CECL Implementation Issues

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CECL Agenda

- Standard Overview
- Accounting Implementation Issues
- Disclosure Matters
### ASC 326 effective dates & scope

**SEC filers**
- Public business entities: Fiscal years beginning after December 15, 2019

**Non-SEC filers**
- Public business entities: Fiscal years beginning after December 15, 2020 (including interim periods within those fiscal years)
- For all other entities: Fiscal years beginning after December 15, 2020 (and interim periods thereafter)

**Early adoption**
- Fiscal years beginning after December 15, 2018

**In scope**
- Loans
- Trade receivables
- Debt securities classified as held-to-maturity
- Loan commitments
- Financial guarantee contracts not accounted for as insurance
- Net investment in leases recognized by a lessor
- Reinsurance receivables

**Out of scope**
- Equity instruments
- Debt securities classified as available-for-sale*
- All financial instruments measured at fair value through net income
- Loans and receivables between entities under common control

* Available-for-sale debt securities are not in the scope of Subtopic 326-20 (commonly referred to as CECL). AFS debt securities, however, are in the scope of Subtopic 326-30, which was included in ASU 2016-13, Financial Instruments-Credit Losses.

### CECL Standard Overview

#### Credit Losses – Which Model Do I follow?

- **Debt instruments (amortized cost)**
- **Trade and lease receivables**
- **Reinsurance receivables**
- **Loan commitments**
- **Financial Guarantees**

  ▸ CECL

- **Purchased credit-impaired loans**

  ▸ CECL gross up

- **AFS debt securities**

  ▸ Securities Impairment – Revised

- **Purchased credit-impaired AFS debt securities**

  ▸ Securities Impairment Gross Up
CECL Standard Overview

Main areas of change – CECL

1. Allowance reduces the amortized cost to amounts expected to be collected
2. No recognition threshold
3. Lifetime loss estimate
4. Need to estimate future economic conditions and the length of the reasonable and supportable forecast period
5. Applies to HTM debt securities
6. Applies to other financial assets (Fed Funds, Repos, etc.)

CECL Standard Overview

Measurement of expected credit losses

- Estimate losses over the entire contractual life (adjusted for prepayments)
- Recognize losses, even when likelihood is remote
- Estimate future economic conditions
- Pool assets with similar risk characteristics

Applies to most financial assets measured at amortized cost
Determining a loss estimate

- Adjustments to historical loss information
  - Differences in economic conditions
    - Historical loss experience
    - Differences in asset-specific characteristics
    - Current conditions
    - Reasonable and supportable forecasts
    - Effects of reversion
      - Estimate of current expected credit losses

Potential for diversity – Judgment will be needed

- Methodology
- Reasonable and supportable forecasts
- Revert to historical loss information
- Determine historical losses
  - DCF or other?
    - What is reasonable and supportable?
      - Immediate, straight line, or other?
    - Adjusted for asset-specific attributes
CECL Standard Overview

CECL considers all of the components of amortized cost

Loan at amortized cost

| Principal | Premium/Discount | Deferred loan fees | Accrued interest and other adjustments |

Allowance for expected credit losses

Loan net of allowance at amortized cost

| Principal | Premium/Discount | Deferred loan fees | Accrued interest and other adjustments |

Regardless of the method, the allowance must consider not only principal, but rather all elements that comprise the amortized cost basis

Purchased credit deteriorated (PCD) financial assets

Applies to loans and debt securities that have more than an insignificant amount of credit deterioration

Expected credit losses at acquisition – recognized as an allowance (i.e., balance sheet gross up)

The implied purchase price discount (attributable to expected credit losses) is NOT recognized as interest income and is NOT reported as a credit loss expense upon acquisition.

Subsequent changes in expected credit losses recognized immediately in earnings as provision for credit losses until allowance is reduced to zero. Further favorable changes would result in prospective yield adjustments.

Discounted cash flow approach or another method may be used

Day 1 impact – PCD on acquisition versus new originations
Initial PCD accounting example

**Entity purchases financial asset**
- Purchase price = $750,000
- Par value = $1,000,000
- Expected credit losses at purchase = $175,000
- Measured on books at amortized cost

**Acquisition-date journal entry:**

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial asset – par amount</td>
<td>1,000,000</td>
</tr>
<tr>
<td>Cash</td>
<td>750,000</td>
</tr>
<tr>
<td>Allowance for credit losses</td>
<td>175,000</td>
</tr>
<tr>
<td>Financial asset – noncredit discount</td>
<td>75,000</td>
</tr>
</tbody>
</table>

**Key points**
- Balance is grossed up for the allowance
- Amortized cost = purchase price + Day 1 allowance for credit losses
- Non-credit discount recognized in interest income over life

CECL Standard Overview

HTM Securities: Main areas of change

Held-to-maturity (HTM) debt securities are within the scope of the current expected credit loss (CECL) model.

