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CURRENT EXPECTED CREDIT LOSS (CECL) ACCOUNTING

IT'S TIME TO GET MOVING

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As a result of the Financial Accounting Standards Board's (FASB's) changes to credit loss accounting, financial institutions will require additional capital and will need to make significant changes to their loss forecasting methodology and infrastructure. FASB ASC 326 requires a move to allowances based on "current expected credit losses" (CECL), forcing financial institutions to estimate expected losses over the life of most credit exposures not subject to fair value accounting. The impact is most significant for banks, but insurers and other financial institutions with credit portfolios will also be affected.

CECL is important because:

- It requires a change in mindset from a backward-looking to a forward-looking approach in setting allowances for credit losses.
- It will increase allowances and reduce capital for most institutions.
- ROEs for many products will fall, likely leading to changes in product structure and pricing.
- Significant changes will be required to institutions' loss forecasting models, infrastructure and systems, necessitating significant coordination across the organization.

The implementation date – the end of 2019 for most large institutions – may seem like a long way off, but financial institutions will need that time to prepare. We recommend a series of steps to ensure firms meet that deadline without undue stress. In particular, we suggest institutions:

- Immediately establish a formal CECL program.
- Conduct a comprehensive gap assessment on loss forecasting methodologies, data, systems and controls.
- Identify resource requirements and begin hiring.
- Educate the Board and senior management on the changes and their impacts.
- Explore changes to product design, pricing and collections practices.

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Exhibit 1: Summary of key implications of CECL for financial institutions

KEY IMPACT AREAS	IMPLICATIONS
CAPITAL RATIOS	• Larger allowances for most products and lower capital ratios • Additional volatility in allowances and capital ratios
PRODUCT PROFITABILITY	• Overall reduction in ROE, greatest for products with longer expected lifetimes (e.g. mortgages, commercial real estate) and "high risk, high return" segments • As a result, changes to product structuring, pricing, collections practices, securitization and loan sales
LOSS FORECASTING METHODOLOGY	• Significant methodological challenges requiring new models or adjustments to existing approaches – Generation of macro-economic forecasts – Accuracy of benign period and near term forecasts – Increased importance of prepayment forecasts – Reversion from forecasts to historical estimates – Supervisory treatment of unconditionally cancellable commitments – Forecasting of future allowances and provisions
DATA MANAGEMENT	• Integration of a large number of risk and finance data elements across a broad range of business functions • Sarbanes-Oxley controls over data and systems, and external audit of results
SYSTEMS AND PROCESSES	• More regular, rapid production of loss forecasts (as frequently as daily) • As a result – Greater automation and integration of systems to support complete automation (in the case of daily runs) – Expanded technology capacity and capability to support multiple concurrent model runs and reduced cycle time
DISCLOSURES	• More granular disclosures • Significantly greater challenge to explain results to stakeholders and to account for changes from period to period within public reporting deadlines

Source: Oliver Wyman

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BACKGROUND AND TIMING

In June 2016, FASB issued its new accounting standard for recognizing allowances for credit losses, including the CECL methodology. Under CECL, for assets measured at amortized cost (i.e. most loans, leases, credit lines and Held To Maturity securities), financial institutions are required to provision for expected losses over the full contractual term of the asset in advance, as described in Exhibit 2.

Exhibit 2: CECL at a glance

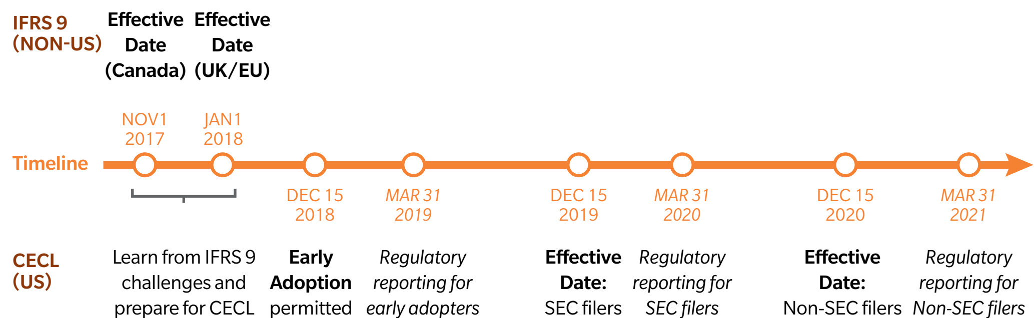
Scope of CECL allowances	• Loans, debt securities (except AFS[1]), trade receivables, net investments in leases, off-balance-sheet credit exposures, reinsurance receivables, and receivables that relate to repurchase agreements and securities lending agreements
Timing of loss recognition	• Immediate recognition of all expected credit losses over the contractual term
Measurement requirements	• Beyond the period for which reasonable and supportable forecasts are obtainable, banks may rely on historical information alone • Assets with similar risks are to be assessed collectively (pooled) when such characteristics exist – this seeks to reduce zero-loss estimates • No methodology is prescribed, though a number of possible methodologies are allowed

