WILARY WINN LLC

ADVICE TO STRENGTHEN FINANCIAL INSTITUTIONS

The Current Expected Credit Loss ("CECL") Model's Effect on Merger Accounting

Released June 2017

Brief CECL Summary

As you know, FASB finally released the long anticipated CECL guidance. This memorandum very briefly addresses the basics and then details how the new standard will affect loans obtained from mergers and acquisitions.

The basics:

- ***Why*** – FASB believed that GAAP did not properly reflect risk pre-financial crisis because of the delayed recognition of credit losses
- ***What*** – ASU 2016-13 Measurement of Credit Losses on Financial Instruments
- ***When*** – Issued June 16th
- ***Effective*** – 2020 for SEC filers, 2021 for all other, early adoption permitted beginning 2019
- ***How*** – In general adopt a cumulative effect adjustment to retained earnings, but there are special rules for PCI assets discussed below.

This post is not intended to be yet another exhaustive discussion of CECL. Instead, it focuses on accounting for acquired loans only. For more information on implementing the standard, see Wilary Winn's white paper *Implementing the Current Expected Credit Loss (CECL) Model*.

Merger Accounting Under the Current Standard

Under the current standard, GAAP requires loans to be measured at fair value.

Loans without significant credit impairment since origination are accounted for under ASC 310-20 (Loan Origination Costs). The difference between book value and fair value for these loans are accreted into income over the life of these loans. Any future credit losses are reserved through the institution's allowance.

Loans with significant credit impairment since origination are classified as Purchased Credit Impaired (ASC 310-30). The difference between book value and fair value for these loans reflects both future credit losses (also termed as non-accretable difference) and a difference between the loan's coupon and fair value discount rate (also termed as accretable difference). The current accounting processes for ASC 310-30 loans is very complex and frequently leads to increased future income statement volatility. See our white paper on *Accounting for Loans with Deteriorated Credit Quality*.

Merger Accounting Under CECL

Similar to the current standard, the new CECL standard requires also loans to be valued at fair value for the purposes of a merger or an acquisition and be accounted for under ASC 310-20 or ASC 310-30. The main difference arises for loans accounted for under ASC 310-20 (loans without significant credit deterioration since origination). Lifetime credit losses on these loans should be recorded in the institution's Allowance for Loan Losses at the time of the merger. Higher risk loans that have not experienced credit deterioration since origination will be most affected by this provision. For example, let's say that a financial institution acquires of group of loans with lower FICOs collateralized by manufactured housing. The fair value of the loans would reflect a significant discount form par – let's use 80 percent. On day one, the acquiring institution will record an increase to its existing ALLL to reflect the expected lifetime losses on these loans. Meanwhile the 20 percent acquisition discount will be accreted into income over the expected life of the loans.

On the other hand, for loans accounted for under ASC 310-30, lifetime credit losses will be reflected in the fair value difference and, therefore, do not have to be recorded in the institution's Allowance for Loan Losses at the time of the merger. We believe financial institutions will therefore have an incentive to account for loans with higher risk under ASC 310-30. We note that FASB renamed loans classified under ASC 310-30 as Purchased Credit Deteriorated loans.

Criteria for Classification as a PCD Loan

In order to be classified as a Purchased Credit Deteriorated loan, FASB states that "acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics) that, as of the date of acquisition, have experienced a more-than-insignificant deterioration in credit quality since origination, as determined by an acquirer's assessment."

In order to meet the definition of more-than-insignificant deterioration in credit quality, we believe that an institution should establish uniform criteria for scoping in PCD loans. This criterion can consist of various credit quality factors such as a 100 point decrease in FICO score or loans that are 90+ days delinquent.

For more information on accounting for PCD loans, please see our *CECL and ASC 310-30 Memorandum.*

About Wilary Winn

Founded in 2003, our mission is to provide advice to strengthen financial institutions. We provide independent, fee-based advice to more than 500 financial institutions located across the country. We offer the following services:

CECL & ALM

We provide holistic solutions to measure, monitor and mitigate interest rate, liquidity, and credit risk on an integrated basis.

OUR CECL & ALM SERVICES INCLUDE:

Credit Risk:
Current Expected Credit Loss (CECL)
Capital Stress Testing
Concentration Risk Management
Real Return Analyses

Outsourced ALM Advisory:
Interest Rate Risk Management
Budgeting and Balance Sheet Optimization
Liquidity Stress Testing

MERGERS & ACQUISITIONS

We provide independent, fee-based determinations of fair value for mergers and acquisitions.

OUR MERGER & ACQUISITION SERVICES INCLUDE:

Preliminary and Final Merger Valuation
Accretion True-up
Goodwill Impairment Testing
ASC 310-30

VALUATION OF LOAN SERVICING

We provide comprehensive and cost-effective valuations of servicing arising from the sale of residential mortgage, SBA 7(a), auto, home equity and commercial loans.

OUR LOANS SERVICING OFFERINGS INCLUDE:

Residential MSRs
SBA 7(a) Loan Servicing
Commercial Servicing

ADDITIONAL SERVICES

We provide services to support our CECL, ALM, Fair Value and Loan Servicing product offerings.

OUR ADDITIONAL SERVICES INCLUDE:

Fair Value Footnote
ALM Model Validation
Non-Maturity Sensitivity Analyses
Mortgage Banking Derivatives (IRLCs)
SBA 7(a) Gain on Sale
Troubled Debt Restructurings (TDRs)
Non-Agency MBS
TruPS

For additional details on Wilary Winn's services, please visit our website at www.wilwinn.com

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