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On The Horizon – The Current Expected Credit Losses (CECL) Model

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The opinions expressed are those of the presenter and are not those of the Federal Reserve Bank of Kansas City, the Federal Reserve System, or its Board of Governors.

Accounting for Credit Losses (i.e., Impairment): Changes Ahead

- Introduce the Proposed CECL Model
- Compare Proposed CECL Model to Existing Incurred Loss (IL) Model
- Identify Impact on Regulatory Reporting

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Introduction to CECL

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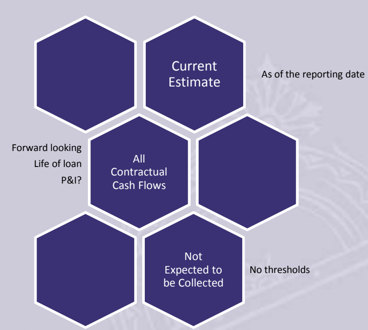
What are the Key Elements of CECL?

- Allowances to be based upon "current estimate of all contractual cash flows not expected to be collected"



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Which Weaknesses in the Current Standard does CECL Address?

- Delayed recognition of losses due to "probable" and "incurred" thresholds
- Inability to consider forward-looking information
- Multiple impairment models:
  - Loans and receivables (ASC 310-10 and ASC 450-20)
  - Purchased credit impaired loans (ASC 310-30)
  - Debt securities (ASC 320-10)
  - Lease receivables (ASC 840)
  - Loan commitments

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How Would CECL Lead to Quicker Recognition of Credit Losses?

- Remove "probable" and "incurred" thresholds for recognition of credit losses
- Extend the time horizon over which "expectations" are to be formed (life of loan)
- Be more forward-looking by incorporating reasonable and supportable forecasts of the future
- Simplify, i.e. replace numerous impairment models:
  - Applicable to *almost* all debt instruments not carried at fair value through net income (loans, receivables, purchased credit impaired loans, *HTM* debt securities), lease receivables and loan commitments

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How Should Expected Credit Losses be Estimated Under CECL?

- Discretion to Choose one or more of the Following Techniques:
  - Loss-rate methods
  - Roll-rate methods
  - Probability of default methods
  - Provision matrix method using loss factors
  - Discounted cash flow methods
- Applied Consistently over time
- Leverage Current Internal Credit Risk Management Approach and System

Comparison of Models: Existing IL vs. Proposed CECL

What is the Framework for Loans Under the Two Models?

- Existing IL model:
  - FAS 5 (ASC 450-20)
    - Pooled basis
    - Non-impaired loans
    - One of the methods used: Annual loss rate plus qualitative adjustment
  - FAS 114 (ASC 310-30):
    - Impaired loans identified using thresholds
    - One of the methods used: Discounted cash flow method applied to all cash flows over life of loan
- Proposed CECL model:
  - Single measurement:
    - Applicable to both impaired and non-impaired loans
    - No thresholds
    - Existing methods allowed with a few adjustments (see next section)
  - Forward-looking:
    - Reasonable and supportable forecasts
  - Unit of measurement:
    - Pooling vs. individual

How Should Expected Credit Losses be Estimated Under CECL?

- While FAS 5 (ASC 450-20) and FAS 114 (ASC 310-30) will be rescinded, if/how should we:
  - Distinguish between “impaired” and “non-impaired” loans?
  - Track a “general” vs. “specific” allowance?
  - Modify the way historical data is captured and analyzed?
  - Determine “life of loan”?
  - Perform a “qualitative overlay”?
  - Form reasonable and supportable forecasts of the future?
    - How far into the future?
    - Use of mean reversion?

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What are Some of the Other Issues Under CECL?

- Purchased credit impaired loans:
  - Simpler treatment. Need to determine the portion of discount related to expected credit loss reflected in the purchase price and record it as allowance upon purchase. Subsequent changes in allowance flow through income statement.
- Troubled debt restructurings:
  - Not to be accounted for as a new loan. Adjust the cost basis of the modified asset (with a corresponding adjustment to the allowance) so that the **effective interest rate** on the modified asset continues to be the original effective rate, given the new series of contractual cash flows.

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What are Some of the Other Issues Under CECL? (Cont'd)

- Non-accrual loans:
  - Proposed definition dropped. Continue to use regulatory definition
- Charge offs (or Write offs) and recoveries:
  - Proposed definition aligned with regulatory definition
- Collateral-dependent loans:
  - Debate over "operation by the lender" and use of practical expedient for loans secured by collateral

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What Happens to the Existing Other-Than-Temporary Impairment Model for Debt Securities?

- Other-than-temporary impairment (OTTI) will no longer apply (i.e., CECL will apply) to held-to-maturity (HTM) securities:
  - HTM securities will have an allowance for credit losses
- *Tentative: OTTI with modifications will apply (i.e., CECL will not apply) to available-for-sale securities:*
  - Allowance to be maintained which allows reversals
  - Remove two considerations currently required: length of time period the security is "under water" and further drops in fair value after balance sheet date

Impact on Reporting: Focus on Loans

What is Likely to be the Key Impact on Reporting?

- The move to CECL is likely to increase allowance balances due to "life of loan" credit loss estimates:
  - Result in a more accurate balance sheet as asset balances, net of allowances, would reflect cash flows expected to be collected
- Upon implementation, a one-time increase in allowance levels for existing assets on the books is likely (aka Transition Impact)
- After implementation, an on-going impact on earnings from new assets is likely (aka Day-One Loss)

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What Would be the Overall Impact Upon Transition?

- Initial estimates indicate an increase in allowance for loan and lease losses (ALLL) of 25-50 percent for large, well-diversified portfolios:
  - However, the impact on individual portfolios across banks vary widely depending upon the current ALLL levels, reserving practices, portfolio attributes and assumptions used
  - Recent pace and magnitude of ALLL releases will likely worsen the impact at transition
- The cumulative effect of the change in allowances would be run through retained earnings or other components of equity:
  - In the statement of financial position *as of the beginning of the first period* for which the guidance is effective

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What Would be the Ongoing Impact After Transition?

- Ongoing day-one recognition of credit losses for stable, open portfolios should not significantly affect earnings:
  - Question the role of historical loss rates experienced during highly stressed economic environments in estimation of expected credit losses on new, high-quality loans during <u>periods of tight underwriting standards</u>
- However, new portfolios or de novo banks may need special consideration

Will CECL Require Significant Implementation Effort?

- Small banks DO NOT need complex models:
  - However, they may need to make changes to current systems for data collection and analysis
- Big banks are likely to already have risk management policies, processes and systems in place to estimate expected credit losses

Questions?

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