Putting current expected credit losses (CECL) in perspective

Fundamentals of implementation success

We are pleased to present the second[1] in a series of publications that highlights Deloitte Advisory's point of view about the significance of the Financial Accounting Standards Board's (FASB) Proposed Accounting Standards Update (ASU), *Financial Instruments—Credit Losses*, and its impact on allowance for loan losses (ALL). Thought pieces describing our perspective and the potential implications of CECL will continue to be published at www.deloitte.com/us/cecl.

Understanding the current landscape

As part of his remarks at the 2013 AICPA Banking Conference, Thomas J. Curry, Comptroller of the Currency, stated: "The financial crisis revealed a distinct flaw in the incurred loss model. By requiring banks to wait for an "incurred" loss event to recognize the resulting impairment, the model precludes banks from taking appropriate provisions for emerging risks that the bank can reasonably anticipate to occur. The result too often has been the need for banks to make large loan loss provisions in the midst of a credit downturn, often when earnings and lending capacity are already stressed. This leads to pro-cyclicality and results in delayed loss recognition."[2]

Mr. Curry's remarks portray the sentiment and primary driver underlying the scrutiny a financial institution's estimate for ALL has received from investors, regulators, and external auditors. Banks and other financial institutions have been challenged to demonstrate that their ALL programs are robust, repeatable, transparent, and defendable and that they contemplate independent model validation and ongoing performance monitoring.

To address the consequences of the financial downturn and resulting stakeholder concerns, the FASB proposed an update to current US Generally Accepted Accounting Principles (GAAP) which was intended to provide financial statement users with more decision-useful information about the expected credit losses related to most[3] debt instruments (other than those measured at fair value through net income (FVTNI)), trade receivables, lease receivables, reinsurance receivables that result from insurance transactions, financial guarantee contracts,[4] and loan commitments. However, available-for-sale (AFS) debt securities would be excluded from the model's scope and would continue to be assessed for impairment under ASC 320 (the FASB has proposed limited changes to the impairment model for AFS debt securities).

Proposed CECL model as a solution

The FASB's proposed ASU, *Financial Instruments—Credit Losses* (Subtopic 825-15), would bring about the following changes to overcome the perceived shortcomings of current GAAP:

- **Expected loss approach over life of loan**—Change the accounting requirement from an incurred loss approach using a "loss emergence period" concept to an **expected** loss approach using **"life of loan" loss forecast horizon** to provide financial statement users with more decision-useful information about expected credit losses. Under this approach, the expected credit loss is an estimate of contractual cash flows an entity does not expect to collect for the remaining life of an instrument. Said differently, under the CECL model, the net asset will be measured to reflect the amount of contractual cash flows that an entity expects to collect.

- **Elimination of the "probable" threshold—**Existing ALL models delay recognition of credit losses until the loss is considered probable. This recognition threshold is perceived to have interfered with the timely recognition of credit losses and overstated assets during the global economic downturn. At the 2015 AICPA National Conference on Current SEC and PCAOB Developments, Russ Golden, FASB Chairman, noted that the CECL model is a result of concerns raised to the FASB "by a group of financial statement preparers […] concerned about the high threshold for recognizing loan losses; [the preparers] requested that the FASB change the existing incurred loss model."[5] Mr. Golden further noted that the high probability threshold in current GAAP prevented the recognition of credit losses despite the fact that stakeholders were aware that substantial amount of risk was present in certain debt instruments. The credit loss

