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Contacts	**Seth Drucker**	Lead Author, Practice Fellow	Ext. 317
	Jared Cline	Co-author, Postgraduate Technical Assistant	Ext. 388
	Damon Romano	Practice Fellow	Ext. 334
	Jay Shah	Project Manager	Ext. 340
	Trent LaFrano	Postgraduate Technical Assistant	Ext. 239
	Shayne Kuhaneck	Assistant Director	Ext. 386

Project	**Transition Resource Group for Credit Losses**
Project Stage	**Post-Issuance**
Issue	**Refinancing and Loan Prepayments**

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Memo Purpose

1. Stakeholders have informed the staff that there is diversity in views on whether entities are required to use the loan refinancing or restructuring guidance in paragraphs 310-20-35-9 through 35-12 to determine what constitutes a prepayment for the purposes of the expected credit losses measurement under Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.

2. This memo summarizes the views and provides the staff's analysis of the issue. The staff will seek input from members of the Transition Resource Group for Credit Losses (TRG).

Question for TRG Members
1. Does the TRG have feedback on the staff's interpretation and recommendation on the issues in this memo?

Issue Background and Description

3. Topic 326 requires entities to consider the effect of estimated prepayments on the measurement of expected credit losses in paragraph 326-20-30-6 as follows:

> **326-20-30-6** 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.

4. Under current GAAP's incurred model, expected prepayments have not been a significant input into allowance calculations, so practice has not been established as to what constitutes a "prepayment" for the purposes of calculating the allowance for credit losses. This lack of a unified definition has led to a diversity in views around how to consider certain transactions or events for the purposes of estimating prepayments under Topic 326.

5. The specific scenarios raised to the TRG through a submission drafted by a group of stakeholders (the submission) are refinancings with the same lender that are not troubled debt restructurings, where it is more difficult to determine whether a prepayment has occurred. It is common for loans to be refinanced with lenders before maturity, whether through a contractual modification or the creation of a new loan agreement, the proceeds of which are used to repay the existing loan. GAAP provides a framework for assessing whether these refinancings are new loans for purposes of determining recognition of fees and other costs in paragraphs 310-20-35-9 through 35-12 (shown below) but does not provide specific guidance in Topic 326 to assess whether these events are prepayments for the purposes of estimating expected credit losses. Therefore, some stakeholders have asked for clarification on this issue as part of the broader question of whether Topic 326 requires a specific definition of prepayment (such as the guidance in paragraphs 310-20-35-9 through 35-12).

6. The loan modification guidance referenced above from Subtopic 310-20, Receivables—Nonrefundable Fees and Other Costs, is shown below. This guidance is written in the context of nonrefundable fees and other costs and has been used in practice to assess whether refinancings and restructurings create new loans and states the following:

310-20-35-9 If the terms of the new loan resulting from a loan refinancing or restructuring, in which the refinancing or restructuring is not itself a troubled debt restructuring, are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans and modifications of the original debt instrument are more than minor. Any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted. The effective yield comparison considers the level of nominal interest rate, commitment and origination fees, and direct loan origination costs and would also consider comparison of other factors where appropriate, such as compensating balance arrangements.

310-20-35-10 If the refinancing or restructuring does not meet the condition set forth in the preceding paragraph or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan. In this case, the investment in the new loan shall consist of the remaining **net investment in the original loan**, any additional amounts loaned, any fees received, and direct loan origination costs associated with the refinancing or restructuring.

310-20-35-11 A modification of a debt instrument shall be considered more than minor under the preceding paragraph if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the difference between the present value of the cash flows under the terms of the new debt instrument and the present value of the remaining cash flows under the terms of the original debt instrument is less than 10 percent, a creditor shall evaluate whether the modification is more than minor based on the specific facts and circumstances (and other relevant considerations) surrounding the modification. The guidance in Topic 470 shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent test.

310-20-35-12 Fees received in connection with a modification of terms of a troubled debt restructuring as defined in Subtopic 310-40 shall be applied as a reduction of the **recorded investment** in the loan. All related costs, including direct loan origination costs, shall be charged to expense as incurred.

