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CECL messaging: What investors may ask CFOs

With year-end approaching, many institutions will be nearing the end of their CECL[1] build phase. As institutions then turn toward their "parallel run" phase, investors' focus on CECL likely will pick up as well.

Investors' efforts to make sense of CECL will likely be challenging, driven by the "perfect storm" of a principles-based standard, a complex process packed with significant judgments and forecasts, and a very flexible disclosure regime that will make comparability very challenging. Investors will look to the CFO to craft a thoughtful, transparent CECL communication strategy from SAB 74 through adoption and beyond.

While much has been written about the challenges of CECL, including its modeling complexity and the use of judgmental forecasting, until recently there has been little written regarding the communication or disclosure aspects of CECL. The American Bankers Association published a Discussion Paper[2] that probes various aspects of the communication challenges ahead.

Institutional investors and sell-side research firms likely will spend considerable time assessing CECL's impact on their modeling and valuation methodologies. Developing their own interpretive framework, some simple and some more complex, to understand and assess CECL and its comparability across the industry will be no simple task.

If today's strong economic environment persists through CECL adoption, near-term provisioning levels should continue to be driven by the sum of forecasted charge-offs plus a provision for loan growth. Given CECL's "life of loan" construct, the cost of loan growth under CECL will be considerably higher; however, the early CECL period-over-period comparisons should remain equally predictable in a strong, unchanging, economic environment.

As the time for year-end institutional investor conferences approaches, CECL dialogue may increase as investors look to CFOs to begin discussing the adoption of the biggest accounting change in decades.

However, during economic transitory periods—that is, moving into and out of a recessionary period—the new CECL "life of loan" construct, combined with forecasted economic factors, will challenge investors' ability to estimate the magnitude of the next cycle's credit cost. Further, given the expected lack of comparability, investors likely will find it difficult to assess expected, relative credit performance among institutions. Institutions that define their initial adoption disclosures contemplating a transitory period may see the benefits of such disclosures when a transitory period begins.

As the CECL dialogue between investors/sell-side analysts and individual institutions picks up, the questions will likely focus on three areas: strategic implications, methodology and measurement, and implementation status and communication plan.

Strategic implications

1. What will be the CECL impact on institutions' current and future capital plans?

Much has been written about the impact of the misalignment of the new CECL measurement requirement and the current regulatory capital rules, whose design construct assumed existing, lower GAAP allowances. CECL requires that the allowance for credit losses be estimated for the "life of loan" using a forecasted economic scenario, thus resulting in larger allowances than exist today. Given the existing regulatory capital rules, this increase in the allowance or "trapped capital" will be reflected only in total capital not common equity tier 1 (CET1), thus it is not included in total loss absorption capacity that is the focus of both investors and regulators.[3]

For all banks, the CECL impact on capital plays out in two ways and investors will strive to understand how institutions are considering both in their current and future capital planning.

The first capital impact will be upon adoption. Even today, it is unclear what the adoption impact will be with today's economic outlook or, more importantly, the economic outlook in January 2020. Some have presented rough estimates of the impact of CECL adoption on the industry and specific companies. The problem with such estimates is they have simplifying assumptions or averages that are counter to the very core of CECL's complexities and its many assumptions as well as the varying portfolio characteristics across institutions. Another uncertainty in the estimates is the level of an institutions' allowance today and specifically estimates of their loss emergence periods by asset class. The second, and more important, impact of CECL for all institutions will be its capital effect upon entering the first post-adoption transitory period and how institutions and regulators plan for that eventuality today.

Furthermore, indirectly the impact of regulatory capital stress testing within a CECL framework could be significant depending on an institution's asset size. For institutions under $100 billion, there is no formal quantitative regulatory stress test, but existing regulations still require institutions to consider stressed economic environments in their capital planning. For institutions with total assets more than $250 billion, the first Comprehensive Capital Analysis and Review (CCAR) stress test calculation that includes CECL will, in effect, combine the capital impact of CCAR and adoption. CECL could be included in the 2020 stress test due just months after CECL adoption. The stress test capital regime for those institutions between $100 billion and $250 billion will depend on final regulatory rulemaking but could be heavily influenced by CCAR.

While the stress test impact is unclear, many commentators to the Federal Reserve Board's (FRB) April 2018 Notice of Proposed Rulemaking (NPR) addressing CECL implementation noted that CCAR in a CECL framework will result in larger losses, sooner resulting in higher required capital levels.[4]

Investors will expect institutions to present a clear capital plan focused on whether institutions' have sufficient excess capital today to cover the total CECL impact or how institutions will "pay for" this new level of required capital. Whether impacted by CCAR or not, investors will seek to understand the combined impact of CECL at adoption and in times of stress. In the end, investors will want to understand whether CECL will curtail growth, dividend increases, and/or stock buyback levels.

> The number one question investors may ask: What will be the total capital impact of CECL including in stressed economic times?