New standard provides a different impairment model for HTM debt securities than the existing other-than-temporary impairment (OTTI) model. New standard makes the following targeted changes:

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>New standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>Other-than-temporary impairment</td>
<td>Lifetime expected credit losses – no recognition threshold</td>
</tr>
<tr>
<td>Credit losses reduce amortized cost basis</td>
<td>Credit losses recognized using an allowance approach</td>
</tr>
<tr>
<td>Prospectively adjust accretable yield if expectations of cash flows improve significantly subsequent to impairment recognition</td>
<td>Recognize subsequent changes in expected credit losses (favorable and unfavorable) immediately in earnings by adjusting the allowance</td>
</tr>
<tr>
<td>Generally measures held-to-maturity debt securities on an individual asset basis using a discounted cash flow methodology</td>
<td>Does not prescribe a specific modeling methodology</td>
</tr>
<tr>
<td>Evaluation based on evidence of deterioration of credit quality since origination for which it is probable, at acquisition, that the investor will be unable to collect all contractually required payments (PCI)</td>
<td>Evaluation based on a comparison of the credit quality of the assets at the time of origination versus at the time of acquisition (PCD)</td>
</tr>
<tr>
<td>Expands the population of purchased financial assets that are eligible to be considered PCD</td>
<td>Expands the population of purchased financial assets that are eligible to be considered PCD</td>
</tr>
</tbody>
</table>
### AFS Debt Securities: Main areas of change

Available-for-sale (AFS) debt securities are not within the scope of the current expected credit loss (CECL) model.

The new standard provides a modified version of the existing other-than-temporary impairment (OTTI) model (ASC 326-30).

<table>
<thead>
<tr>
<th>Current U.S. GAAP</th>
<th>New standard</th>
</tr>
</thead>
<tbody>
<tr>
<td>When determining whether a credit loss exists, an entity is allowed to consider among other factors:</td>
<td>When determining whether a credit loss exists, an entity is NOT allowed to consider:</td>
</tr>
<tr>
<td>1. The length of time during which the fair value has been less than the amortized cost basis;</td>
<td>1. The length of time during which the fair value has been less than the amortized cost basis;</td>
</tr>
<tr>
<td>2. The historical and implied volatility of the fair value;</td>
<td>2. The historical and implied volatility of the fair value;</td>
</tr>
<tr>
<td>3. Changes in fair value after the balance sheet date.</td>
<td>3. Changes in fair value after the balance sheet date.</td>
</tr>
</tbody>
</table>

Based on an assessment of the qualitative factors in 326-30-55-1 – 55-4 an entity may determine that it expects to receive all contractual cash flows.

| Credit losses can exceed total unrealized losses | Credit losses limited to the difference between the amortized cost basis and fair value of a debt security (“floor concept”) |
| Credit losses recognized through a direct write down of the amortized cost basis | Credit losses recognized through an allowance account |
| Improvements in credit loss forecasts are recognized prospectively and accreted into interest income | Recognize reversals of credit losses immediately, including reversals due to fair value increases |

### CECL Standard Overview

#### Transition

1. **Cumulative effect adjustment to the statement of financial position as of the beginning of the first reporting period** (i.e., increase to beginning retained earnings)

2. **PCD financial assets (loans and securities)**
   - Assets to which Subtopic 310-30 (including by analogy) was applied – reclass as PCD at adoption
   - Gross up the allowance at adoption date
   - Prospective interest income will be recognized based on EIR determined after the adjustment for credit losses made on the adoption date

3. **Previously-impaired debt securities**
   - Prospective
   - Amounts in AOCI at the adoption date that relate to improvements in expected cash flows on previously impaired debt securities will continue to be accreted in interest income
## Accounting Implementation Issues: Transition Resource Group