7. The submission put forth two views for the consideration of how to define prepayments in the context of calculating the allowance for credit losses as follows:

   (a) **View A:** To apply the expected prepayment guidance in paragraph 326-20-30-6 to an expected refinancing with the same lender prior to contractual maturity, assuming the refinancing is not a troubled debt restructuring, an entity must first apply the guidance in paragraphs 310-20-35-9 through 35-12 to determine whether the refinancing is expected to be a modification of the original loan or a new loan. If the refinancing is expected to be a modification under paragraphs 310-20-35-9 through 35-12, it will not be considered in determining the term over which expected credit losses are estimated. Conversely, if the refinancing is expected to be an extinguishment of the original loan under paragraphs 310-20-35-9 through 35-12, it will be considered in the same manner as an expected prepayment with cash settlement.

(b) **View B:** Topic 326 does not define a specific framework for the consideration of prepayments and, consistent with other elements of CECL, whether a transaction or amendment should be considered to be a prepayment pursuant to paragraph 326-20-30-6 is a matter of professional judgment. Moreover, although the framework articulated in paragraphs 310-20-35-9 through 35-12 may provide one approach to considering prepayments, it is not the only approach, and for many types of loans it may not represent an approach that is either conceptually appropriate or operationally feasible.

8. Proponents of View A believe a forecast of the quantitative and qualitative assessment required under paragraphs 310-20-35-9 through 35-12 must be performed to determine if the refinancing is expected to be a modification of the original loan or an extinguishment and creation of a new loan. Some supporters of View A stated that certain qualitative factors, such as the completion of a full underwriting as part of the refinancing for which there were multiple lenders involved in "bidding" for the new loan, may indicate the modification is more than minor.

9. Proponents noted that the vintage disclosure for refinanced loans is based on whether the refinancing was treated as a modification (use original loan's origination date for the vintage) or a new loan (use the refinancing date for the vintage disclosure) and believe that View A would ensure that the prepayment definition aspect of the credit loss modeling would be consistent with these disclosures.

10. Finally, proponents stated that this view is most aligned to the guidance in paragraph 326-20-30-6, which requires consideration of expected prepayments but prohibits consideration of expected extensions, renewals, or modifications.

11. Proponents of View B believe that:

(a) CECL is flexible and allows for judgments to be made to enable lenders to appropriately estimate expected credit losses in accordance with its principles.

(b) Paragraphs 310-20-35-9 through 35-12 was developed to determine appropriate loan fee recognition, and not in the context of assessing credit risk or exposure.

(c) Assessing whether a transaction or modification should be considered a prepayment of a loan in the context of Topic 326 requires consideration of the facts and circumstances, and particular consideration should be given to whether credit risk to the borrowers for non-homogeneous loans has been curtailed.

(d) Differentiating between loan types and portfolios is a well established concept in the accounting literature and is particularly relevant in the consideration of prepayments under CECL.

(e) The application of paragraphs 310-20-35-9 through 35-12 in many cases may not be operationally feasible because many of the prepayment models commonly used in practice for homogeneous loans are not based on a "new loan" accounting analysis.

12. Therefore, proponents of View B stated that a reasonable conclusion could be reached to incorporate prepayment data (which uses internal refinancings as prepayments) for certain loan portfolios while not incorporating internal refinancings into prepayment estimates for other portfolios with different characteristics.

13. Although the submission focused on internal refinancings, the staff notes the overall question posed is applicable for all prepayments. Therefore, the staff has decided to address the issue more broadly.

Issue 1: Are Entities Required to Use the Loan Modification Guidance in Paragraphs 310-20-35-9 through 35-12 to Determine Whether a Refinancing Constitutes a Prepayment for the Purposes of Measuring Expected Credit Losses under Topic 326?

Feedback and Outreach

14. Additional feedback and outreach with preparers and auditors indicated that the loan modification guidance in Subtopic 310-20 does not seem to be entirely appropriate for the purposes of estimating prepayments when measuring expected credit losses generally. Specifically, they noted that this guidance was written in the context of accounting for fees, costs, and prepayment penalties upon a refinancing or restructuring, and may not provide the best framework for the purposes of Topic 326. However, auditors with whom the staff conducted outreach noted that the loan modification guidance is currently the only area within GAAP that could be used to ground the definition of a prepayment for credit loss purposes if the Board chose to do so.

15. Preparers with whom the staff conducted outreach did not support defining the term *prepayment* in the context of Topic 326, either by linking it to the loan modification guidance or by some other method. Throughout GAAP, the term *prepayment* is generally not defined[1], and stakeholders raised concerns that if the FASB were to define the term in this instance, there could be significant cross-cutting issues.

