FASB FINANCIAL ACCOUNTING STANDARDS BOARD

MEMO	Memo No.	**6C**	
	Issue Date	**December 21, 2017**	
	Meeting Date(s)	**BM December 13, 2017**	

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Project	**Transition Resource Group for Credit Losses**
Project Stage	**Post Issuance**
Issue	**Using a Prepayment-Adjusted Effective Interest Rate as of the Adoption Date for Troubled Debt Restructurings**

[Note: This memo serves as an addendum to Transition Resource Group for Credit Losses (TRG) Memo No. 6 June 2017 Meeting—Summary of Issues Discussed and Next Steps.]

Memo Purpose

1. The purpose of this memo is to discuss the accounting for troubled debt restructurings (TDRs) under the amendments in Accounting Standards Update No. 2016–13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* and subsequent discussions at the Transition Resource Group for Credit Losses (TRG) meeting on June 12, 2017.

2. This memo provides the staff analysis and recommendation for providing transition relief when an entity elects to use a prepayment-adjusted effective interest rate (EIR) when using a discounted cash flow (DCF) method to determine the allowance for credit losses for existing loans accounted for as TDRs at the adoption date. This Board meeting is a decision-making Board meeting.

Question for the Board
1) Does the Board want to provide transition relief for entities that elect to use a prepayment-adjusted EIR in a DCF method to measure credit losses to use the prepayment-adjusted EIR as of the adoption date for existing loans accounted for as TDRs?

Issue Background

Accounting for Troubled Debt Restructurings: Changes Made in Update 2016-13

3. In Update 2016-13 the Board decided to amend existing guidance for measuring credit losses for financial assets restructured in a TDR. The amendment permits various measurement methodologies for measuring credit losses for TDRs and eliminates the explicit requirement to use a DCF method. However, many entities may still use DCF methods to measure credit losses on TDRs because the guidance requires that all effects of reasonably expected TDRs need to be incorporated into the allowance for credit losses, some of which can only be captured using a DCF method (or reconcilable method).[1]

4. When an entity uses a DCF method to measure credit losses on TDRs, paragraph 326-20-30-4 indicates that "the entity shall discount expected cash flows at the financial asset's effective interest rate." Furthermore, paragraph 310-40-35-12 indicates the following:

> **310-40-35-12** The effective interest rate for a loan restructured in a troubled debt restructuring is based on the original contractual rate, not the rate specified in the restructuring agreement. As indicated in paragraph 310-40-35-10, a troubled debt restructuring does not result in a new loan but rather represents part of a creditor's ongoing effort to recover its investment in the original loan. Therefore, the interest rate used to discount expected future cash flows on a restructured loan *shall be the same interest rate used to discount expected future cash flows on the original loan*. [Emphasis added.]

Therefore, under the updated guidance in Update 2016-13, credit losses on TDRs measured using a DCF method should be calculated from cash flows discounted at the effective interest rate (EIR), which should not be modified for the TDR (it should be based on the original contractual rate or the EIR adjusted for prepayments if that methodology was elected by the entity).

Consensus at June 2017 Transition Resource Group Meeting: Using Prepayment-Adjusted EIR

5. At the June 12, 2017 TRG meeting, one of the topics discussed was whether entities using a DCF method to measure credit losses on financial assets should be permitted to adjust the EIR on the assets for expected prepayments (Topic 1).[2] The issue discussed is summarized in Memo 6, "June 2017 Meeting—Summary of Issues Discussed and Next Steps," as follows:

[1] See discussion of the issue and summary of September 6, 2017 Board meeting in Memo No. 6A, "Addendum to Memo No. 6—Accounting for Troubled Debt Restructurings."

[2] See discussion and summary in Memo No. 1, "Discounting Expected Cash Flows at the Effective Interest Rate," Memo No. 1A, "Discounting Expected Cash Flows at the Effective Interest Rate—Appendix A," and in June 2017 Board meeting Memo No. 6, "Summary of Issues Discussed and Next Steps."

> Specifically, if expected cash flows are discounted based on the contractual EIR, the expectation of prepayments will always increase the allowance for credit losses for financial assets held at a premium, whereas the expectation of prepayments will always decrease the allowance for credit losses for financial assets held at a discount. Stakeholders consider these outcomes to be issues because credit risk is not isolated and the increase in, or offset to the allowance related to premiums or discounts respectively, can potentially be material in determining the amount of credit losses recorded depending on facts and circumstances.

6. The consensus of the TRG members at the June 2017 meeting was to support the staff's recommendation that would allow for an accounting policy election to use an EIR adjusted for prepayment expectations when using a DCF method to determine the allowance for credit losses. Upon making the accounting policy election, entities should update the adjusted EIR periodically based on changes in expected prepayments.