---

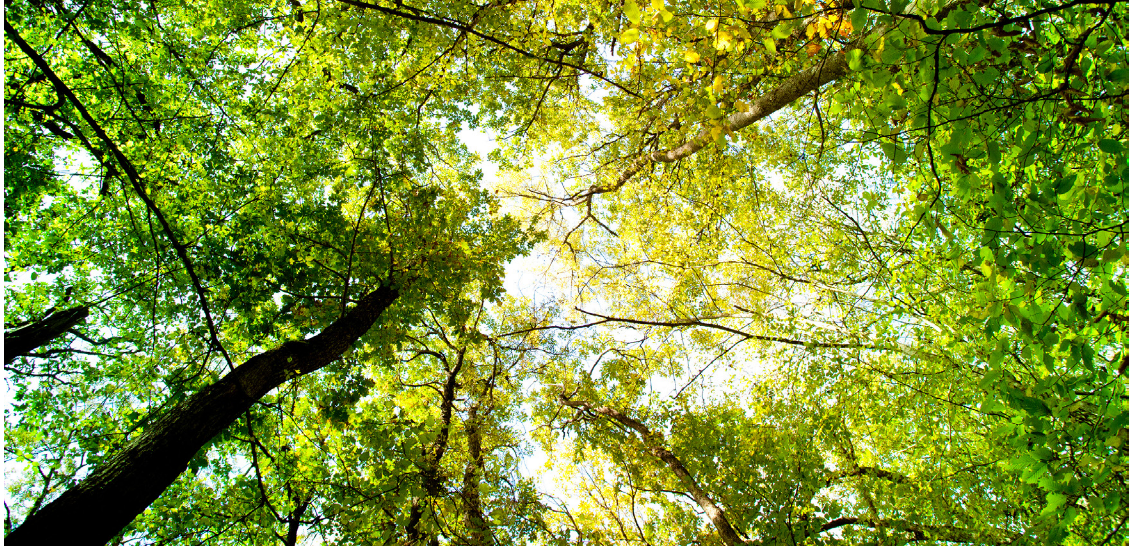
[1] The first publication, *Allowance for loan losses, Staying ahead*, can be found at www.deloitte.com/us/all.

[2] Remarks of Thomas J. Curry, Comptroller of the Currency, at the AICPA Banking Conference in Washington, DC—September 16, 2013. http://www.occ.treas.gov/news-issuances/speeches/2013/pub-speech-2013-136.pdf.

[3] The CECL model would not apply to the following debt instruments:
- Loans made to participants by defined contribution employee benefit plans.
- Policy loan receivables of an insurance entity.
- Pledge receivables (promises to give) of a not-for-profit entity.
- Loans and receivables between entities under common control.

[4] The CECL model would not apply to financial guarantee contracts that are accounted for as insurance or measured at FVTNI.

[5] Remarks of Russell G. Golden, Chair, Financial Accounting Standards Board, at the AICPA Conference on Current SEC & PCAOB Developments in Washington, DC—December 10, 2015. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176167706891.



recognition guidance under the CECL model eliminates this recognition threshold in GAAP and instead requires an entity to reflect the **current estimate of expected credit losses**. Because the CECL model does not have a minimum threshold for recognition of impairment losses, entities will need to measure expected credit losses on assets that have a low risk of loss (e.g., investment grade held-to-maturity debt securities).

- **Forward-looking approach**—When credit losses are measured under current GAAP, an entity generally only considers past events and current conditions in measuring the incurred loss. The CECL model requires an entity's estimate of credit losses to be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectability of the financial assets' remaining contractual cash flows. Although the CECL model will require contemplation of future conditions, an entity would not be required to forecast conditions over the contractual life of the asset. Rather, for the period beyond the period for which the entity can make reasonable and supportable forecasts, the entity would revert to an unadjusted historical credit loss experience.

- **Reduced complexity**—FASB's CECL model replaces or amends five different impairment models for instruments that are within the scope of the proposed amendments and would result in a consistent measurement approach that simplifies the estimation process. In addition, the CECL model will not be prescriptive and will permit use of variety of methods to estimate expected credit losses.

Other major components of the new model include considerations around unit of account, reasonable and supportable forecasting to estimate expected losses over the life of the loan, and the evaluation of the possibility of occurrence of loss at the time of origination itself. Further, a recent FASB decision around troubled debt restructurings (TDRs) would no longer require a discounted cash flow measurement for TDRs.