1. For AFS securities, the current OTTI model continues to apply, with some targeted improvements

Source: Oliver Wyman

CECL is effective for reporting periods beginning after December 2019 for SEC filers, with an option for early adoption. Meanwhile, the International Accounting Standards Board's (IASB's) similar IFRS 9 standard was finalized in 2014, and is effective for reporting periods beginning on or after January 1st, 2018. US banks with substantial international business and large Foreign Banking Organizations operating in the US will therefore have an opportunity to learn from their IFRS 9 experience as they prepare for CECL.

Exhibit 3: Key dates for CECL and IFRS 9[1]



1. A distinction exists between public business entities that do not file with the SEC and private companies – private companies may delay CECL reporting for interim periods until fiscal years beginning after December 15, 2021.

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KEY CHALLENGES AND IMPLICATIONS FOR FINANCIAL INSTITUTIONS

LOWER AND MORE VOLATILE CAPITAL RATIOS

Implementation of CECL will result in larger allowances for most products and therefore lower capital ratios, with some commentators estimating a reduction in industry common equity tier 1 ratios of as much as 0.50% once fully phased in.[1] In addition to the initial impact, institutions will suffer a drain on capital during periods of strong credit growth, since the higher provisions are booked upfront, before any income is accrued.

CECL is also likely to introduce greater volatility in provisions, P&L and capital ratios (though not to the extent of IFRS 9, since CECL does not have the staging concept of IFRS 9 – see Exhibit 6 for details). To assess the stability of their CECL allowances, we recommend institutions conduct extensive sensitivity testing on their models, assumptions and scenario development processes.

To offset the increase in allowances and absorb this greater volatility, institutions will need additional capital.

PRODUCT PROFITABILITY

With significantly higher provisions booked upfront, some product ROEs will fall. The impact will be greater for products with longer expected lifetimes (e.g. mortgages, commercial real estate), and lower (even positive) for those with short contractual maturities (e.g. undrawn balances on credit cards, or commercial lines with short renewal periods). It will also disproportionally affect high risk, high return products (e.g. "revolver" credit card portfolios) since the provisions will now be now front-loaded before any revenue can be accrued.

Exhibit 4: How will different products fare under CECL?

Significantly higher allowances/Lower profitability	• Mortgages • HELOC • Credit cards ("revolver" accounts) • Commercial real estate • Commercial lending • Leases
Little impact or lower allowances/Higher profitability	• Credit cards ("transactor" or low utilization accounts) • Other unconditionally cancellable lines • Commercial lines with short renewal periods

Source: Oliver Wyman

1 The American Bankers Association (ABA) has recently lobbied the Basel Committee on Banking Supervision (BCBS) for a transition timeline of no less than five years for the inclusion of CECL allowances in regulatory capital ratios; however, at the time of writing, the transition period is still unclear. Naturally, a longer transition period will be beneficial for banks.

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Institutions will likely respond in a variety of ways:

- **Product structuring**: Since institutions must only reserve for losses up until the end of the contractual term, institutions may seek to reduce contractual terms for some products (e.g. by instituting shorter renewal periods).
- **Pricing:** Naturally, institutions will seek to pass some of the cost onto borrowers and longer term products will become more expensive. In addition, as CECL allowances for many institutions will be more risk-sensitive, there will be a greater incentive for institutions to embed more risk sensitivity into their pricing. This may include higher fees to discourage undisciplined payment behavior and/or incentives to reward good behavior.
- **Collections practices and early state intervention:** As customers become delinquent, future expectations of losses ramp up quickly under the typical loss forecasting approaches institutions will use for CECL. This may encourage greater investment in early stage collections processes and counselling to borrowers identified as at-risk.
- **Securitization and loan sales:** For longer term, securitizable products (e.g. mortgages) there will now be a greater incentive to securitize and/or sell on loans to investors rather than holding loans on the balance sheet.

