Loan accounting: COVID-19 impact

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The COVID-19 challenge throws a wrench in loan accounting processes

Loan assistance and relief offered through the CARES Act for both individuals and small businesses has an impact on loan accounting and disclosure reporting.

For individuals, the CARES Act includes an option for financial institutions to suspend the requirements of U.S. GAAP for certain loan modifications that would otherwise be categorized as a TDR. A financial institution may elect not to apply TDR accounting to modifications that defer or delay the payment of principal or interest (i.e., payment holiday), that meet certain conditions.

For small business, the CARES Act created the Paycheck Protection Program (PPP), a program allowing small businesses to apply for loans to be used to pay for payroll costs. The loans may be fully or partially forgiven if the small business meets certain requirements on how the loan proceeds are used.

Loan accounting issues arise once payment deferral or forgiveness is granted. Continuing to recognize interest using the original effective interest rate (EIR) will overamortize the cost basis adjustment. In addition, although PPP loans qualify for CECL zero credit loss exemption, the loans must still flow through banks' CECL models at zero ECL in order to be included in the amortized cost vintage disclosures.

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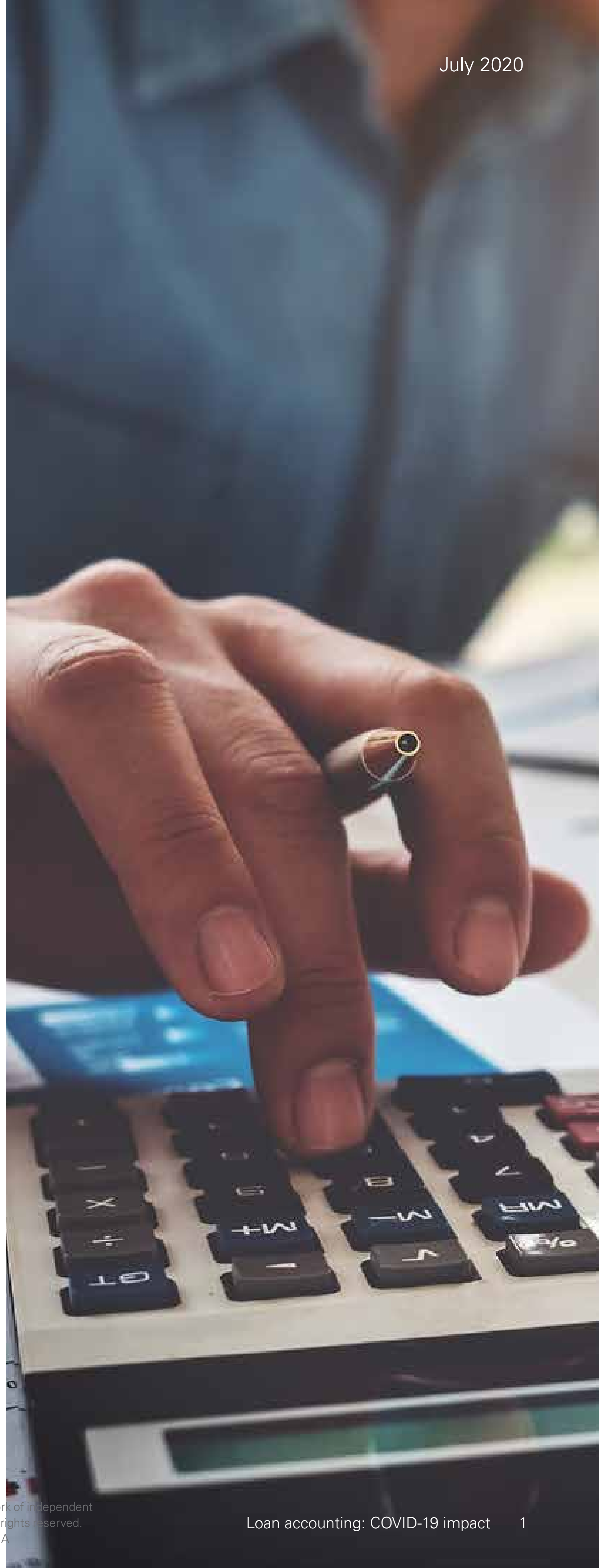
Challenges



Loans on payment holiday

During the payment holiday and prior to a minor modification, it was inaccurate to calculate and report cost basis amortization and recognized interest income based on the original carry amount and EIR. Applying the EIR to the carry amount may negatively amortize the cost basis adjustment of the loan when principal and interest payments are not collected during a payment holiday.

In order to counter the effects of negative amortization, assumptions can be made about the amount and timing of the missing payments prior to modification (i.e., lump sum added to the end of loan amortization schedule or extend the cash flows after maturity by a corresponding number of months during payment delay).

The alternative cash flows discounted at the original EIR will generate a different present value and corresponding cost basis adjustment amount when compared to the original amortization calculation.

The Financial Accounting Standards Board (FASB) indicated that determining a new EIR is appropriate for recognizing interest income during the payment holiday for modifications not accounted for as a TDR. If the lender determines a new EIR based on the revised contractual terms, then interest income is recognized prospectively for the entire remaining term, even if that results in the carrying amount of the loan exceeding the amount at which the borrower could settle the loan.

Consider the following scenario: $25,000 loan with 18-month term, $250 discount, 5% note rate, and a 3-month payment holiday beginning in period 12. If the alternative cash flows are discounted using the original EIR of 5.99%, the new present value of $9,869 is less than the carry value of $9,903. Therefore, a cost basis adjustment of $(33) would need to be recorded.

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In scenario 1, the unamortized discount negatively amortizes to zero before the end of the loan term. Once the discount reaches zero, only cash interest is recognized.