Anticipated implementation challenges

In September 2015, Deloitte Touche Tohmatsu Limited (DTTL) released the results of its fifth global IFRS banking survey[6] (the Survey), with a focus on the implementation efforts around IFRS 9, *Financial Instruments,* and FASB's CECL model. The respondents[7] indicated the following anticipated implementation challenges:

- Clarity around acceptable interpretation of the IFRS 9/FASB CECL model externally
- Necessary level of coordination between finance, credit, risk, IT, and others to execute the implementation
- Availability of data
- Capability to design, build, and test new models with limited internal resources
- Capability to plan and execute a program of this size in parallel with other current initiatives

Based on the Survey conducted by DTTL, financial institutions estimate that, after the implementation of the CECL model, the loan loss allowance will increase by up to 50% as compared to current reserves.

With respect to the external stakeholder interpretation of FASB's CECL model, the banks are intently following the regulators' commentary related to the proposed GAAP changes. Several questions arise in this context, including whether

[6] The Survey can be found at http://www2.deloitte.com/global/en/pages/financial-services/articles/fifth-banking-ifrs-survey.html.

[7] Respondents were comprised of 59 global banks, out of which 42 were IFRS reporters.

We note that "loss" is not always the same number when considering the interaction between CECL, Basel III, and stress testing requirements. For example, CECL does not specifically define "credit losses." Stress testing requirements are grounded in the GAAP balance sheet, projected 9 to 13 quarters ahead; hence, the stress testing "loss" is the same as the GAAP "loss" albeit the measurement is adjusted for stressed economic scenarios. Finally, Basel III focuses on "economic loss," which considers items such as workout expenses and overhead (i.e., indirect costs).

the sector should anticipate certain regulatory-to-GAAP differences (e.g., on treatment of TDRs) and whether certain items scoped out of the CECL model would default to legacy guidance in ASC 450 (e.g., cancellable loan commitments) for regulatory or financial reporting purposes.

The rest of this point of view discusses the challenges described above that are within an entity's control.

Integration with existing models, systems, and processes

Implementation of the new impairment model is expected to impact multiple dimensions of an entity's operating model. An effective implementation should encompass a plan that contemplates the impact on finance, credit, risk, IT, and compliance.

For example, CECL, Basel III,[8] and Comprehensive Capital Analysis and Review (CCAR)/Dodd-Frank Act Stress Testing (DFAST) processes are enabled through an infrastructure that is expected to have increased alignment, across multiple functional domains. Entities should determine the extent to which their current models, IT systems, and solutions will need to be revisited in order to implement the FASB's CECL model.

Approaches to loss estimation (see green callout) across the enterprise have several points of convergence that can be leveraged through an integrated approach. Some examples of areas where entities can leverage their existing models, processes, and controls include:

- **Balance sheet mapping/exposure identification**—Dual-purpose definitions and classifications of both on and off balance sheet exposures can facilitate a holistic approach for balance sheet mapping and ongoing exposure identification activities.
- **Data sourcing**—Given the significant overlap in data requirements (e.g., balance amounts, obligor data), an upfront effort to align data sourcing can reduce redundancies.
- **Infrastructure**—Multi-purpose components, including enterprise-level data warehouses and related activities, such as common data quality protocols, can simplify infrastructure design, reduce cost, and maximize operational efficiencies.
- **Processes and controls**—Multi-purpose processes and control points can be identified and leveraged to reduce the implementation and operational burden.
- **Risk models and valuation engines**—Quantitative tools can be aligned and calibrated for use across the capital management framework to ensure consistency.

Based on the Survey conducted by DTTL, approximately 68% of the participants responded that their current system allows some flexibility via system enhancements to incorporate the required capabilities. 11% of the participants responded that their current systems only cater to the current requirements.

A holistic approach can provide an opportunity to assess current capabilities related to allowance methodology, internal processes, credit modeling, and regulatory and financial reporting. In addition to developing a baseline for future transformation activities, taking a fresh look at current capabilities can result in recognizing synergies from using a holistic and integrated approach for estimating the ALL.