<table>
<thead>
<tr>
<th>Topic</th>
<th>Details</th>
</tr>
</thead>
<tbody>
<tr>
<td>Adjusting the discount rate for prepayments - TRG</td>
<td><strong>Issue arises when applying discounted cash flow methodologies to measure expected credit losses</strong></td>
</tr>
<tr>
<td>Scope of PCD beneficial interests - TRG</td>
<td><strong>Cash flows required to include estimated prepayments</strong></td>
</tr>
<tr>
<td>Transition from purchased credit impaired (PCI) financial assets to PCD - TRG</td>
<td><strong>Previous interpretations of CECL required cash flows to be discounted at EIR that was based on contractual cash flows</strong></td>
</tr>
<tr>
<td>Accounting for troubled debt restructurings (TDRs) – TRG and FASB</td>
<td><strong>TRG agreed that a prepayment-adjusted EIR should be permitted but not required for measuring credit losses. Policy to be applied consistently for financing receivables at the class of financing receivables level or for debt securities at the major security type level</strong></td>
</tr>
<tr>
<td>Estimated life of credit card receivables – TRG and FASB</td>
<td><strong>Transition relief for TDRs if an entity uses a prepayment-adjusted EIR (FASB Board meeting 12/17/17)</strong></td>
</tr>
</tbody>
</table>
TRG: Scope of PCD beneficial interests

Term "contractual cash flows" not defined

Impacts:
- Scope of PCD for Beneficial Interests ("BI") subject to ASC 325-40
- Initial measurement of credit losses for PCD BI
- Determining initial accretable yield

Discussed at TRG
- Look to the contractual terms of the security
- If contractual payments are not specified, consider the terms of the underlying assets
- "Contractual cash flows" should consider estimated prepayments but not estimated credit losses
- Isolates credit risk

ASC 325-40 is an integrated interest income and credit loss model

TRG: Transition from PCI to PCD

Transition guidance for an entity’s ability to elect to maintain pools of ASC 310-30 loans upon adoption

View A – Maintain pools only for credit measurement purposes, assuming criteria are met
- Allocate the non-credit discount and allowance to individual loans

View B – Maintain pools for all areas
- Gross up applied at pool level and freeze the EIR

Discussed at TRG
- Either view is supported under the guidance
- Election to maintain pools should be determined on a pool-by-pool basis
- Entities would have the choice of either maintaining their existing pools accounted for under ASC 310-30 at adoption only or doing so on an ongoing basis after adoption
- Only certain aspects of ASC 310-30 will continue to apply
TRG: Accounting for TDRs (FASB tentative conclusions - 9/6/17)

- **Identification**
  - Day 1 Identification on an asset by asset basis, not on pool basis
  - Reasonably Expected TDR
  - Executed TDR

- **Measurement on a pool basis**
  - Required to use a DCF (or a method that reconciles to a DCF) when an entity grants a concession that can only be measured using a DCF model (interest rate concession or term concession)
  - If an entity uses a DCF method for measurement of credit losses on a performing loan portfolio, any effects of TDRs that are incremental to what is embedded in the historical loss information should not be incorporated as an input to the DCF method until a TDR is reasonably expected

TRG: Credit Cards (FASB tentative conclusions - 10/4/17)

- **How to allocate expected future payments**
  - An entity is permitted, but not required, to apply expected principal payments to the credit card receivable balances existing at the reporting date until the balance is exhausted.
  - An entity could choose other methods that allocate expected principal payments between the balance existing at the reporting date and future balances.

- **How to determine expected future payments**
  - No specific approach is required.
  - An entity may:
    - Include all future payments expected from the borrower
    - Include a portion of the payments expected from the borrower
    - Apply a different approach
FASB: Implementation Issues (Tentative conclusions -12/13/17)

Variable-rate financial assets

— An entity may determine the effective interest rate (the discount rate) and expected contractual interest cash flows using its projections of future interest rates when estimating credit losses using a discounted cash flow approach.

— An amendment to the Codification will be proposed as part of the FASB’s ongoing Codification improvements project.

Subsequent events

— An entity should not recognize in the financial statements the effects of events that occur after the balance sheet date but before the financial statements are issued or available to be issued.

— Any information received after the balance sheet, including changes in forecasts, should not be reflected in the allowance for credit losses.

Accounting Implementation Issues: AICPA Depository Institutions Expert Panel

Reasonable & supportable forecasts and use of historical information

Collateral maintenance agreements

Consideration of recoveries

Reversals of interest income
Accounting Implementation Issues:
AICPA Depository Institutions Expert Panel

- Reversion method: estimation versus accounting policy
- Zero expected credit losses
- ISA 540 Auditing CECL versus IFRS 9
- Inclusion of future advances of taxes and insurance payments

CECL Disclosure Matters

- Rollforward of the allowance for expected credit losses for financial assets measured at amortized cost and FV-OC
- Qualitative disclosure about how an entity estimates expected losses, including changes in factors that influenced the estimate and the reason for the change (e.g., changes in portfolio composition)
- Current credit quality indicators that are disclosed under current GAAP would be disaggregated by year of origination (vintage disclosures)
- Reconciliation between the purchase price and the par value of PCD financial assets at the time of purchase including an allocation between the allowance and the discount (premium) due to other factors

