INSIGHT
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2020

CECL: Current Expected Credit Loss Accounting Standard

Significance of the regulation & the value of partnering with a trusted advisor

The financial crisis of 2007-2008 demonstrated that the Allowance for Loan and Lease Losses (ALLL) accounting standard does not allow for timely adjustment of reserve levels based on reasonable expectation of future conditions. Under this method, banks set aside their reserves on an incurred-loss basis. The reserves were only for loans showing signs of trouble and typically only for 12-month periods. The FASB reviewed the standard and replaced it with CECL. Under CECL banks and other firms are required to set aside reserves for their entire book of loans based on estimated losses for the full life of those loans.

While the new current expected credit loss (CECL) model will indeed impact financial institutions more heavily, non-financial services entities are also included in the scope of the standard. Trade receivables, certain lease receivables, held-to-maturity debt securities, and financial guarantees will all be affected by the new model — and these are just a few of the financial assets held by non-financial services companies that are subject to CECL.

"CECL Affects Most Industries, Not Just Financial Services Companies." *2019 : Articles : Resources : CLA (CliftonLarsonAllen)*, www.claconnect.com/resources/articles/2019/cecl-affects-most-industries-not-just-financial-services-companies.

Organizations Impacted by CECL

Banking Institutions

All banks will be impacted by CECL. The standard took effect for larger public banking institutions in January 2020. Q1 earnings for many of these banks reflected the extensive impact of COVID 19 on loan loss reserves, with further impact to be felt in Q2 and Q3. For smaller institutions, private banks and credit unions that will report in January 2023, it will be critical to start planning soon for this event.

Commercial Lenders

Covid-19 has exacerbated the challenges experienced by commercial lenders to manage the implications of CECL. Monitoring BAU while working with the new requirements of CECL will be difficult for lenders. The rule is expected to make lenders more prudent as they form expectations of losses and write down risky loans that are nonperforming, hence allowing banking regulators to ease requirements for lenders holding capital

Mortgage Lenders

Pricing for mortgages will drastically change once CECL is implemented, and new tools and models will need to be created for reporting.

Insurance Firms

While credit losses are usually low with insurance companies, collateral accounts will see a big difference moving forward. Implementing new reporting systems, developing credit risk modelling capabilities and new sources of current and historical data, will involve major efforts.

Retail Companies

Retailers who rely on in-house branded credit cards (Macy's, Kohl's etc.) may face a potential P&L hit as banks will end up making less credit available, and at a higher cost, because of the increased volatility the change introduces in their reserve calculations. This is because the amount banks set aside in their reserves determines how much, and at what cost, they make credit available, largely affecting the amount of credit-related income retail partners with in-house cards can expect to generate.

CECL: Key Provisions

1 **Scope**

The standard applies to a larger number of commonly held assets, as compared to the incurred loss models in legacy US GAAP. Hence, a wide range of companies will be subjected to CECL.

2 **Recognition**

The CECL model requires an entity to recognize upfront as an allowance its estimate of expected credit losses for financial assets as of the end of the reporting period.

3 **Measurement**

The CECL standard allows an entity to choose from a variety of measurement approaches such as DCF, project future principal, interest cash flows etc. as long as it is consistently applied.

Implementation Timeline by Institution Class

Large Public Financial Institutions	Smaller Reporting Companies (SRCs)	Private Banks, Credit Unions & All Other Entities
Larger public business entities that are Securities and Exchange Commission filers, excluding entities eligible to be smaller reporting companies as defined by the SEC (Ex: J.P. Morgan, Citi, Wells Fargo).	The SEC defines a small reporting company as one with public float of less than $250 million or annual revenue of less than $100 million and either no public float or a public float of less than $700 million.	CECL applies to smaller consumer entities such as credit unions, private banks and all other financial and non-financial companies (public & private sector).
January 2020	**January 2023**	**January 2023**

"Other." *SEC Emblem*, 9 Aug. 2018, www.sec.gov/corpfin/amendments-smaller-reporting-company-definition.

