinquent based on applicable regulatory guidance. This policy is not applied to pooled PCI assets under current GAAP, but once the amendments in Update 2016-13 are adopted the entity would writeoff the grossed-up allowance for credit losses for all assets over 120 days delinquent. Such a writeoff would not have an income statement effect; however, the gross-up adjustment and corresponding writeoff would be captured in the PCD rollforward disclosure required by paragraph 326-20-50-19.

(d) Identification of TDRs—Entities may not currently have processes in place to identify TDRs for PCI pools that will need to be in place once the amendments in Update 2016-13 are adopted.

26. Notwithstanding the incremental implementation activities noted above, the staff notes that View A may still provide some transition relief for purposes of credit loss measurement. First, at the time of transition, View A provides relief in determining the new effective interest rates for PCI assets when pools are maintained because entities can use historical PCI pools as a starting point. Under this approach, it should be easier to allocate the allowance for credit losses to the assets and determine the individual effective interest rates for each asset.

27. Second, the staff notes that the amendments in Update 2016-13 allow significant judgment to be applied when determining the similar risk characteristics used to pool assets under Subtopic 326-20.[4] One reason the Board did not prescribe detailed guidance in this area is because each entity has different risk management practices, and the intent of the amendments is to allow entities to measure credit losses for financial reporting consistent with how their risk function evaluates credit risk. Therefore, the staff observes that in many cases, entities should be able to apply judgment when defining risk characteristics such that they can isolate the former PCI pool on an ongoing basis. If

[4] Examples of risk characteristics provided in paragraph 326-20-55-5 include any one or a combination of the following (which is not an all-inclusive list):

(a) Internal or external (third-party) credit score or credit ratings
(b) risk ratings or classification
(c) financial asset type
(d) collateral type, size
(e) effective interest rate
(f) term
(g) geographical location
(h) industry of the borrower
(i) vintage, historical, or expected credit loss patterns
(j) reasonable and supportable forecast periods

entities "maintain pools" within the boundaries of paragraph 326-20-30-2, they should still be able to leverage some of their existing systems and processes.

28. For example, an entity with a pool of purchased assets previously accounted for under Subtopic 310-30 could consider factors that may distinguish that pool from all other assets that have been originated and held by the entity, which could include any one or a combination of the following:

(a) Underwriting standards of the originating bank are significantly different from underwriting standards in place for other assets held by the entity.

(b) The historical or expected credit loss pattern of the assets is different from other assets held by the entity.

(c) The geographical location of the borrowers and collateral is different from other assets held by the entity.

(d) Reasonable and supportable forecast adjustments, or other qualitative adjustments, are expected to be different for assets in the pool compared with other assets held by the entity.

(e) The average effective interest rate of the assets in the pool is significantly different from other assets held by the entity.

29. If an entity were to determine that assets in the pool previously accounted for under Subtopic 310-30 have different risk characteristics from its other assets, the entity would not be required to merge assets in the PCI pool with any of its other pools. In this case, the entity could maintain the pool at adoption, and after adoption it could evaluate the similar risk characteristics that exist within the PCI pool only. In the first period after adoption, the entity may need to break the PCI pool down into subpools. For example, if a certain portion of the assets are delinquent then an entity may determine the delinquent assets have similar risk characteristics and should be in a separate subpool. Each subpool would need to be evaluated separately; however, by isolating the PCI assets, existing processes and systems for Subtopic 310-30 accounting may still be leverageable with some modifications. For example, an entity that utilizes a DCF model to measure the nonaccretable difference at a pool level under Subtopic 310-30 could, under the amendments in Update 2016-13, isolate former PCI pools and continue to use the DCF model for measuring credit losses on those pools, albeit likely based on subpools of the original PCI pool. Under this approach, the PCI pool is being maintained to a degree which reduces implementation costs, while also maintaining consistency with other assets accounted for under the amendments.

30. The staff notes that the primary benefit of View B is that entities could retain their current accounting systems and processes for PCI assets with minimal modifications. Entities would not need to allocate the noncredit premium or discount to individual assets or change their writeoff or TDR identification policies for these pools. This would result in reduced implementation costs compared with View A. Additionally, the staff notes that this view would provide relief to smaller financial institutions that

experienced mergers during the financial crisis that resulted in PCI assets. For these institutions, PCI assets often are more significant as a percentage of the total loan portfolio when compared with larger institutions.

31. However, the staff notes that there are several drawbacks to View B, which include:

(a) If assets are maintained in a pool even though risk characteristics are clearly different, the measurement of expected credit losses on a collective basis may not meet the objective of the amendments in Update 2016-13. Under View B, positive changes in credit factors for some assets may offset negative changes in credit factors for other assets, which may obscure changes in expected credit losses from period to period.

(b) Applying a pool unit of account concept to former PCI assets would be inconsistent with all other assets within the scope of Topic 326. The staff notes this inconsistency could remain for a significant period of time depending on when the PCI pool was formed and the types of assets in the pool. This may result in less transparent financial reporting on expected credit losses, writeoffs, and TDR activity.

32. Some stakeholders argue that View B is justified, despite the drawbacks, because the current value of Subtopic 310-30 pools is relatively low compared with the years immediately following the financial crisis. Therefore, these stakeholders add that the effect on the usefulness of financial reporting under View B should not be significant, and that the effect would be mitigated over time by portfolio turnover because all new assets will be accounted for under the amendments in Update 2016-13. The staff acknowledges this is the case for some stakeholders but notes that this depends on each entity's individual facts and circumstances. Overall, in the staff's view, even if an entity has a significant portfolio of PCI loans at the time of transition, View B may bring further relief to the entity that is likely to already be incurring significant costs to implement the amendments.

Staff Recommendation

33. The staff does not have a recommendation for this issue. The staff notes that based on the guidance as written, View A appears to be more consistent with the Board's original intent. However, depending on feedback from the TRG members about the level of incremental cost relief and whether the drawbacks would be manageable, the staff notes that it may be appropriate for the Board to consider clarifying the guidance to allow View B.

34. The staff adds that based on the varying degrees of sophistication among entities that apply Subtopic 310-30 accounting, where systems may range from spreadsheets to more complex models, the balance of cost relief and other implications may vary significantly by entity. Therefore, a discussion among the TRG members on the question in this memo will be helpful for the Board to determine what, if any, action may be needed to address the issue.