

CECL Implementation Challenges: The Life of Loan Concept

A Discussion Paper of the

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Discussion Paper

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Background

As the Financial Accounting Standards Board (FASB) deliberated on its Current Expected Credit Loss (CECL) model for accounting for the impairment of loans and held-to-maturity (HTM) debt securities, bankers and banking regulators urged FASB to ensure that CECL will not result in a requirement to implement complex financial models and processes. Indeed, as FASB normally issues principles-based accounting standards, the CECL standard does not explicitly require specific methods in estimating expected credit losses. In fact, even during initial discussions held after issuing the original 2012 exposure draft, FASB members and staff were open in their desire to allow virtually any and all generally accepted measurement methods, similar to those used today, though the underlying data would be required to change.

With this in mind, the American Bankers Association (ABA) believes it is critical to analyze the practical, operational differences between the current “incurred loss” model as practiced today by banking institutions in the U.S. and the CECL model.

The many constituents of FASB have different interests related to the implementation of CECL:

1. Investors seek to forecast capital levels that ultimately result in dividend payouts or capital-raising requirements. Thus, investors seek transparency as to management’s expectation of total losses (without a concern that the loss has actually been incurred or not). Investors also seek a standard that is easy to understand in order to execute proprietary forecast models that evaluate management’s expectations and compare expectations between companies.
2. In their enforcement of safety and soundness standards, regulators must ensure that the allowance for loan and lease losses (ALLL) recorded is a fair representation of the losses expected in bank loan and HTM debt security portfolios. In their supervisory roles, however, while regulators encourage bankers to be “forward-looking” in their analysis of credit risk management, they do not want bankers (especially community bankers) to be burdened with systems that are costly and complex.¹
3. Bankers seek to minimize cost and reduce complexity. Bankers must efficiently estimate the ALLL within tight regulatory reporting timeframes and also explain to investors and board members the results of their operations and how their estimates are derived.

¹ Both Comptroller of the Currency Thomas J. Curry (September 16, 2013) and Federal Reserve Board Chairman Janet L. Yellen (May 1, 2014) have spoken publicly of the need for an impairment model that does not require complex modeling processes for community banks.

Bankers also are concerned with reliability of the CECL model -- and the volatility that is the result of that. This unreliability can, for practical purposes, result in building unneeded capital buffers on top of those already required.

The objective of this paper is to assist investors, regulators, bankers, and FASB in evaluating the various challenges of a conversion to CECL². Some challenges are naturally a part of any change and can be addressed through an adequate time period for transition to the new standard, through industry-based discussions that focus on comparability and consistency of practice, and through appropriate educational efforts for all the parties involved. ABA will be assisting bankers through webinars, additional papers, and coordinating peer group discussions through the implementation period.

Scope

The biggest challenges of CECL center on the “life of loan” (LOL) loss concept, whereby credit losses expected over the life of the loan are effectively recorded upon origination. While implementation of an expected loss impairment model will require significant work, the LOL concept appears to *require* certain changes that compound the challenges. There are other challenges with specific aspects of the CECL model.³ However, this paper focuses on the LOL concept, as it is the centerpiece of the CECL model.

We hope this paper elicits discussions by all parties on these and other ideas and viewpoints for effective implementation. ABA will also update this paper as feedback is received, questions are posed, and alternatives are proposed. Questions and comments can be sent to Mike Gullette at mgullette@aba.com.

June 2016 Update

This Discussion Paper has been updated based on many discussions with FASB members and staff, as well as staff at the banking agencies, PCAOB, SEC, partners at auditing firms, and ABA members who have discussed CECL with their examiners and third-party service providers. The June 2016 additions are highlighted, and the June 2016 version deletes the recommendations made in the previous versions (which were mostly recommendations made to FASB).

² Auditors are also a key constituent within the financial reporting process. The key concern that auditors have is the auditability of the data and assumptions underlying the ALLL estimate. For the purposes of this paper, auditor concerns are similar to those of bankers in that bankers must provide auditors with appropriate reasonable and supportable evidence to support their ALLL estimate. Specific mention of auditor-related concerns is provided as needed.

³ For example, certain disclosures may require significant overhaul of many loan servicing systems.

Discussion

1. Vintage analysis, whereby loan portfolios are generally broken out into cohorts by each issuance year, could become a minimum requirement in order to support the ALLL estimate under CECL.