2. Will institutions exit or modify any products given the new CECL provision methodology?

The debate around this topic is mixed. Some argue CECL is an accounting measurement framework and the economics of lending are unchanged. Others argue that accounting measurement will affect the willingness of institutions to lend under the same structure, price, and terms as currently available. Both views are true. Importantly, the debate is likely different in benign times versus recessionary times.

Investors will expect to hear whether CECL will result in institutions changing components of their business model. Will CECL drive institutions to change their credit term structures or pricing? Will institutions exit certain lending products, geographies, or customer segments?

Current industry dialogue suggests these decisions will be made after the CECL adoption dust settles. However, investors will remain focused on these long-term questions and CECL's impact on lending through an economic cycle.

Methodology and measurement

1. Will investors be able to estimate institutions' future credit provision under CECL for valuation purposes?

Today, many institutions provide estimates of future charge-off ranges and an expected allowance coverage ratio for the overall portfolio to aid investors in estimating future credit provisions. Historically, as institutions entered transitory economic times, by updating these estimates, investors were provided simple, transparent information for estimating future credit provisions. This all changes under CECL, and investors will have to embrace a new, more complex paradigm for estimating future credit provisions through the economic cycle.

An investor's ability to estimate future credit provisioning levels will require clear disclosures identifying the most impactful allowance assumptions and the sensitivity of the allowance to changes in those assumptions. Institutions that provide investors a clear picture of their CECL methodology at adoption may reap the benefits of transparency when the next downturn occurs.

Providing sensitivity analysis within CECL disclosures should be very useful information to investors in estimating future credit provisions, but it may not be that simple. The complexity and interdependencies of CECL may make single-attribute sensitivity analysis less meaningful. Furthermore, credit losses often do not react in a linear fashion for a given change in macro-economic variables. Thus, institutions will need to be thoughtful in how they might present any sensitivity disclosures.

Finally, institutions may be asked what would have been the likely impact of CECL on their institution during the last recession. By baselining the last recession, investors may be better able to frame the impact on future cycles.

2. Will institutions provide information that will help investors link the multiple CECL disclosure components?

Generally, CECL requires institutions to discuss, by portfolio segment, the impact of past events, current conditions, and reasonable and supportable (R&S) forecasts on their current allowance estimate. CECL also requires, by class of financing receivable (usually a more granular level than portfolio segment), quantitative and qualitative information about the credit quality of financial assets. Another key pillar of the CECL disclosure regimen requires institutions to discuss the factors that changed the period-over-period allowance estimate. Finally, CECL now requires "vintage" disclosures (year of origination) for each class of financing receivable.

Investors will look for the linkage between the disclosures for (1) the allowance components by portfolio segment, (2) the credit quality indicators and vintage quantification, and (3) the period-over-period allowance change attribution with other required disclosures to enhance transparency. Further, providing sensitivity analysis around the R&S forecasts and the credit quality indicators also may provide investors useful information to demystify the CECL allowance. Institutions can expect investors to probe for more information to better understand the linkage between these critical disclosures.

3. What will be the nature of institutions' disclosures regarding "reasonable and supportable" forecasts and reversion method?

Estimating the allowance amount using a "life of loan" construct and a R&S forecast is the bedrock of CECL. Thus, understanding institutions' R&S approach is fundamental to understanding their results—and it is crucial for assessing comparability among institutions. The R&S concept also encompasses the reversion period and methodology. Without understanding the impact of these decisions, understanding the allowance measurement methodology will be extremely challenging during transitory economic periods.

Understanding the sensitivity of the reasonable and supportable forecast will be a key tenet to understanding the allowance estimate.

Looking at the disclosures of international institutions that have adopted International Financial Reporting Standards (IFRS) 9 suggests investors can expect to see a wide range of disclosures regarding institutions' R&S forecasts from granular, tabular to higher-level narrative. Assessing investor reaction to IFRS 9 disclosures will provide useful insights for US institutions.

The most transparent approach to understanding R&S/reversion may likely be to provide sensitivity analysis. Absent this type of quantification, investors will be forced to guess what the impact could be as a transitory period approaches. Determining the nature of the R&S information provided likely will be institutions' most critical disclosure decision.

In the end, institutions should benefit if investors are well prepared to understand the impact of R&S forecast changes before they occur.

4. Will investors be able to bridge from institutions' current allowance to their new CECL allowance?

For decades, preparers and investors have evolved a communication construct that has provided increased understanding and transparency regarding institutions' allowance for credit loss methodology. Disclosing the "layers" of the CECL allowance may help investors use their knowledge of the existing "incurred loss" allowance model to gain transparency into the new CECL allowance.

