CRE Finance Council
The Voice of Commercial Real Estate Finance

Allowance for Loan and Lease Loss (ALLL) Accounting: Current Expected Credit Loss (CECL)

Shift to Life-of-Loan Reserving will Require Major Operational Changes and Potentially also Add to Earnings Volatility

Last updated: April 9, 2018

Executive Summary

- **What Is CECL:** The Current Expected Credit Loss (CECL) accounting rule dramatically changes the approach to reserving for the allowance for loan and lease losses (ALLL) from the current methodology known as 'incurred loss' accounting. CECL is a component of IFRS 9 (FASB ASU No. 2016-13 in the US), which replaced IFRS 39 during the crisis, and will apply in most G20 jurisdictions and many others globally. In the U.S., CECL will become effective for public business entities (PBEs) in January 2020 and for non-PBEs in January 2021.

- **CECL Differs Substantially from Incurred Loss Accounting:** Incurred loss accounting, put simply, requires lenders to allocate reserves when and only when a clear weakness or concern related to a loan or a portfolio arises. In its FAQs regarding CECL published on December 19, 2016, the Federal Reserve described CECL as: *…an estimate of the expected credit losses on financial assets measured at amortized cost, which is measured using relevant information about past events, including historical credit loss experience on financial assets with similar risk characteristics, current conditions, and reasonable and supportable forecasts that affect the collectability of the remaining cash flows over the contractual term of the financial assets.*

- **Some of the Intended Benefits of CECL:** 1) a reduction in pro-cyclicality with more forward-looking loss projections and reserves; 2) better alignment with the existing risk management frameworks; and 3) a reduction in the number of impairment models that currently apply to loan, lease, available for sale (AFS), held for investment (HFI), and held to maturity (HTM) portfolios.

CECL QUICK FACTS

- CECL is a forward-looking methodology and is limited to credit losses only; it does not include market, operational, or other types of losses.

- The industry generally believes that CECL will inject greater volatility into financial institutions' earnings and incorporate assumptions that will require increased loss reserves based on macroeconomic factors rather than credit conditions within a specific asset class and market.

- Expected losses are booked at origination or purchase and without a threshold for inclusion (i.e., even *de minimus* loss estimates must be reflected in reserves).

- Some CECL reserves will be allowed to be included as regulatory capital (as is the case today with incurred loss reserves), but the industry believes that the banking regulators' proposal is too conservative and that it should be made 'capital-neutral' (where an equivalent amount of reserves are given credit as regulatory capital under both approaches).

- Because CECL requires that covered entities allocate reserves at origination, it follows that the new rule could impact structuring, pricing, collections and other downstream practices, such as securitization and loan sales.

- **Some of the Industry Concerns are:** 1) Greater complexity and significant operational burdens; 2) threat of material increase in ALLL requirements when implemented; 3) increased income statement and balance sheet volatility; 4) increased model error for institutions and the industry; and 5) greater variance across portfolios and institutions resulting in lower levels of comparability across institutions.

Covered Universe

Covered entities include GAAP-compliant institutions, including SEC filers and non-filers. Within the financial sector, this includes banks of all sizes, insurers, funds that issue traded securities and even those that do not, foundations, endowments, pension funds, and others. It is also conceivable that CECL would apply to government sponsored entities (GSEs) (Fannie Mae and Freddie Mac) once they exit conservatorship. While the GSEs allocated reserves prior to conservatorship, their regulator, the Federal Housing Finance Agency, has yet to weigh in on how they will account for impairments post-conservatorship.

Portfolios covered by CECL include loans, leases, available for sale (AFS), held for investment (HFI), and held to maturity (HTM). CECL does not cover trading accounts that are marked-to-market.

CECL effectively scopes in a wide range of ***products***, including loans and leases, debt securities, trade receivables, off-balance sheet credit exposures, trade receivables, and receivables relating to repurchase and securities lending agreements.