Other analyses may be more appropriate than vintage analysis as a basis for the ALLL estimate. However, because vintage analysis allows for review of loan activity from the beginning of the life of the loan (origination) to the end (pay-off or charge-off), it will likely be the minimum requirement⁴. This is a major change from current practice and, while it may not always involve unmanageable complexity, it could increase the amount of work required by many bankers by multiples. For example, an ALLL estimate for a portfolio of loans with an expected life of four years will necessitate four different ALLL estimates – one for each vintage.

(Update added January 2016)

When applying a forecast of the future over four years, since loans are likely to behave differently based on their age, calculations not only for each vintage may be necessary, but separate estimates addressing each vintage by loan age in each future year may be necessary. As a result, for a portfolio with an expected life of four years, ten different sub-calculations would be needed for practical purposes.

For example, the percentages below represent loss rate history for a loan portfolio that has a four year term, with the purple representing future periods that must be forecasted. (In the chart, the current year is 2015. See that vintage year 2012 has one year remaining, vintage 2013 has two years remaining and so on.). In order to calculate the total LOL loss rates in the portfolio, four calculations are needed (one for each outstanding vintage). However, since forecasts of the future will impact different vintages differently, ten different estimates (four for vintage year 2015, three for 2014, etc.), as shown in the red “Xs”) would need to be performed. This process is much more complex than current processes for incurred losses.

Origination Year	Loss Rates by Vintage				Total
	Year 1	Year 2	Year 3	Year 4	
2010	0.20%	1.00%	1.40%	0.30%	2.90%
2011	0.25%	1.00%	1.50%	0.35%	3.10%
2012	0.30%	1.20%	1.30%	X	
2013	0.25%	1.25%	X	X	
2014	0.35%	X	X	X	
2015	X	X	X	X	

Chart assumes the current year is 2015. Not only will forecasts of the future result in more required estimates, applying estimates to each vintage is much more complex than current processes.

⁴ While bankers may use “origination-to-charge-off” loss information (without a break out by vintage) on all loans issued during a specified period, vintage analysis will likely be requested by auditors in order to identify “loss curve” patterns and to evaluate exposures that may result from changing underwriting standards or the progression of an economic cycle.

2. Internal control requirements over the loan origination function are likely to expand under CECL.

Because loan originations will create immediate accounting events – loss expectations – under CECL, it is expected that additional detailed processes will be required to ensure that factors underlying loss expectations are appropriately identified and tracked. Such factors may include appraisals underlying loan-to-value ratios on collateral and analyses performed during underwriting. While work like this may currently be performed operationally at many banks, this is expected to be a new process within a financial audit, as it is not currently assumed that the loan origination transaction creates a loss expectation.

(Update added April 2015)

The PCAOB has outstanding Staff Consultation Papers: *Auditing Estimates and Fair Value Measurements* and *The Auditor's Use of the Work of Specialists*. Any new auditing standard that ultimately results from these PCAOB proposals⁵ could significantly increase the extent of auditing procedures related to the loan origination process. While an increase could result under the current incurred loss impairment accounting model, it would likely be significantly greater under CECL. For example, the work of appraisers and the related data that the appraisers use often are key factors in estimating a loss expectation. As a result of any additional PCAOB standards, under certain circumstances, testing of the work of third-party property appraisers and other specialists involved in the credit risk evaluation process could be treated as though they were not independent of the company, thus increasing the required audit procedures over that area.

3. Data used to support ALLL estimates will likely change under CECL.

Data underlying most current ALLL estimates are not based on a LOL loss concept. In other words, current charge-off ratios, probabilities of default, loss given default, and rates based on past due status are based on yearly charge-offs. These rates, based on activity during specific time periods (such as one year), do not satisfy the LOL loss expectation requirement. Therefore, systems must be reconfigured and static pools must be maintained to adequately provide appropriate LOL loss rates. Depending on the individual portfolio and accompanying credit risk management systems, origination data – a key part of the LOL loss

⁵ Modifications to PCAOB standards are subject to a formal due process. The PCAOB evaluates feedback received on staff consultation papers and, if necessary, issues a proposal that also is subject to public feedback. Any approved standards are then subject to approval by the Securities and Exchange Commission. Therefore, it may be years before such changes go into effect.

analysis – may not exist and must be retrieved amidst hard-copy documents for the initial years of implementation.