LOSS FORECASTING METHODOLOGY

Since FASB does not prescribe a particular methodology for calculating allowances under CECL, there are multiple methodological decisions to be made and a number of key challenges to be addressed by financial institutions.

- **Generation of macro-economic forecasts:** Institutions must consider "reasonable and supportable forecasts" in their estimates of expected credit losses, taking into account current conditions.
- **Accuracy of benign period and near term forecasts:** Existing loss forecasting models often have poor benign period performance and discontinuities between recent losses and near term forecasts – these will not be acceptable under CECL. Benign period errors are often caused by conservative assumptions that are appropriate in a stress testing context (either because they are reasonable estimates under stress or because a prudent approach is taken), but are not appropriate for CECL.
- **Increased importance of prepayment forecasts:** Though the impact of prepayments is often muted in stress testing exercises due to the relatively short time horizon, prepayments can have a large effect on losses for assets with longer contractual maturities – and are therefore much more important in a CECL context.
- **Reversion from forecasts to historical estimates:** For longer time horizons where reasonable and supportable forecasts cannot be produced, institutions will also need to define an approach for reverting from scenario-driven loss estimates to historical loss estimates.
- **Treatment of unconditionally cancellable commitments:** Allowances are not required for unconditionally cancellable commitments (e.g. unutilized credit card limits). This is unlikely to be acceptable to prudential supervisors, who may require institutions to hold more capital as a result.

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- **Forecasting of CECL allowances and provisions:** Various applications, such as strategic planning and stress testing, require forecasting of the balance sheet and P&L – including allowances and provisions. In theory, CECL introduces into these processes a need to produce a "forecast within a forecast" (i.e. a forecast of what forward-looking economic projections are likely to be at each point in the future). This will require a number of assumptions and some complex methodology choices – for example, how wrong are economists' forecasts likely to be as the economy first enters a deep recession? Given these complexities, banks will need to consider reasonable simplifications that still account for these elements.

RETAIL UNFUNDED COMMITMENTS: CREDIT CARD

Credit cards present a unique challenge in adhering to CECL's focus on contractual terms. Should expected customer payments be assumed to apply first to pre-existing balances or to any new purchases, finance charges, or other fees? In other words, are balances FIFO (first in, first out) or LIFO (last in, first out)?

Assuming payments apply first to the "oldest" balances (FIFO) is consistent with some credit-related processes, such as defining account delinquency – if a customer pays off any past-due amount, the account will return to current and stop aging even if new purchases in the same cycle keep the balance from decreasing. On the other hand, banks make the opposite assumption in other situations such as asset characterization for interest rate risk disclosures and funds transfer pricing (FTP), and in issuing securities backed by credit card receivables. In these cases, institutions assume a core set of balances have a long-dated maturity and that idiosyncratic purchases and repayments offset each other before drawing from core balances (LIFO).

Relative to LIFO, a FIFO view has the potential to significantly reduce allowances, particularly on "transactor" portfolios. The industry has not reached a consensus, however, on which assumption will be adopted, with banks likely to argue for a FIFO view but unsure of the audit and regulatory response.

DATA MANAGEMENT

CECL will require the integration of a large number of risk and finance data elements across a broad range of business functions – a major challenge for most financial institutions today. Furthermore, unlike other loss forecasting applications, CECL results will be audited and Sarbanes-Oxley controls will be required now that the results directly affect public financial statements.

While banks have been making enhancements to risk and finance data quality and governance in response to a range of regulatory requirements, new concerns are likely to arise around around data and loss forecasting systems now that they will directly affect public financial statements. The increased burden for accuracy calls for even more stringent controls across a wider scope of data elements and systems.