Interaction with TDR Guidance

7. Because entities may choose to measure credit losses on TDRs using a DCF method, the consensus from the June 2017 TRG meeting allowing a policy election to use a prepayment-adjusted EIR affects the measurement of credit losses on TDRs. However, the TRG meeting summary specifically indicates that accounting for TDRs is slightly different from the overall model because "after the troubled debt restructuring (TDR) event, the EIR used should not be periodically updated for prepayment expectations." Therefore, if an entity makes the policy election to use a prepayment-adjusted EIR, the rate that the entity should use for measurement of credit losses on TDRs is the prepayment-adjusted EIR before the date the TDR takes place. This outcome reflects the conclusion from paragraph 4 of this memo, which was that the guidance under Update 2016-13 indicates that the EIR used for discounting should not be modified for the TDR.

Stakeholder Feedback

8. Certain stakeholders indicated that it would be very difficult to adopt a prepayment-adjusted EIR for DCF measurement of credit losses for preexisting TDRs. Determining the prepayment-adjusted EIR for these financial assets would be extremely difficult from an operational standpoint. To properly recalculate a prepayment-adjusted EIR as of the historical TDR date of each loan, they would have to restore the economic assumptions and models that were appropriate for each TDR date in order to project cash flows. This process would be the same for all entities that have significant numbers of historical TDRs and would be complex and costly. Thus, the stakeholders are asking the Board for transition relief to allow them to use prepayment-adjusted EIRs as of the adoption date of Update 2016-13, which would avoid the process of recalculating historical adjustments, instead of the historical prepayment-adjusted EIRs as of the TDR dates.

Staff Analysis and Recommendation

9. The staff notes that this issue was raised from a purely operational standpoint; there is no interpretive issue and the standard and subsequent TRG consensus are clear on the accounting model to be applied to this situation. Furthermore, this is primarily being raised as an issue by stakeholders that have significant portfolios with significant historical TDR volume that plan to use a DCF method to calculate credit losses for multiple portfolios (including TDRs). The staff performed additional outreach to try and determine how pervasive the issue is. However, the feedback we received is that it is too early in the implementation process to know how many entities will use a DCF method to calculate credit losses at a portfolio level or will be required to use a DCF method based on the Board's recent discussions. However, because entities are using a DCF method to calculate losses for TDRs today given the explicit requirement, and in light of the Board's recent discussions regarding the DCF method and TDRs, the staff expects that practice likely will continue. Therefore, for those entities that choose to use a prepaid adjusted EIR and continue to use a DCF method, this problem will exist. Consequently, it is likely the Board would need to address this issue in the future as more entities are further along in the implementation process.

10. The general spirit of transition guidance is to provide a cost-effective and practical bridge for entities moving from legacy guidance to the new guidance. Following this idea, the Board already provided incremental transition relief for purchased financial assets with credit deterioration (PCD assets) at the adoption date to reflect the amendments made in Update 2016-13 on a prospective basis (paragraph 326-10-65-1(d)). This relief was provided in response to stakeholders' concerns that they would need to reamortize the PCD assets to comply with a modified retrospective approach, a process for which the Board concluded the benefits do not justify the costs.[3] Requiring entities electing to use the prepayment-adjusted EIR to go back and calculate the rate as of historical TDR dates would be similar in that the historical rate would have to be recalculated. It is impossible for the staff to estimate the effects that this provision would have on entities' allowances because entities currently do not have data tracking the change in prepayment expectations from TDR date to the adoption date. Additionally, as mentioned above, the staff does not know how many entities intend to elect to use a prepayment-adjusted EIR and, if so, the size the portfolio of TDR assets.

11. Considering the analysis above, the staff recommends that the Board make a transition provision to allow entities that elect to use a prepayment-adjusted EIR when using a DCF method to measure credit losses to use the prepayment-adjusted EIR *as of the adoption date* for TDRs. The stakeholders' request for relief seems appropriate given the Board's other transition provisions, and it would avoid causing entities to incur significant costs upon adoption of Update 2016-13. Without this specific transition

[3] Paragraph BC199 of Update 2016-13

provision, entities may not even be able to use prepayment-adjusted EIRs in general because it could be cost prohibitive to apply the policy election to preexisting TDRs.

Next Steps

12. If the Board agrees with the staff's recommendation, the staff could publish an amendment to the TRG meeting minutes in Memo No. 6, "June 2017 Meeting—Summary of Issues Discussed and Next Steps," which indicates the appropriate relief provisions. The staff believes an amendment to the TRG meeting minutes is appropriate because this issue stems from decisions reached at the TRG meeting and a subsequent Board meeting, which are all contained in the public meeting minutes. Additionally, because this decision pertains only to the transition provisions within Update 2016-13 and will not need to be codified past the implementation timeline, documentation of the decision within the updated TRG meeting minutes is appropriate.

Summary of December 13, 2017 Board Meeting

13. The Board decided (7–0) to provide transition relief for entities that elect to use a prepayment-adjusted EIR in a DCF approach to measure credit losses on TDRs that exist as of the adoption date. As a result of this relief, entities are not required to calculate the prepayment-adjusted EIR for each TDR as of the date preceding the asset restructure in accordance with the consensus reached by the TRG in the June 12, 2017 public meeting. Instead, entities may calculate the prepayment-adjusted EIR based on the original contractual terms of the loan and prepayment assumptions as of the date of adoption.