Loan Loss Calculation Methodologies

Below is a high-level overview of the various data points that enable a firm to measure their expected credit loss:

Historical Loss Informaton	Current Economic Condtions	Reasonable & Documented Forecasts	Reversion to Historical Loss Data	Expected Credit Loss
Loans with similar historical risk characteristics are pooled together	Historical loss data is adjusted based on current qualitative and quantitative economic factors to account for risk of the specifc loan segment	Organizations must determine reasonable forecasts and document their ideology to support these expected scenarios	Organizations are allowed to revert to historical loss data for the loan pools in situations where they are unable to make rational and well supported forecasts	The result of these calculations should provide the expected credit loss for the particular segment of loans over the remaining contractual period

The Financial Accounting Standards Board (FASB) has explicitly mentioned five loan loss calculation methodologies as appropriate for community lenders. Choosing a methodology that aligns best with a firm's business model is critical. The chart below from Riskspan highlights the strengths and weaknesses of each approach.

	Vintage	Loss Rate	PDxLGD	Roll Rate	DCF
Historical Calculations	Simple	Simple	Simple	Complex	Most Complex
Data Requirements	Limited	Moderate	Moderate	Robust	Most Robust
Use of Advanced Statistical Methods	Optional	No	No	No	Almost Always
Management Adjustments	Detail-level, Transparent	Top-level, Difficult to quantify	Top-level, Difficult to quantify	Detail-level, Lengthy	Less reliance on management adjustments
Insight & Control	Moderate	Low	Moderate	Moderate-High	High
Early Model Performance Indicators	Delayed	None	None	Yes	Yes
Loan-level Factors Considered	Segment-level forecasts can consider credit mix	Segment-level forecasts can consider credit mix)	No Segment-level forecasts can consider credit mix)	Beginning loan status	Various loan-level credit Characteristics
Macroeconomic Factors Considered	Optionally yes	No (address through Q-factors)	No (address through Q-factors)	Optionally yes	Transparently incorporated into the model

"Choosing a CECL Methodology." *RiskSpan*, 5 June 2020, riskspan.com/choosing-a-cecl-methodology/.

CECL Impact on Large Banks

- Non-payments and the most damaging economic effects of COVID-19 have not yet manifested in the loan portfolio as of the Q1 earnings results. The second quarter will provide more insight.
- The total credit losses reserve build grew 22% YoY with the largest portion coming from the consumer sector, mainly from credit cards.
- The overall loan loss reserve has nearly doubled (+47%) QoQ

Q1 Impact on J.P. Morgan Earnings

1Q20 Reserve build

Allowance for credit losses ($B)[1]

	12/31/2019	CECL adoption impact	1/1/2020	Reserve build	3/31/2020
Consumer					
Card	$5.7	$5.5	$11.2	$3.8	$15.0
Home Lending	1.9	0.1	2.0	0.3	2.3
Other Consumer[2]	0.7	0.3	1.0	0.3	1.3
Total Consumer	8.3	5.9	14.2	4.4	18.6
Wholesale[2]	6.0	(1.6)	4.4	2.4	6.8
Firmwide	$14.3	$4.3	$18.6	$6.8	$25.4

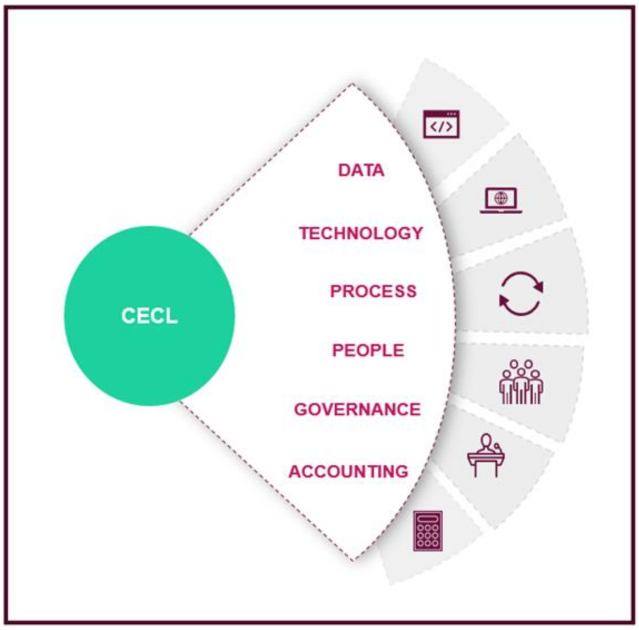
- Firmwide total credit reserves of $25.4B – net build of $6.8B driven by the impact of COVID-19
  - Consumer reserves of $18.6B – net build of $4.4B, predominantly in Card
  - Wholesale reserves of $6.8B – net build of $2.4B across multiple impacted sectors, including Oil & Gas

"First Quarter 2020 Amid COVID-19: Big Banks Report." *CFA Institute Market Integrity Insights*, 16 Apr. 2020, blogs.cfainstitute.org/marketintegrity/2020/04/15/first-quarter-2020-amid-covid-19-big-banks-report/.