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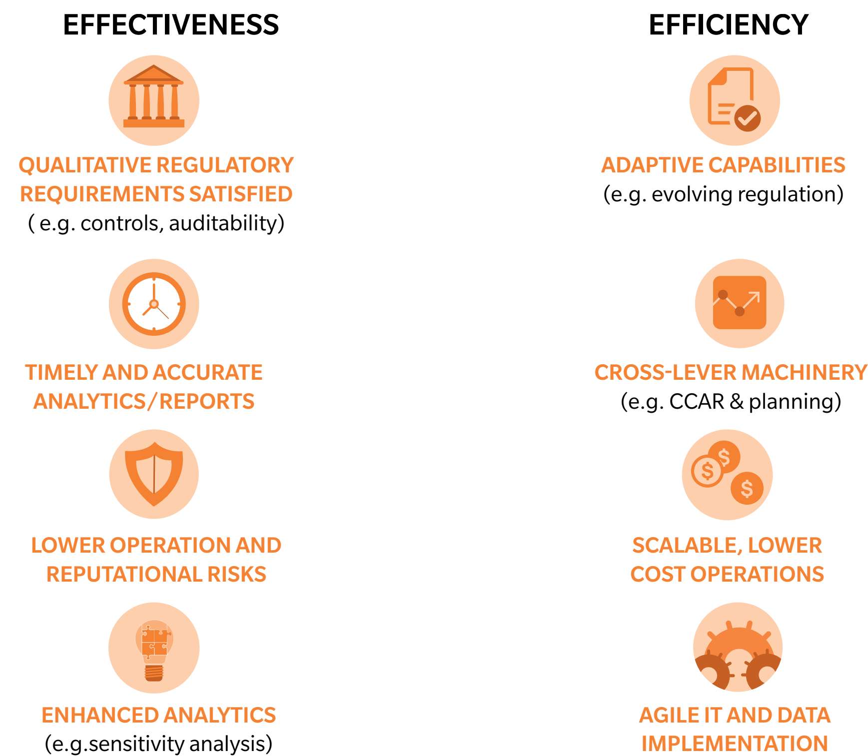
SYSTEMS AND PROCESSES

CECL will also require more regular, rapid production of loss forecasts. Since each new loan reduces an institution's capital, (due to the immediate recognition of expected credit losses over the contractual life), institutions will have a desire for much more frequent estimates of allowances – as frequently as daily. Due to the significantly increased frequency of estimation, higher demand on system capabilities, and need for strict controls, many of the manual processes used in stress testing and capital planning will become unacceptable for CECL.

Greater automation – and therefore integration of systems – will be required. Enabling intra-month runs will require institutions to reduce manual processes to a minimum, and in the case of daily runs, to eliminate them completely. Additionally, such frequent calculations will require faster computational speed for many large portfolios to enable overnight loss forecasts and reserve estimates.

Several institutions have already begun streamlining their loss forecasting processes for other purposes, with the objective of making loss forecasting more reliable and efficient. Banks who have been investing already in this "industrialization" of their loss forecasting processes will be ahead of the curve. But the ongoing demands of CECL are much greater than today's periodic loss forecasting processes, such as stress testing and budgeting.

Exhibit 5: The case for industrialization of loss forecasting processes



Source: Oliver Wyman

DISCLOSURES

In addition to requiring more granular disclosures, CECL will make it significantly more challenging to explain results to stakeholders – both internal (senior management and board) and external (auditors, regulators, and investors) – and to account for changes from period to period within public reporting deadlines. This will be especially true if an institution's allowances move in a significantly different way than those of peer institutions, which could occur in situations where an institution's outlook is different to peers or where there are material changes in model assumptions.

IMPLICATIONS FOR IFRS 9 INSTITUTIONS

Dual IFRS 9 and CECL institutions (US banks with large subsidiaries abroad, and Foreign Banking Organizations in the US) will need to maintain parallel processes to satisfy both sets of requirements. Institutions will need to conduct a careful assessment of the differences in the standards (see table below) to determine where common approaches are acceptable and where distinct approaches are required – and be prepared to explain these differences to auditors, supervisors, and investors.

In addition to maintaining parallel methodologies and processes for IFRS 9 and CECL, affected institutions will need to analyze movements in allowances and explain any significant divergences. The major differences described below may offset each other, and will have different impacts across the economic cycle. Institutions will need to provide their boards and auditors with sufficient detail to allow them to understand the dynamics of the two approaches.