In scenario 2, a new EIR is calculated as 5.71% at the beginning of the payment holiday in period 12 and the discount amortizes to zero at the end of the loan term.

		Original amortization				Payment holiday		Scenario 1			Scenario 2		
Period	Balance	Cash	U nam disc	Total interest	Cash interest	Balance	Cash	U nam disc	Total interest	Cash interest	U nam disc	Total interest	Cash interest
1	25,000	1,445	(250)	130	104	25,000	1,445	(250)	130	104	(250)	130	104
2	23,660	1,445	(224)	123	99	23,660	1,445	(224)	123	99	(224)	123	99
3	22,314	1,445	(200)	116	93	22,314	1,445	(200)	116	93	(200)	116	93
4	20,962	1,445	(177)	109	87	20,962	1,445	(177)	109	87	(177)	109	87
5	19,605	1,445	(155)	102	82	19,605	1,445	(155)	102	82	(155)	102	82
6	18,242	1,445	(135)	95	76	18,242	1,445	(135)	95	76	(135)	95	76
7	16,874	1,445	(116)	88	70	16,874	1,445	(116)	88	70	(116)	88	70
8	15,499	1,445	(99)	81	65	15,499	1,445	(99)	81	65	(99)	81	65
9	14,120	1,445	(82)	74	59	14,120	1,445	(82)	74	59	(82)	74	59
10	12,734	1,445	(68)	66	53	12,734	1,445	(68)	66	53	(68)	66	53
11	11,342	1,445	(54)	59	47	11,342	1,445	(54)	59	47	(54)	59	47
12	9,945	1,445	(42)	52	41	9,945	0	(42)	52	41	(42)	47	41
13	8,542	1,445	(32)	45	36	9,945	0	(32)	52	41	(37)	47	41
14	7,133	1,445	(23)	37	30	9,945	0	(21)	52	41	(31)	47	41
15	5,718	1,445	(25)	30	24	9,945	1,445	(11)	52	41	(25)	47	41
16	4,298	1,445	(9)	22	18	8,666	1,445	0	36	36	(19)	41	36
17	2,871	1,445	(5)	15	12	7,258	1,445	0	30	30	(14)	34	30
18	1,439	1,445	(2)	8	6	5,844	1,445	0	24	24	(10)	28	24
19	(0)	0	0	0	(0)	4,424	1,445	0	18	18	(7)	21	18
20						2,997	1,445	0	12	12	(4)	14	12
21						1,565	1,445	0	7	7	(2)	7	7
22						127	128	0	1	1	(1)	1	1
23						0		0			0		

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PPP loans

PPP loans issued to small businesses may be fully or partially forgiven by the Small Business Administration (SBA) if the loan proceeds are used primarily for payroll costs. The loans either have a two- or five-year term with a stated interest rate of 1%. Similar to consumer loans receiving a payment holiday, loan accounting and reporting issues arise with full or partial forgiveness on small business loans.

1 Amortization and interest income recognition

Borrower principal and interest payments and origination fees and costs at initial recognition may be deferred to the date that SBA remits the borrower's loan forgiveness amount to the lender. If loan forgiveness is granted, then banks may account for the portion of fees and costs to be recognized immediately on the forgiven portion of the loan. In our experience, an entity may prorate the unamortized cost basis adjustment using a relative allocation of forgiven balance divided by total balance. However, this approach may result in a partially unamortized cost basis adjustment at the end of the term. The other approach is to discount the reamortized payments over the remaining term and compare to the beginning book value to estimate the portion of the unamortized cost basis. This approach maintains the original effective yield and amortizes the remaining payments and cost basis to zero. In the end, this approach requires a dynamic amortization engine to handle the necessary cash flow and accounting logic.

2 Bifurcation

If a loan is only partially forgiven due to ineligible expenses, then banks should not charge the borrower for interest once the SBA notifies the lender of partial forgiveness. Therefore, banks may need to bifurcate the loan's interest income and separately report the amount due from the borrower on the ineligible portion of the PPP loan amount. Otherwise, the bank may be in a situation where it is billing the borrower for the interest the SBA agreed to pay from the time of notification to final settlement on the forgiven loan amount.

3 CECL model and reporting impacts

Banks need to update their CECL accounting policy regarding zero credit loss exemption and ensure PPP loans aren't included in their CECL loss process since the loan is fully insured by a U.S. government agency. However, the F/S disclosure does not exempt these loans from vintage or past due tables. As such, banks must include the population of PPP loans into their financial reporting process, which is typically sourced from models. As such, the PPP loans need to pass through the models without an ECL calculation in order to build out the amortized cost disclosure tables.

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How KPMG can help

KPMG can assist financial institutions with these new provisional accounting calculations as well as the loan accounting policy changes that impact processes, data, and systems.

Define the accounting positions and determine the appropriate accounting treatment for cost basis amortization and adjustment, interest income recognition, and new effective interest rate applied to the alternative cash flows. The approach selected should be applied consistently.

Assist with data extraction and model implementation—guide the bank in setting up its own interest income and amortization model by leveraging the proprietary amortization engine by KPMG. The KPMG amortization engine can estimate level amortization on loans based on modified terms, calculate prospective yield, and recognize interest income based on the approach selected.

Assist with the CECL disclosure table requirements, design, and internal controls needed to help ensure accurate reporting and model impacts.

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Contact us and see how you can benefit from our experience, global bench strength, and customized client care. To learn more about loan accounting services associated with the CARES Act, contact one of the professionals below:

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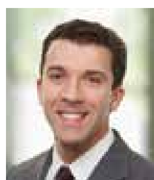

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