Potential Solutions

- **Pursue Fair Treatment of Reserves under Regulatory Capital Requirements:** While reserves are geared to cover 'expected losses', capital is sized to absorb so-called 'unexpected losses'. Because CECL requires that covered institutions calculate estimated life-of-loan losses, the line between expected and unexpected losses is arguably blurred. As a result, the industry, banks in particular, is interested in not only refining CECL models as they go, but also in ensuring that, the prudential regulators allow covered depository institutions a relatively capital-neutral option for risk-based capital requirements in the future.

  Until CECL goes into effect, the ALLL/reserves are allowed to represent some of Tier 2 capital (see below for more information). That will remain true in the future as well. However, based on the bank regulators' capital proposal of May 14, 2018, the industry generally believes that the banks will essentially have to double count some unexpected losses – in both CECL reserves and in regulatory capital.

  Regulators acknowledge that the scope of CECL is broader than that of incurred loss accounting, but they maintained the same cap on inclusion of reserves in regulatory capital – 1.25% in Tier 2 capital. They did allow that those banks experiencing a reduction in retained earnings (capital) due to CECL adoption would be allowed to phase in the new capital treatment over three years.

	Limit for Inclusion of Reserves in Tier 2 Capital	Conditions
Current Treatment	Can apply up to 1.25% of the banking organization's standardized total risk-weighted assets	
Proposed CECL Treatment	Current limit applies (excluding its standardized market risk-weighted assets, if applicable)	For advanced approaches banks, must have adopted CECL and completed parallel run

- **Regional Bank Letter to FASB Recommends Fine Tuning CECL Approach to Separate More Certain Losses from Those That Are More Speculative:** A group of regional banks signed a letter to FASB on November 5, 2018 recommending that they consider separating out loss estimates that are more certain from those that are less so. More specifically, the coalition recommends that loss estimates up to one year and those that are related to impaired positions should be treated as already mandated under CECL, running them through earnings, and impacting capital as if the losses were realized. For losses forecast out more than one year, the coalition recommends that they be counted in the 'Other Comprehensive Income' category of capital on the balance sheet. In that way, the reserve allocations estimated based on less stable assumptions will not create unnecessary earnings volatility.

  FASB held an industry roundtable on January 28, 2019 to discuss this proposal. During the meeting, it appeared that if FASB were to adopt the revisions, they would in turn also require additional disclosures supporting the decision-making around bifurcation of reserves. When the FASB board met on April 3, 2019, they tentatively rejected the plan, noting that it would not have provided enough benefit to the reporters or users to warrant the additional complexity.

- **Industry Makes Plain its Preference for Fair Value over CECL in Certain Cases:** On February 6, 2019, FASB proposed an irrevocable fair-value option for assets held at amortized cost (generally HTM portfolios), with the comment period ending on March 8, 2019. However, FASB did not extend the option to instruments held in AFS portfolios, which would have been logical and more cost effective for firms, including some mortgage REITs (mREITs), that hold more assets at fair value already. The appeal of maintaining the current fair value approach can be especially true in the case of acquired assets, as these portfolios would have been priced using one assumption, and the transition to CECL would require a whole different set of assumptions be applied going forward.

  In response to the exclusion of AFS, a coalition of mREITs filed a letter with FASB asking for the election to be extended to AFS portfolios, as well. I addition, the same coalition of mREITs also asked for transition relief in that the changes of fair valued instruments should be allowed to run through capital, instead of earnings for a period of time, but then should be allowed to be treated as other fair valued instruments, running changes in value through earnings.

CREFC Policy & Strategy

- CREFC supports the following recommendations:
  - Ask the SEC and FASB for a delay in effective dates; and
  - Ask that the SEC conducts a comprehensive impact study prior to imposing any effective dates.

- CREFC is working with its members to determine whether to:
  - Support the regional bank proposal to bifurcate more certain and speculative losses (submitted to FASB in Nov 2018);
  - Support efforts to work with banking regulators to achieve a CECL-neutral approach to regulatory capital;
  - Support further exploration of the Fair Value Option; and
  - Compile a list of potential questions for clarification.