[1] Although the staff recently published an interpretation of the term *prepayable* for the purposes of hedge accounting under Topic 815, Derivatives and Hedging, the terms *prepayable* and *prepayment* occur many other places throughout the Codification and are generally not defined. The staff also notes the recently published interpretation for hedging provides guidance for the types of features within an instrument that make the instrument prepayable but does not define when a prepayment occurs.

16. Preparers also noted that a single definition of prepayment under Topic 326 would limit entities' ability to differentiate between loan types and portfolios, a concept that stakeholders argue not only matches risk management practices but is well established in existing GAAP.[2] Many preparers specifically referenced different risk management practices between homogeneous loan portfolios, such as portfolios of consumer mortgages, and nonhomogeneous loan portfolios, such as wholesale commercial and industrial (C&I) loans. C&I loans operate under relationship-based lending, which drives specific patterns of underwriting, refinancing, and prepayment tracking, whereas consumer mortgages do not and, thus, have different practices in those areas. Therefore, these preparers argued that a single definition of prepayments would not align with how entities assess credit risk internally. However, some auditors raised concerns about entities using an inconsistent approach to considering prepayments under Topic 326.

17. Practically, stakeholders noted that developing prepayment data to use in expected credit loss models that reflects the loan modification guidance is not operationally feasible for certain types of loans, including consumer mortgages. Market prepayment data for these loans is developed using contractual payments on the loans, regardless of the source of funds, and does not consider the loan modification guidance. Therefore, entities would have to adjust this data with an accounting analysis that does not currently exist and would be complex, difficult, and costly to accomplish.

18. Many stakeholders with whom the staff conducted outreach (including many preparers in particular) strongly oppose requiring an entity to use the loan modification guidance in Subtopic 310-20 to determine what a prepayment is for the purposes of estimating expected credit losses under Topic 326. These stakeholders stated that this view aligns with the flexibility provided throughout the amendments in Update 2016-13 and would enable entities to better reflect their expectations of credit risk across different loan types.

Staff Analysis and Recommendation

19. The staff notes that this question arises from the underlying issue of whether the creation of a new loan for *recognition* purposes is equivalent to a prepayment for the purposes of *measuring* expected credit losses. This underlying issue is reflected in certain stakeholders' support of using the loan modification guidance, where they argue that because the loan modification guidance is referenced to determine origination year for the vintage disclosure requirements in paragraph 326-20-50-7, it should be used for determining prepayments when measuring expected credit losses. In resolving this underlying issue of a new loan being akin to a prepayment, the answer to this issue of the use of the loan modification guidance becomes clear.

[2] For example, the guidance on estimating principal prepayments for purposes of calculating constant effective yield in paragraphs 310-20-35-26 through 35-33 has different accounting outcomes for portfolios of similar loans for which prepayments are probable versus all other loans (i.e., an entity may include prepayment estimates for the former).

20. In its deliberations on the amendments in Update 2016-13, the Board did not consider a specific definition of prepayment, and that term was not discussed in connection with the concept of a new loan under the loan modification guidance. The term *prepayment* for a loan was limited to the general concept of a reduction of principal outstanding, and the Board did not determine whether the framework for identifying a new loan under Subtopic 310-20 is related to identifying prepayments under Topic 326. Therefore, the staff believes it would seem inappropriate to narrow this concept in the context of a refinancing and equate prepayment to the point at which a new loan is created, especially given the Board's overall intent to provide flexibility in how entities may measure credit losses on their portfolios. Furthermore, the staff notes that the Board generally does not define other inputs to the calculation of the allowance for credit losses and, therefore, the staff does not see a compelling reason to define this particular input.

21. The staff also notes that the guidance in Topic 326 on the calculation of expected credit losses is for the purposes of *measurement* of expected credit losses, whereas the loan modification guidance in Subtopic 310-20 is for the purposes of *recognition* of new loans. Paragraph 6 of FASB Concepts Statement No. 5, *Accounting for Contingencies,* states "Recognition is the process of formally recording or incorporating an item in financial statement of an entity as an asset, liability, revenue, expense, or the like." Only after an item has been recognized is it then measured; these are separate processes. Therefore, while the loan modification guidance may inform the measurement of expected credit losses, it appears that requiring the use of recognition-based guidance to perform the measurement as a starting point in all instances does not align with the purposes of the guidance. By natural extension, it appears reasonable that an entity could establish separate policies and processes for identifying new loans to meet the vintage disclosure requirements and to determine prepayments for measurement purposes.