(Added January 2016)

No matter the planned level of sophistication, banks should begin gathering as many relevant data points as possible, with the expectation that practice will likely evolve over the several years after the CECL effective date. Banks will not want to be constrained in implementing future solutions that may improve their processes.

4. Use of historical data must be reconsidered under CECL.

- a. As current annual charge-off data will no longer be relevant under CECL, discussions will be necessary to determine what charge-off periods will be used for the ALLL analysis. For example, many banks currently use, as a starting point for their estimate for commercial loans, average charge-off rates based on the most recent two to four years of data. Assuming a loan portfolio with a four year expected life, using the most recent four years of *fully-developed* LOL data (vintage data) will require the bank to rely on data that is three years old (this will be the latest vintage to mature). Due to its age, the relevance of such underlying data is put into question.

(Added January 2016)

Origination Year	Loss Rates by Vintage				Total
	Year 1	Year 2	Year 3	Year 4	
2010	0.20%	1.00%	1.40%	0.30%	2.90%
2011	0.25%	1.00%	1.50%	0.35%	3.10%
2012	0.30%	1.20%	1.30%		
2013	0.25%	1.25%			
2014	0.35%				
2015					

As an example, note how vintage year 2011 is the most recent fully-developed LOL vintage available to estimate a 2015 LOL loss rate. Bankers will need to support why such data is relevant.

- b. Economic cycles tend to be exhibited by several years of low levels of charge-offs, followed by short periods of high charge-offs. The resulting averages, with extremely wide ranges of outcomes, puts into question the statistical validity of much historical data. If historical averages are used as a starting point for the ALLL estimate, large adjustments, based on management’s judgment will often be required in order to arrive at an actual loss expectation.⁶ This will challenge both bankers and auditors.⁷

⁶ This situation can exist under the current incurred loss impairment model, but is greatly amplified by the much longer forecast period required under CECL.

⁷ A significant portion of audit deficiencies noted by the Public Company Accounting Oversight Board (PCAOB) relate to accounting estimates (of which the ALLL is one). The greater judgment required under CECL (as compared to the current ALLL process) is expected to put more pressure on auditors in complying with PCAOB standards. See Comment #12 for more detail.

(Added January 2016)

To clarify, recent history does not inherently represent a sound basis for LOL loss expectations. Loans originated in 2010, for example, were likely subjected to very different underwriting and future outlook than loans originated in 2007 through 2009. 2010 originations may be expected to perform like loans originated in 2004. With this in mind, ABA believes historical experience may be required to be justified on a vintage-by-vintage basis.⁸

5. Asset/Liability management (ALM) systems may be subject to audit under CECL.

Prepayments will be considered in determining an expected life of a loan portfolio under CECL. As a result, new internal controls over the ALM systems will likely be necessary in order to comply with Sarbanes-Oxley and FDICIA-related internal control attestation requirements. In most cases, this will necessitate integrating the timing of charge-off expectations with prepayments. ALM is performed at many smaller institutions by third-party service providers, thus introducing additional costs relating to third-party verification for community banks.

(Update added June 2016)

Within the final standard, prepayments may be considered explicitly in order to estimate effective portfolio lives or implicitly, through use of charge-off and default experience (loss rates, for example, that include balances that were subject to prepayment). Therefore, ABA believes that implicit use of charge-off experience will not necessarily require incremental audit procedures. Those banks that use expected prepayments as an explicit factor in their credit loss estimates may need to integrate default and charge-off experience into their ALM models in order to satisfactorily support the resulting assumptions.

⁸ This also calls into question the validity of using unadjusted historical averages (“reverting to the mean”) for future years that cannot be reasonably forecasted.

6. Traditional relationships of credit metrics to ALLL levels and loss provisions will change under CECL. (Update added April 2015)

Because expected losses are recorded at origination, there will be no natural relationship between the levels of key credit metrics to the current ALLL or the loss provision. Metrics like this will include:

- current delinquencies,
- loan-to-value ratios,
- impaired loans,
- annual charge-offs or annual loss rates, and
- troubled debt restructurings (TDRs)

The historic relationship of “credit performance improves, credit losses decrease (and vice versa)” will no longer be a relevant theory. Metrics related to current period performance may help identify concerns related to future net interest income. However, they will not necessarily be used to forecast credit losses. For example, a period-to-period increase in defaults may, nevertheless, result in a decrease in the credit loss provision if the level of defaults is lower than expected and already provided for at the time of origination.