Additional Background and History

- **Baking in a Forward-Looking Methodology:** Under CECL, the process of assessing impairment and reserves will become mechanically very different than it is today. Covered firms will have to develop and integrate a forecasting framework underpinned by macroeconomic factors and data that then feed into an analysis of probabilities of default (PDs) and loss given default (LGD) alongside other data, most importantly performance histories. The move to a statistically-based framework is meant to reduce the influence of human judgment (and error) over time, as forecast performance is back-tested against actuals, theoretically facilitating the improvement of calibrations.

  Practically, however, there are many reasons why judgment will remain an essential part of the CECL framework across the financial services industry. New firms, new products, and even traditional products with long histories but too few credit events to be statistically relevant, may have to resort to proxy, data-driven analysis in order to meet the necessary data criteria for development of PDs and LGDs. This, of course, would involve setting assumptions that determine the calibration of stabilized insurance company loans, for instance, to CMBS data, which are readily available. This process may require several rounds of back-testing to meaningfully improve the quality of the forecasting and reduce error.

- **Questions about Correlations between Macroeconomics and Credit Performance:** Another aspect of CECL that raises questions for the industry is whether there is enough evidence to establish with certainty that macroeconomic indicators being fed into the models are the best predictors of credit performance. Several analyses have suggested otherwise, including the Bank Policy Institute's staff working paper, "Current Expected Credit Loss: Lessons from 2007-2009," in which the authors assert that had CECL been in place leading into the last crisis, bank lending would have contracted by an additional 9% in the downturn partly due to the lateness of the signaling traveling through the forecasting overlay. Because CECL is intended to avoid pro-cyclical timing, if it works as intended, CECL estimates should signal the need to reduce lending volume going into a contraction, and rebounding steadily coming out of the trough. The study also points out that macroeconomic indicators lose much of their predictive value during turns in the cycle and also as indicators extend out into the future.

- **Sizing the Estimated Quantitative Impact Depends on the Point in Time:** Because CECL requires ALLL reserves to be allocated for all loans and leases at their inception, the move from accrual accounting would seemingly by default require that reserves be added. Depending on a variety of factors and conditions, estimates by industry members and regulators suggest the required increase in reserves have reached as high as 30% or more.

  Moody's Analytics in its whitepaper "How Much Will CECL Impact Reserves for First Mortgage Portfolios?" estimates that reserves for residential first mortgages would increase by 100% under CECL. At the same time, the authors (as did Moody's Chief Economist Mark Zandi in House Financial Services Testimony on December 11, 2018) laid out the case for CECL's value arguing that standard would encourage less growth and more restraint in good times and, because reserves would already be higher going into a downturn, lending could be relatively more robust than it was under incurred loss accounting in a trough.

  Somewhat unexpectedly, as the industry implements CECL, some participants have observed instances in which their CECL models would direct them to release reserves for certain portfolios. Considering the current point in the cycle, it is counterintuitive to think that lenders should be releasing reserves, signaling that, depending on a number of challenges with CECL related to assumptions, macroeconomic data, and/or credit performance, the new methodology may actually be *pro*-cyclical and could cause greater (not lesser) contractions in lending going into a downturn.

CREFC and Industry Resources

mREIT coalition Letter to FASB, March 8, 2019

CREFC Comment Letter to SEC and FASB, March 8, 2019

Coalition Letter to SEC and FASB, March 5, 2019

Regional Bank Letter to FASB, Bifurcated Treatment

Bank Policy Institute's Whitepaper – "CECL: Lessons from 2007-2009"

Moody's Whitepaper - "How Much Will CECL Impact Reserves for First Mortgage Portfolios?"

Mark Zandi's Written Testimony to House Financial Services (December 11, 2018)

FASB, Other Regulatory, and Congressional Resources

FASB Rule (ASU No. 2016-13)

FASB Article: Understanding Costs and Benefits (of ASU: Credit Losses (Topic 326))

FASB Article: Benefits of the CECL Model and Vintage Disclosures

Federal Reserve FAQs

Federal Reserve, FDIC and OCC: Notice of Proposed Rulemaking "Implementation and Transition of the CECL Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations

FASB Board Meeting Materials, April 4, 2019

Letter to SEC from Blaine Luetkemeyer and Patrick McHenry, April 4, 2019

For further Information, see CREFC's Resource Center at: https://www.crefc.org/library