CECL requires a discussion of how past events, current conditions, and reasonable and supportable forecasts influence the current allowance estimate. Quantifying this construct may allow investors the ability to bridge from today's incurred loss model to the CECL model. This "bridge" may be accomplished by providing a quantitative "layering" of the total CECL allowance estimate into three components: 1) past events—one year estimated charge-offs, 2) current conditions—expected losses over a "loss emergence period" in excess of the loss estimate in number one, and 3) the forecasted "life of loan" estimate beyond the combined estimates in one and two, which in total would equal the CECL estimate. Alternatively, if an institution uses an Expected Loss (EL) modeling construct in CECL, breaking down the allowance using two layers consisting of a one-year EL estimate, which would approximate the existing IFRS 9 model, and a net forecasted lifetime loss estimate component may add transparency.

However accomplished, "layering" the allowance components may aid investors' understanding and better facilitate comparability. Additionally, a layering approach also may provide insights to the amount of institutions "trapped capital" and thus better illuminate its total loss absorption capacity.

Implementation status and communication plan

1. What is the status of institutions' implementation efforts?

Much like other large change efforts, investors will expect institutions to provide periodic updates on the status of their implementation efforts. Given today's extensive dialogue in the marketplace regarding the magnitude, complexities, and uncertainties of implementing CECL, investors will want to determine that institutions have well-defined plans and are on track to be compliant on January 1, 2020. Understanding institutions' end-to-end plan, at a high level, would be beneficial.[5]

Specifically, investors likely will seek to understand the scope and length of an institution's planned parallel run.[6] Understanding the extent that institutions plan CECL "dress rehearsals"—that is, full end-to-end execution—will be valuable to investors.

2. When will institutions disclose a SAB 74 range and will they provide contextual information?

Investors may not see SAB 74 disclosures from many institutions until mid-2019 or later given the complexity of CECL estimation processes and institutions' efforts to determine they are highly confident in the range disclosed.

As institutions think through what it will take to be sufficiently confident to disclose an estimated CECL impact, the checklist is long. For example, institutions will want to determine whether their models are fully validated and tested in various scenarios; their accounting decisions have been fully reviewed; their internal control construct has been tested to determine there are no operating risks; their "qualitative" allowance adjustments are fully defined, measured, and reviewed and not a "double count" of their quantitative estimate; and their audit committee has been fully advised of the total allowance estimate under CECL. Finally, obtaining feedback from an institution's external auditor also will be important to achieve that final level of confidence. Practically, the timing of institutions' SAB 74 disclosures will likely be after completing significant parallel efforts. In the end, investors will benefit more from institutions' having highly-confident disclosures versus early, evolving disclosures.

SAB 74 disclosures with R&S information will aid transparency and comparability into the significance of CECL.

Given CECL is a principles-based standard and many decisions will be left to the institution, within the broad standard construct, investors will look for more contextual information within SAB 74 disclosures so that they can understand what is behind the number. Undoubtedly, institutions will spend significant time determining the best contextual information.

In SAB 74, the Securities Exchange Commission (SEC) staff noted that, because each accounting standard is different, each new standard should be evaluated to determine appropriate disclosure. Recently, the chief accountant of the SEC provided insights, drawing from experience with IFRS9 transition reports, into what he believed could help investors understand the anticipated effects of CECL including disclosures regarding a specific description of the CECL methodology and significant judgments, tabular presentation of the economic assumptions utilized, and quantified effects of adopting CECL by lending portfolio.[7]

In the context of the SEC's chief accountant SAB 74 comments, investors will likely benefit most from a high-level disclosure regarding methodology and more specific disclosures regarding the institution's "reasonable and supportable" forecast used in the impact assessment.

3. Will institutions provide CECL approach/methodology information pre-adoption?

As CECL challenges preparers to find the right level of disclosures, this will not be easy. A silver lining in striking the disclosure balance is that the institutions subject to IFRS 9 have adopted and are now reporting. Looking at the variety of the disclosures of the international institutions should provide US institutions useful perspectives in their decision-making process.

Institutions should conduct a CECL pre-adoption information session with investors. Such a session could be similar to one held by one of the major software technology companies for the rollout of the new revenue recognition accounting standard.[8] Similarly, comparing CECL adoption to the importance of an announced merger suggests investors may benefit from such an information session.

Understanding how CECL will behave during the critical "transitory" economic periods may not be fully apparent until after the next credit cycle. However, institutions that provide investors a thorough understanding of their CECL methodology at adoption may reap the benefits of transparency when the next downturn occurs.

The path forward

Getting the CECL disclosures right will be no easy task. Getting the right balance of qualitative and quantitative information to tell a complicated story about a highly judgmental estimate with significant impact on institutions' market valuations will likely be the biggest disclosure challenge since communicating credit quality during the last recession. Developing a communication strategy will take an enormous investment of time, and institutions that begin this effort early will be better prepared at adoption.

Given the magnitude of the CECL change and the importance to understanding credit loss estimation to investors coupled with the lack of a mandated, standard measurement approach, institutions may conclude that additional disclosures may prove valuable.

Institutions that tell the CECL story well will benefit over the long run.

End notes

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