Bankers, auditors, and investors must, therefore, devise and rely on other types of metrics in order to evaluate the reasonableness of credit loss forecasts. It will likely be necessary for bankers to insert “tipping points” to credit metrics in order to determine levels in which changes in the expected loss will be necessary. Otherwise, bankers may be increasingly subject to criticisms of “earnings management”.

(Added January 2016)

While there have been suggestions that metrics, such as delinquencies, should be compared to the expected delinquencies, this begs the question of whether the comparison is to delinquencies expected at origination or expected as of the previous reporting date. Depending on the frequency of change, each metric could vary in relevance. With this in mind, management, directors, and investors will be challenged in finding ways to communicate such statistics without furthering confusion.

7. Credit quality disclosures may increase significantly under CECL.

As vintage analysis may become the basis for credit quality evaluation, disclosures related to credit quality may need to expand to address each critical vintage⁹. This could increase the

⁹ Under Accounting Standards Codification 310-10-50, disclosures are broken out by class of financing receivable. Among other things, Class is determined by the entity’s method for monitoring and assessing credit risk. In this

current GAAP-based disclosures four-fold or more. For SEC-registered institutions, disclosures will also need to address those concerns raised under the previous point on traditional credit metrics.

8. Investors may need more guidance related to capital buffers.

As with other models used for financial decision-making, a new model used to estimate the ALLL under CECL will be subject to regulatory model risk management standards. Those standards detail expectations related to model validation procedures, including the evaluation of back-testing results.¹⁰ Any new process naturally introduces questions of model reliability and may result in unwarranted volatile ALLL estimates. Further, a new process that requires long range forecasting compounds those concerns and may make back-testing validation of the model very challenging.

Increased ALLL volatility may require an increased capital buffer, which will limit the dividend-paying capability of the bank. Investors will require more information of the impacts in order to make their own forecasts of dividends.

(Added January 2016)

Forecasting is difficult, even for the experts. It should be noted that blue chip forecasting organizations largely missed forecasting the financial crisis and openly admit the difficulty in forecasting turns in the economic cycle. Two-year economic forecasts of economic growth performed by the Congressional Budget Office for 2007 were 4% higher than the actual rate (a forecasted increase of over 2%, though the actual growth was almost a negative 2%).¹¹ ABA believes bank practice will largely start with the macroeconomic forecasts made by these firms (as a basis for being “reasonable and supportable”). Therefore, community banks will be challenged in supporting any adjustments from these forecasts, based on their local community economies.

case, it appears that a vintage will often qualify as a class. (Update added June 2016) [Non-public business entities are not required to provide vintage disclosures. However, if vintage qualifies as a Class of receivable, non-PBEs may still be required to provide this disclosure if vintage is how the ALLL is assessed.](#)

¹⁰ Vintage analysis also will play an important role in back-testing, as original expectations (at origination) will be a significant part of the CECL model.

¹¹ 2007 is the year many people believe was the start of the financial crisis. Other blue chip consensus forecasters did not fare much better, per CBO’s own report. See https://www.cbo.gov/sites/default/files/114th-congress-2015-2016/reports/49891-Forecasting_Record_2015.pdf

9. Support for the length of “forecastable futures” may be needed. (Added April 2015)

(Certain portions updated June 2016)

Under CECL, for future periods beyond which the entity is able to make or obtain reasonable and supportable forecasts, CECL requires the bank to revert to unadjusted historical credit loss experience (actually, certain adjustments will be made to reflect current conditions, but no forecast of the future will be included). While such a requirement appears to necessitate vintage analysis as a primary basis for the ALLL estimate¹², it also appears to then require banks to maintain documentation of the process to determine the length of the foreseeable future, including how the length is determined and why it is limited.