Certain smaller institutions and unregulated institutions such as consumer finance and captive entities, however, may face additional difficulties in implementing the model due to lack of availability of quality historical data and systems relying on simplified methodologies for estimating the ALL. For these entities, a cost/benefit analysis of implementing the CECL model leveraging solely in-house resources versus an off-the-shelf solution and, further, vendor selection would be an important phase in the implementation project.

[8] International regulatory framework for banks developed by the Basel Committee on Banking Supervision.

Data requirements and assumptions

Entities will require loan-level detail for a historical period that is reflective of management's expectations for future credit losses to estimate the credit losses under FASB's CECL model. This will involve (1) gathering high quality historical loan level data reflective of a complete credit cycle for each asset class and (2) developing and layering in appropriate and supportable forecast assumptions.

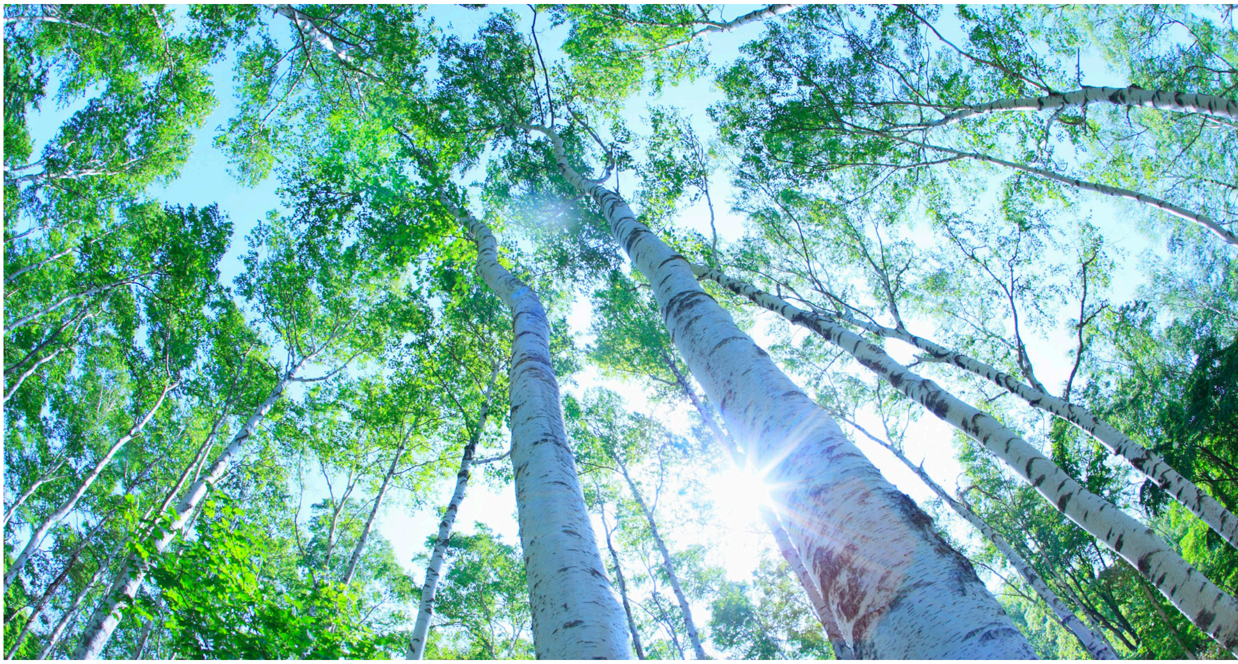
The inputs used in the CCAR/DFAST and Basel III processes that can be leveraged for the CECL loss estimation process include operational and credit loss data, trading/market data, balance sheet/income statement data, external data, and placeholder information. Among these models, common processes and control points can be identified and leveraged to reduce the implementation and operational burden. Regulatory stress scenarios are not intended to be used directly for accounting purposes but can provide key inputs for portfolio data that is required to initiate the ALL estimation process. The regulators' expectations are that the entity will be able to reconcile the baseline (not-stressed) forecast assumptions used as the foundation for regulatory reporting with the forecast information used in the CECL model.

