Case 23-7c
Current Expected Credit Losses — Financing Receivables

Background

Seasill Bancorp ("Seasill" or the "Bank"), an SEC registrant, is a federally regulated commercial bank that provides consumer and commercial banking products and services to individuals and small and medium-sized businesses, respectively. Seasill has a network of bank branches that serves customers throughout the Pacific Coast of the United States, with principal operations in California, Washington, and Oregon.

The Bank offers the following types of consumer loan products:

- Residential mortgages secured by subject properties (e.g., a single-family primary residence of the borrower).
- Home equity loans and lines of credit secured by first or second liens on subject properties (e.g., a single-family primary residence of the borrower).

The consumer loan products are prepayable, at any time without penalty, by the borrower. Seasill has experienced that borrowers often prepay their residential mortgage and home equity loans many years before contractual maturity. For example, borrowers often refinance (prepay their loans) when market interest rates are below the contractual interest rate. The consumer loan products do not have stated renewal or extension rights.

Historical Credit Loss Experience

The Bank has historical credit loss experience for its consumer loan products for the past 20 years, which is greater than or equal to the contractual maturity for many of its loan products except for 30-year residential mortgages. The 20-year historical credit loss experience covers a full economic cycle and, except as described in the next paragraph, is representative of the Bank's recent credit loss experience.

The Bank sustained credit losses attributable to the subprime mortgage crisis in its residential mortgage loan, home equity loan and line of credit, and residential construction loan product portfolios. Twelve years ago, Seasill management made its underwriting policies for residential mortgage loans and home equity loans and lines of credit more stringent in response to the subprime mortgage crisis by, for example, increasing minimum FICO scores and debt-to-income ratios for eligibility. For its consumer loan products, Seasill tracks loss information by borrower credit score, delinquency status (i.e., number of days past due), and original loan-to-value ratio (e.g., an "80 percent original loan-to-value ratio" means the borrower has 20 percent equity in the subject property at origination).

Seasill management routinely evaluates what macroeconomic factors are correlated to its historical loss experience to effectively forecast its operating results. For its consumer loan products, Seasill management determined that losses are strongly correlated with changes in local unemployment rates and house price indices.

Current Conditions and Reasonable and Supportable Forecasts

Seasill management has observed in recent periods that local unemployment rates are lower (i.e., favorable to the Bank) and house price indices are higher (i.e., favorable to the Bank) compared to those throughout in its historical credit loss experience.

Seasill management determined the length of its reasonable and supportable forecast period to be two years for its consumer loan products.

Over the next two years, reputable sources forecast that local unemployment rates will remain steady and house price indices are expected to rise. However, house price indices are expected to fall in the three-to-five-year outlook because of expected increases in mortgage interest rates.

Required:

1. What risk characteristics should Seasill management consider when determining the unit of account to measure expected credit losses for its consumer loan products?
2. How should Seasill management consider prepayments when estimating expected credit losses using a method in accordance with ASC 326-20-30-5 (e.g., a loss-rate method)?
3. Seasill management must consider the nature of its consumer loans and their risk characteristics when determining the appropriate historical credit loss data to use in calculating historical loss information. Evaluate the following:
   a. Is there sufficient historical credit loss information to estimate losses over the contractual term of its consumer loan products? Why or why not?
   b. Is Seasill required to revert to historical credit loss information (as adjusted, if applicable) in estimating expected credit losses?
4. Would it be appropriate for Seasill management to adjust its historical credit loss information for differences in asset-specific risks characteristics? If so, what adjustments? If not, why not?
5. Would it be appropriate for Seasill management to adjust its historical credit loss information for current economic conditions? If so, what adjustments? If not, why not?
6. Would it be appropriate for Seasill management to adjust its historical credit loss information for forecasted conditions during the two-year reasonable and supportable forecast period used by Seasill management in its estimate? If so, what adjustments? If not, why not?