AFS debt securities
- Retain current disclosure requirements, updated for the general principles regarding disclosing credit risk
### CECL quantitative disclosure requirements

<table>
<thead>
<tr>
<th>Disclosure requirement</th>
<th>Description</th>
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</table>
| Credit quality information                 | — Amortized cost basis within each credit quality indicator  
— Broken down by year of origination, class of financing receivable, and major security type for the five years preceding the current period |
| Portfolio changes                           | — Amount of significant purchases, sales, or reclassifications of loans held for sale by portfolio segment and major security type                                                                                                   |
| Allowance for credit losses                | — Amount of any significant purchases of financial assets during the reporting period  
— Amount of any significant sales of financial assets or reclassification of loans held for sale  
- Entire change in PV as a credit loss expense (or reversal of credit loss expense)  
- Portion of the change in PV that is due to the passage of time as interest income  
- If the latter method is used, that amount must be disclosed |
| Rollforward of the allowance for credit losses | — Includes beginning balance, current period provision for loan losses, initial allowance for purchased credit deteriorated assets, write-offs charged against the allowance, recoveries of amounts previously written off, and ending balance  
— For each item, report by portfolio segment and major security type |
| Days past due                              | — Aging analysis of the amortized cost basis for past-due financial assets  
— Reported by class of financing receivable and major security type  
— Also provide criteria for identifying past-due financial assets |
| Non-accrual status                         | — Beginning and ending amortized cost basis of financial assets on nonaccrual status; includes:  
- The amount of interest income recognized during the period on nonaccrual assets  
- Amortized cost basis of 90 days or more past due assets that are still on accrual status  
- Amortized cost basis of nonaccrual assets with no related expected credit losses  
— Reported by class of financing receivable and major security type |
| Purchased financial assets with credit deterioration | — Reconciliation between the purchase price and par value  
— Includes purchase price, allowance for credit losses at acquisition based on the acquirer’s assessment, the portion of the discount/premium attributable to other factors, and par value |

### SAB 74 requirements

**SAB 74 (codified as Topic 11.M) requirements**

- Brief description of the new standard, the date that adoption is required and the date that the registrant plans to adopt, if earlier.
- Discussion of the impact that adoption of the standard is expected to have on the financial statements of the registrant, unless not known or reasonably estimable. In that case, a statement to that effect may be made.
- Discussion of the method of adoption allowed by the standard and the method expected to be utilized by the registrant, if determined.
- Disclosure of the potential impact of other significant matters that the registrant believes might result from the adoption of the standard (such as technical violations of debt covenant agreements, planned or intended changes in business practices, etc.) is encouraged.
- If a company cannot reasonably estimate the impact, qualitative disclosures may be necessary to meet the objectives of SAB 74. This includes a qualitative description of the effects, comparison to current policies, status of implementation process, and significant matters yet to be addressed.
- Judgment required!
Example SAB 74 Disclosures

Accounting for Financial Instruments—Credit Losses
In June 2016, the FASB issued ASU No. 2016-13, Financial Instruments—Credit Losses (Topic 326). The ASU introduces a new credit loss methodology, Current Expected Credit Losses (CECL), which requires earlier recognition of credit losses, while also providing additional transparency about credit risk.

The CECL methodology utilizes a lifetime “expected credit loss” measurement objective for the recognition of credit losses for loans, held-to-maturity securities and other receivables at the time the financial asset is originated or acquired. The expected credit losses are adjusted each period for changes in expected lifetime credit losses. This methodology replaces the multiple existing impairment methods in current GAAP, which generally require that a loss be incurred before it is recognized. For available-for-sale securities where fair value is less than cost, credit-related impairment, if any, will be recognized through an allowance for credit losses and adjusted each period for changes in credit risk.

The CECL methodology represents a significant change from existing GAAP and may result in material changes to the Company’s accounting for financial instruments. The Company is evaluating the effect that ASU 2016-13 will have on its Consolidated Financial Statements and related disclosures. The impact of the ASU will depend upon the state of the economy and the nature of Citi’s portfolios at the date of adoption. Based on a preliminary analysis performed in 2017 and the environment and portfolios at that time, the overall impact was estimated to be an approximate 10% to 20% increase in credit reserves as of that time. Moreover, there are still some implementation questions that will need to be resolved that could affect the estimated impact. The ASU will be effective for Citi as of January 1, 2020.