Exploring Synergies and Differences with other Regulations

Firms adopting the CECL standard must ensure that their policies and implementation strategies align well with their existing protocol to adhere to other regulatory requirements. This increases the complexity for potential clients and strengthens the need for partnering with a trusted advisor to navigate them through the process. We have identified three that regulations that are directly impacted by CECL, as depicted below.

Key Questions for Firms Implementing CECL



Description

1. **DATA**
   Do you have access to the data you need to make reasonable and supportable economic forecasts?

2. **TECHNOLOGY**
   Can your modeling platform support additional data attributes and handle the necessary level of complexity, and is it flexible enough to respond to changes in external data or assumptions? What additional enabling technology might you need?

3. **PROCESS**
   What organizational processes are impacted by CECL implementation?

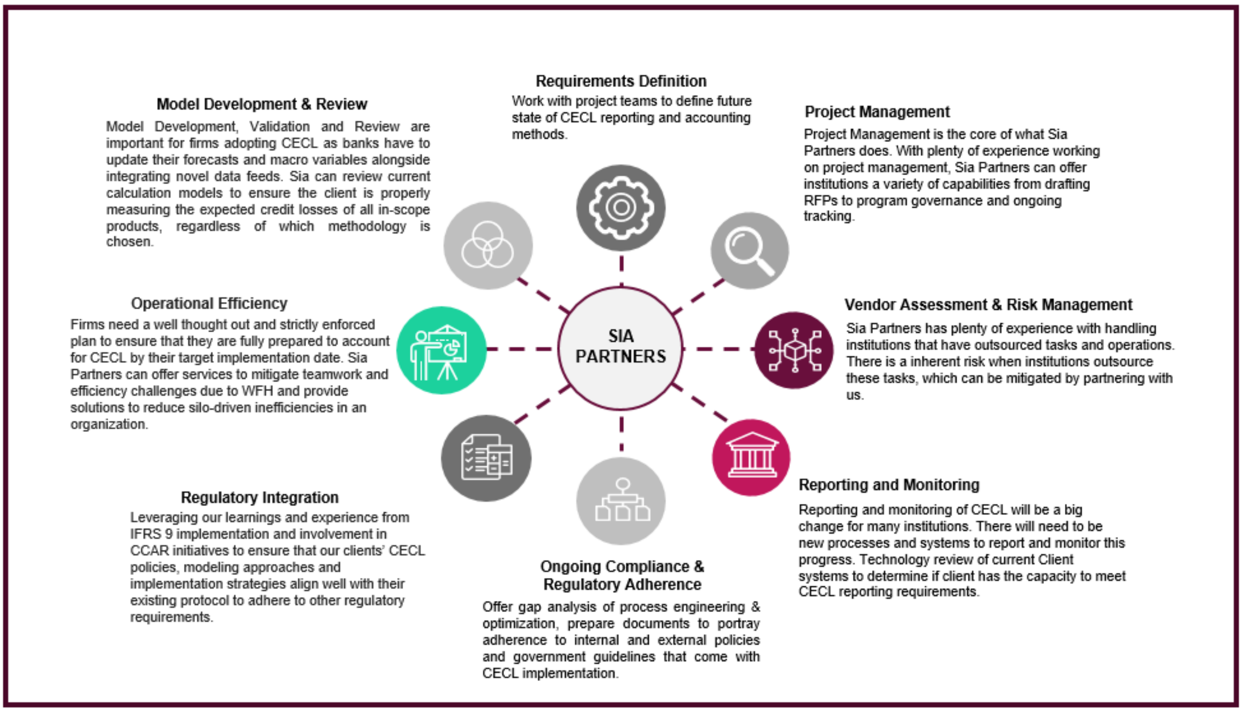
4. **PEOPLE**
   Do you have enough resources to support CECL execution? How are you breaking down silos to encourage collaboration?

5. **GOVERNANCE**
   Does your CECL oversight committee include both audit and risk professionals? Have you stepped up oversight of internal controls over financial reporting?

6. **ACCOUNTING**
   Which CECL accounting methodology is right for your business? What is the financial statement impact?

"Getting Started." *BDO*, www.bdo.com/insights/industries/fisf/cecl-implementation-guide-(1)/%E2%80%8Bgetting-started.

Sia Partners CECL Service Offering



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