We understand that this aspect of the standard was made to allay concerns that institutions voiced on their capabilities to forecast the future. However, such a bifurcation of the portfolio life might also require further audit focus and testing. Bankers are noting that accounting firms are requiring detailed supporting documentation on the length of “loss emergence periods” under the current incurred loss accounting model. Thus, we are concerned that the firms may also want an analysis to support the length of the forecastable period. Given that in times of stress the unadjusted historical average loss rates outside of the forecastable future could be perceived by investors to be significantly different from an actual expectation, detailed documentation that supports this forecastable future may become a critical piece of audit evidence. This could add to both complexity and cost.

10. Accurate quarterly financial reporting may need more time. (Added April 2015)

Banking institutions normally are the first companies to report their financial results each quarterly earnings reporting season in the U.S., with the largest banks conducting their earnings calls within days after the end of the fiscal period. Under the incurred loss method of impairment accounting, losses on newly-issued loans normally are considered to be insignificant (as a rule, banks do not make loans that are impaired at origination) and, thus, new loan commitments and disbursements are not a critical measurement in quarter-end

¹² If unadjusted historical credit loss experience is used for periods beyond the forecastable future, double-counting of loss rates will likely occur unless the loss experience is broken out by age of asset (vintage). As an example, a bank holding a loan portfolio with a four year life may feel fairly confident of their forecasting ability over the next eighteen months. Therefore, impairments and charge-offs (resulting from predicted macroeconomic activity) are forecast over eighteen months. Per CECL, unadjusted historical loss rates are used for the remaining thirty months. Unless the pattern of charge-offs experienced over the life of a portfolio is flat (equal amounts each year, no matter the age of the loan), unadjusted historical rates will reflect an inappropriate charge-off rate, unless each vintage is analyzed.

financial reporting of ALLL¹³. Under CECL's LOL concept, however, new loan commitments are expected to have an impact on profit and loss and must be closely tracked.

Because of the relatively large "day 1" impact to net income and capital, quarter-end cut-off procedures will now be a larger focus of the audit. As a result, banks may require longer closing periods from the current reporting timeframes.

¹³ In current practice, the ALLL for unimpaired loans is based on the outstanding balance of unimpaired loans, which includes newly-issued loans. However, this is consistent with the notion that some losses have been "incurred but not reported" and not because there is a loss expectation on these loans. As a result, the ALLL that would be proportionately applied to such loans would also be much smaller than a LOL-based ALLL.

11. Guidance related to individual vs. pool analysis will be critical. (Added April 2015)

Within the current incurred loss model, the ALLL for impaired loans is generally estimated using a detailed loan-by-loan analysis of expected loss, while the ALLL for unimpaired loans is estimated collectively (using pools of loans) for what is incurred, but not reported (IBNR).¹⁴ Such a distinction between individual vs. collective analysis and impaired vs. IBNR allowances goes away with CECL, as the ALLL for all loans is evaluated and measured based on an expected loss concept. Guidance (perhaps coming from the U.S. banking agencies) will now be needed to determine whether collective evaluation or individual evaluation will be appropriate, for the following reasons:

- a. FASB has preliminarily decided that the expected life of a loan should consider expected prepayments, but should not consider expected extensions, renewals, or modifications, unless the institution anticipates executing a troubled debt restructuring (TDR). Anticipating a TDR is relatively straight-forward when evaluating individual loans. However, it is not clear on how to integrate such an expectation into a collective loss analysis. Guidance will be needed on whether historic TDR patterns should be considered in estimating the portfolio life. If historic TDR patterns will be required, then additional data points are needed within loan servicing systems.
- b. Impairment on debt securities is currently evaluated on a security by security basis. CECL will generally require impairment on held to maturity (HTM) securities to be evaluated on a collective basis, unless there are no multiple assets with similar risk characteristics. ABA believes that some HTM investments, such as many municipal securities, may not be appropriate for collective analysis. However, the work that may be required for a bank to prove/document that individual analysis is more appropriate on an ongoing basis could be substantial.
- c. The overall requirement to first consider collective (pool) analysis causes concerns for many community banks because there may often be insufficient data that supports “statistically valid” loss assumptions.¹⁵ The lack of a critical mass for specific portfolios, accentuated by any need to break the life of loan performance of those portfolios into vintages or other credit risk characteristics, may result in average loss rates that are not meaningful.

¹⁴ Losses on unimpaired loans that are individually significant may also be evaluated and measured individually.