Exhibit 6: CECL vs. IFRS 9 – Key differences

REQUIREMENT	CECL	IFRS 9
Loss projection horizon	• Expected credit losses through the contractual term of the loan	• For performing assets (stage 1), 12 month expected credit loss • For assets with significant deterioration in credit risk (stages 2, 3), lifetime expected credit losses
Impact of renewals and prepayments	• Institutions must include pre-payment expectations • No need to consider loan re-issue or renewals	• No explicit requirement on prepayment models, and loan renewals/re-issues included based on best judgment
Treatment of unfunded commitments	• Expected credit losses must reflect the full contractual period over which an entity is exposed to credit risk via a present obligation to extend credit • No allowance required beyond the contractual term or beyond the point in which a loan commitment may be unconditionally cancelled by the issuer	• Expected credit losses to reflect the period that an entity is exposed to credit risk, even if that period extends beyond the maximum contractual period
Scenario(s)	• Single forecast may be used	• Multiple scenarios are required to capture a range of economic conditions

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RECOMMENDATIONS FOR FINANCIAL INSTITUTIONS

ESTABLISH A CECL PROGRAM – NOW

Where they have not already done so, US institutions should promptly establish formal CECL programs to ensure they are adequately prepared for implementation, including a parallel run period. The need to do so is both organizational (since credit provisioning is a joint Risk-Finance exercise) and budgetary (significant investments, both IT and non-IT, will be required). Global IFRS 9 banks were often slow to start developing their IFRS 9 frameworks, realizing later that the exercise was more complex than first thought.[2] Furthermore, many US banks are still assessing the implications of early adoption and may base their decisions on competitor actions, which would force institutions to be prepared for early adoption.

CONDUCT A DETAILED GAP ASSESSMENT

A successful CECL program begins with a comprehensive gap assessment, and development of a roadmap and resource plan.

Given the various methodological challenges discussed above, most existing credit loss forecasting models are not appropriate for use off-the-shelf for CECL purposes without adjustment – a fact that is not fully appreciated at all firms. Frontloading the intellectual investment in thinking through methodological choices and tradeoffs is critical to avoid a last minute scramble.

Similarly, the data and systems in use for stress testing are not suited for the more rigorous, frequent and time-sensitive nature of financial reporting and will therefore require upgrades. Leading US banks are already doing this, while players who are slow to respond will face increased pressure to play catch up.

IDENTIFY RESOURCE REQUIREMENTS AND BEGIN HIRING

Additional analysis, documentation and internal control requirements will require more resources. Even where the organization has the capabilities, many of the same resources will be required as for stress testing. Institutions should plan for this and begin hiring early, to avoid a resource crunch.

EDUCATE SENIOR MANAGEMENT AND THE BOARD ON POTENTIAL CAPITAL IMPACT

For many institutions, CECL will increase allowances significantly in the near term and reduce capital ratios. Upfront recognition of credit losses on new assets will also adversely impact capital going forward, in particular when credit growth is strong, and will increase volatility in reserves during benign times. Understanding the nuances of the new provisioning approach will take time, and we recommend banks institute a formal process of senior management and Board education in the lead-up to the "go live" in 2019.

2 In the European Banking Authority's November 2016 report, it expressed concern around banks' readiness – in particular for smaller banks – and around the involvement of all key stakeholders in the IFRS 9 program.

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EXPLORE CHANGES TO PRODUCT DESIGN, PRICING AND COLLECTIONS PRACTICES

As discussed above, CECL will affect the economics of credit products, and of the banking business as a whole. Leading institutions will conduct an assessment of product profitability and identify new strategic initiatives resulting from the changes, act quickly to design and implement product changes, realign customer incentives and collections practices with bank economics, and implement other changes to mitigate the impact of CECL.

CONCLUSION

For the various reasons identified above, implementing CECL will be more complex than many institutions realize, in terms of methodology, data, systems and disclosures. CECL will also be more time consuming and more costly than many realize. Some institutions have made good progress already, though many have been slow to get started, and even leading institutions have a long way to go.

It's time to get moving.

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