Roadmap to future state

To stay ahead of this evolving landscape, institutions need an integrated framework for estimating ALL that encompasses current accounting standards and regulatory views while simultaneously laying the foundation for the future. In light of this, entities should consider:

- Benchmarking themselves against leading practices in estimating the ALL.
- Evaluating existing impairment accounting and regulatory policy decisions based on GAAP and existing regulatory requirements.
- Identifying additional data required for modeling and new disclosures and seeking opportunity to leverage data competencies from regulatory processes.
- Reviewing existing ALL estimation models to identify appropriate changes to methodologies to enhance functionality.
- Evaluating the framework currently used to estimate the ALL and the corresponding regulatory and reporting processes to identify areas for efficiencies and leading practices.
- Assessing current capabilities of internally-developed and third-party technology to identify necessary system changes or upgrades.

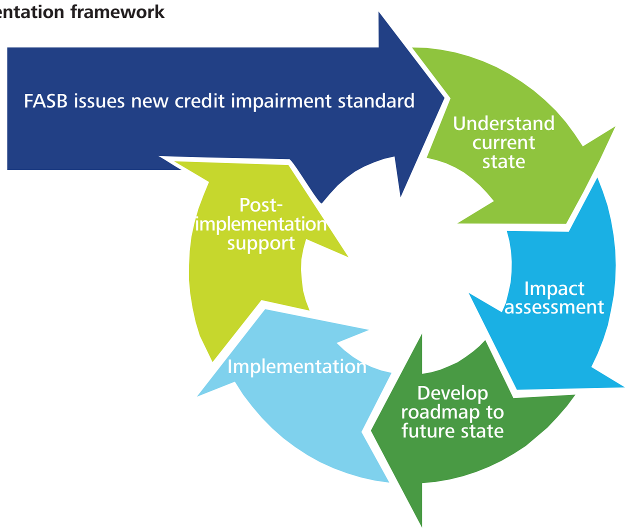
Although the final standard is yet to be issued, the operational changes should be planned in advance through the development of a CECL implementation playbook which leverages the ALL program. This involves considering resource requirements, planning to close gaps, and arranging the infrastructure needed to support the CECL model. In this effort, the implementation issues will be identified early on, allowing ample time for remediation.



Transforming a challenge into an opportunity

A change program of this magnitude calls for a strategic approach with clear-cut program management and defined roles and responsibilities. Further, given the broad nature of the implementation across the organization, senior management should be engaged around the strategic importance of an effective implementation and the critical milestones and challenges in the implementation roadmap. Figure 1 illustrates an implementation framework that can be used by an organization to guide its adoption of FASB's CECL impairment model and obtain stakeholder engagement.

Figure 1. Illustrative implementation framework



As a final thought, more than 85% of the respondents to the Survey conducted by DTTL noted that they plan to use IFRS 9/FASB's CECL model implementation as a **catalyst** to align accounting impairment and regulatory capital processes. It is evident that the changes in the impairment model will challenge current practice, but will also present opportunities for improving the financial position and business processes of the organization. The key is to plan ahead.

Contacts

Jade Shopp
Partner | Deloitte Advisory
Deloitte & Touche LLP
+1 213 593 3581
jademshopp@deloitte.com

Irv Bisnov
Partner
Deloitte & Touche LLP
+1 513 412 8329
ibisnov@deloitte.com

Sandy Pfeffer
Director | Deloitte Advisory
Deloitte & Touche LLP
+1 215 405 7846
spfeffer@deloitte.com

Jonathan Prejean
Director | Deloitte Advisory
Deloitte & Touche LLP
+1 703 885 6266
jprejean@deloitte.com

Anastasia Traylor
Senior Manager | Deloitte Advisory
Deloitte & Touche LLP
+1 703 251 3676
aztraylor@deloitte.com

Abby Velanand
Senior Manager | Deloitte Advisory
Deloitte & Touche LLP
+1 718 508 6126
avelanand@deloitte.com