¹⁵ ABA is not saying that all ALLL models must strictly be based on “statistically valid” data. However, generally speaking, the lower the sample size, the less reliable and precise the estimate. There naturally becomes a point where low reliability and precision are not acceptable. In these cases, market data may be available, though market data will not often be relevant to specific local communities.

12. Evolving auditing processes will compound the complexity of forecasting future losses (Added January 2016 and updated June 2016).

In the past several years, bank auditors and examiners have increased their demands for banks to provide documentation that quantifies how specific drivers of credit risk (macroeconomic factors, underwriting standards, etc.¹⁶) have affected their incurred loss expectations, significantly increasing the complexity of ALLL estimates made today under the incurred loss model. Under CECL, the complexity escalates, as forecasts of the impact of future levels of an economic driver (say, a forecast of unemployment or of interest rates) on a loan portfolio will affect different loans differently, based on their loan terms and age. For example:

- Future interest rate increases will affect variable-rate loans differently from fixed-rate loans.
- Forecasts of losses on those variable-rate loans will differ for those that mature within the next year compared to those that will be outstanding for the next two to three years.
- Borrowers with lower credit ratings will perform, over time, to such interest rate changes differently than those with higher credit ratings.

Forecasting future levels of economic drivers and their impact on credit losses is difficult. However, the potentially much larger and more volatile CECL balances and credit loss provisions present an additional challenge to bankers in supporting their estimates. The International Auditing and Assurance Board, in providing their initial views of expected credit loss models in light of their project to amend auditing standards related to estimates, observes this:

*“Given the complexity and uncertainty implicit in an ECL (expected credit loss) model, and the significant level of judgment that is involved in measuring the ECL, it is possible that the auditor’s range, or difference between management’s estimate and the auditor’s point estimate, may be **multiples of performance materiality.**”*

*“Large ranges can **result from only minor differences in assumptions** due to...**sensitivity** of the output to changes in the assumptions. It is possible that well-credentialed and experienced experts may disagree with respect to the appropriate assumptions for a given circumstance.”¹⁷*

ABA staff, thus, believes that auditors will require greater quantitative support for the qualitative factor adjustments. While the complexity and sophistication of the CECL analysis will be consistent with the complexity and sophistication of the bank itself, the practical requirement of additional data and analysis will still need to be addressed, and the level of detail can expected to be greater than under current accounting.

¹⁶ These are currently referred to as “Qualitative Factors” or “Q Factors.”

¹⁷ International Auditing and Assurance Board Task Force Report “*An Update on the Project and Initial Thinking on the Auditing Challenges Arising from Expected Credit Loss Models.*” March 2016.

**13. There are situations in which the Life of Loan concept can result in lower ALLL.
(Added June 2016)**

While most believe that CECL will require increases to ALLL levels, there are certain aspects of CECL whereby ALLL levels could decrease:

- The CECL LOL concept cuts off any consideration of loss expectation at the contractual maturity (adjusted if there is a reasonable expectation of a troubled debt restructuring), no matter the likelihood of renewal. Banks commonly structure corporate lines of credit as renewable every one or two years. Such banks that currently use “loss emergence periods” in their estimates that exceed the contractual maturity (expecting the loan to renew) may be required to reduce their ALLL estimates under CECL, depending on the timing of the maturity.¹⁸
- Banks currently provide an allowance for probable losses on credit card (and other unconditionally cancellable) lines of credit that generally represents the amounts to be charged by borrowers with financial difficulty before those difficulties are identified and cancellation of the borrower’s credit line goes into effect. Under CECL, it is likely these provisions will not be allowed, as they are for activity that technically goes beyond the contractual end.
- Likewise, there are situations in which more granular information may assist a bank in decreasing its ALLL. For example, a shift to borrowers of higher credit quality should decrease the amount of expected loss than what is expected based on experience that also includes lower quality credits. An example of this would be loans originated just after the financial crisis. Those borrowers were likely of the highest credit quality. As a result, very low life of loan loss expectation could accompany those loans and, in some cases, could even be lower than the incurred loss estimate that a bank would have recorded at that time.

¹⁸ The basis of the standard is the assumption that the bank re-underwrites the loan upon renewal. Therefore, the substance of the renewal is important, as renewals at the option of the borrower without any further underwriting would likely not qualify as an end to the contractual term.