22. Consequently, the staff's interpretation is that entities should not be required to use the loan modification guidance in paragraphs 310-20-35-9 through 35-12 to determine what constitutes a prepayment. However, the staff believes that an entity should not be precluded from using the guidance if the entity determines the guidance provides an appropriate basis for determining prepayments given its specific portfolios and facts and circumstances.

23. In reaching this interpretation the staff placed more weight on:

(a) The Board's overall intent to provide flexibility in Update 2016-13

(b) The primary purpose of the modification guidance (that is, recognition versus measurement)

(c) The fact that Update 2016-13 generally does not define specific inputs to the calculation of the allowance for credit losses

(d) The significant costs noted by stakeholders to adjust market prepayment data for the Subtopic 310-20 analysis

(e) The potential cross-cutting issues.

24. The staff placed less weight on the desire of some stakeholders to create consistency across entities or to ensure that the prepayment definition aspect of credit loss modeling is consistent with how an entity determines new loans for purposes of meeting the vintage disclosure requirements.

25. Consequently, the staff did not find a strong reason to require entities to apply guidance on loan modifications that many stakeholders believe to be inappropriate for the purposes of measuring expected credit losses.

26. Finally, the staff believes that prepayments should not be specifically defined for purposes of calculating the allowance for expected credit losses.

27. The staff recommends no further work on this issue.

Appendix A—Relevant Literature

310-20-35-9 If the terms of the new loan resulting from a loan refinancing or restructuring, in which the refinancing or restructuring is not itself a troubled debt restructuring, are at least as favorable to the lender as the terms for comparable loans to other customers with similar collection risks who are not refinancing or restructuring a loan with the lender, the refinanced loan shall be accounted for as a new loan. This condition would be met if the new loan's effective yield is at least equal to the effective yield for such loans and modifications of the original debt instrument are more than minor. Any unamortized net fees or costs and any prepayment penalties from the original loan shall be recognized in interest income when the new loan is granted. The effective yield comparison considers the level of nominal interest rate, commitment and origination fees, and direct loan origination costs and would also consider comparison of other factors where appropriate, such as compensating balance arrangements.

310-20-35-10 If the refinancing or restructuring does not meet the condition set forth in the preceding paragraph or if only minor modifications are made to the original loan contract, the unamortized net fees or costs from the original loan and any prepayment penalties shall be carried forward as a part of the net investment in the new loan. In this case, the investment in the new loan shall consist of the remaining **net investment in the original loan**, any additional amounts loaned, any fees received, and direct loan origination costs associated with the refinancing or restructuring.

310-20-35-11 A modification of a debt instrument shall be considered more than minor under the preceding paragraph if the present value of the cash flows under the terms of the new debt instrument is at least 10 percent different from the present value of the remaining cash flows under the terms of the original instrument. If the difference between the present value of the cash flows under the terms of the new debt instrument and the present value of the remaining cash flows under the terms of the original debt instrument is less than 10 percent, a creditor shall evaluate whether the modification is more than minor based on the specific facts and circumstances (and other relevant considerations) surrounding the modification. The guidance in Topic 470 shall be used to calculate the present value of the cash flows for purposes of applying the 10 percent test.

310-20-35-12 Fees received in connection with a modification of terms of a troubled debt restructuring as defined in Subtopic 310-40 shall be applied as a reduction of the **recorded investment** in the loan. All related costs, including direct loan origination costs, shall be charged to expense as incurred.

326-20-30-6 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.

326-20-50-6 When disclosing credit quality indicators of **financing receivables** and net investment in leases (except for **reinsurance recoverables** and funded or unfunded amounts of **line-of-credit arrangements**, such as credit cards), an entity shall present the **amortized cost basis** within each credit quality indicator by year of origination (that is, vintage year). For purchased financing receivables and net investment in leases an entity shall use the initial date of issuance to determine the year of origination, not the date of acquisition. For origination years before the fifth annual period, an entity may present the amortized cost basis of financing receivables and net investments in leases in the aggregate. For interim-period disclosures, the current year-to-date originations in the current reporting period are considered to be the current-period originations. The requirement to present the amortized cost basis within each credit quality indicator by year of origination is not required for an entity that is not a **public business entity**.

326-20-50-6 An entity shall use the guidance in paragraphs 310-20-35-9 through 35-12 when determining whether a modification, extension, or renewal of a financing receivable should be presented as a current-period origination. An entity shall use the guidance in paragraphs 842-10-25-8 through 25-9 when determining whether a lease modification should be presented as a current-period origination.