With the adoption deadline nearing, specificity remains elusive as entities continue to build and refine their processes and controls.
<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Introduction</td>
</tr>
<tr>
<td>2</td>
<td>The expected impact</td>
</tr>
<tr>
<td>3</td>
<td>Accounting</td>
</tr>
<tr>
<td>4</td>
<td>Modeling</td>
</tr>
<tr>
<td>5</td>
<td>Qualitative overlays</td>
</tr>
<tr>
<td>6</td>
<td>Forecasting</td>
</tr>
<tr>
<td>7</td>
<td>Business impacts including data and controls</td>
</tr>
<tr>
<td>8</td>
<td>Conclusion</td>
</tr>
</tbody>
</table>
Introduction

Recently, many financial statement preparers received news that it is possible they will receive more time to comply with new standards around current expected credit losses—CECL. Still, entities are expending significant effort to prepare to implement the new standards, before they go into effect between January 2020 and January 2023, depending on the size and nature of the institution.

As we did last year, KPMG LLP has surveyed a number of entities in the commercial and consumer banking organization space, as well as other distinct financial services sectors, to determine the progress these entities are making in preparing for the new CECL requirements.

Two key themes emerged from this year’s survey:

— Entities have made progress on implementation but still lack specific CECL impact insight or analysis at a granular level.
  - Survey respondents have clearly made many key CECL decisions over the last year.
  - However, the progress has been insufficient to lead financial statement preparers to have a comfortable idea of what their CECL impact might be. This uncertainty is evidenced by the fact that few respondents were able to provide their CECL impacts at a product level.
  - In part, this might be because build of certain key components (for example, the design of a qualitative framework or the implementation of SOX controls for CECL) is not complete or is being refined following internal reviews or initial testing.
— A significant number of entities still have uncertainties relating to accounting concepts and modeling approaches.
  - Although these unresolved issues are not insurmountable, it is clear that significant work remains and that some of these concepts and approaches, while unresolved, will cause delays in the implementation project.
  - On the one hand, most respondents are optimistic that they will be able to wrap up their implementation in time to do one or more CECL parallel runs (or dress rehearsals) and potentially even have SAB 74 disclosures with a point estimate or range by Q3 2019. On the other hand, it is clear that many entities are significantly delayed compared to their original plans and we note that in past surveys, many respondents had planned to spend all of 2019 in parallel run.
  - Auditors are beginning to evaluate the CECL process, reading documentation around modeling and accounting, and asking questions designed to identify areas of weakness. This will accelerate as the transition date nears.

The transition from the Allowance for Loan and Lease Losses under the current incurred loss model to an allowance for credit losses under CECL will present a number of challenges for institutions with financial assets measured at amortized cost, including U.S.-based banks, foreign banks with U.S. reporting obligations, insurance institutions, and nonfinancial institutions with an active treasury or financing group.

1The FASB has released an Exposure Draft on August 15, 2019. This proposed Update would grant private companies, not-for-profit organizations, and certain small public companies additional time to implement FASB standards on current expected credit losses (CECL), leases, and hedging.
2CECL Survey 2018: Financial institutions feeling the crunch in the countdown to CECL
3SEC Staff Accounting Bulletin 74 sets out the disclosure requirements for SEC registrants relating to new accounting standards. The SEC staff has stated its expectations that SAB 74 disclosures for CECL should become more detailed as the effective date approaches in order to give readers of financial statements a clear picture of implementation progress and expected impact.
The CECL accounting change is a significant shift from an incurred losses model to an expected lifetime credit loss model. It affects the credit risk organization, including credit and financial data capture, including related systems, financial reporting, analysis, and internal control.

This publication examines the results of our survey and aims to provide insights and analysis as larger SEC filers enter the final leg of the CECL implementation.

### In which of the following sectors of financial services does your organization fall?

#### By FS sector

<table>
<thead>
<tr>
<th>Sector</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking – Commercial</td>
<td>67%</td>
</tr>
<tr>
<td>Banking – Consumer</td>
<td>58%</td>
</tr>
<tr>
<td>Banking – Investment</td>
<td>23%</td>
</tr>
<tr>
<td>Insurance – Life</td>
<td>12%</td>
</tr>
<tr>
<td>Insurance – Non-life</td>
<td>4%</td>
</tr>
<tr>
<td>Reinsurance</td>
<td>2%</td>
</tr>
<tr>
<td>Specialty Finance – Auto</td>
<td>9%</td>
</tr>
<tr>
<td>Specialty Finance – Industrial</td>
<td>9%</td>
</tr>
<tr>
<td>Specialty Finance – Other Consumer</td>
<td>5%</td>
</tr>
<tr>
<td>Specialty Finance – Other Consumer</td>
<td>5%</td>
</tr>
<tr>
<td>Other</td>
<td>9%</td>
</tr>
</tbody>
</table>

**Specialty Finance – Other Consumer includes:**
- Healthcare and Office equipment finance
- High net worth wealth management
- Solar lending

**Other includes:**
- Broker dealer in securities
- Custody
- Food and agriculture lending
- Several lessor entities
- U.S. Broker Dealer

#### Methodology

Respondents were primarily operating in the commercial and consumer banking space; however, other distinct financial services sectors are represented in this survey. Life and non-life insurance providers are also found among the survey respondents, as well as specialty finance entities in auto, industrial, and other specialized sectors, such as healthcare-equipment finance, high net worth wealth management, and renewable energy technology. A number of broker-dealers and lease financing entities also participated in this year’s survey. The total assets of respondents provided an even spread of entities from small, mid-sized and large companies, and those over $200 billion. SEC filers accounted for 72% of respondents. 21% of the individuals who submitted the survey self-identified themselves as C-level executives.
The single most discussed question relating to CECL is what the dollar (or percentage) impact of the new standard will be on the allowance for credit losses and on capital once finally adopted. Last year, it was clear that a very significant portion of entities believed that CECL would either have no effect or would increase the allowance for credit losses by up to 30%. With the CECL implementation date approaching, it is clear that entities are becoming more aware that CECL will have a quantitative impact. From the 2019 responses, significantly fewer (2019: 12%, 2018: 33%) believe that CECL will have no impact on their allowance for credit losses.

One noteworthy result from the 2019 survey was the questions that could not yet be answered. We asked respondents, if they could, to provide the impact of CECL at a product level, to show, for example, the change to the allowance for credit losses expected for commercial revolving loans or retail mortgages as a result of CECL.

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We also asked respondents to estimate this impact under different economic scenarios. Disappointingly, there were too few responses to this question for the answers to be statistically reliable. Also, it may be a red flag for some readers, that as late as June 2019, entities are still not confident in disclosing the CECL expected impacts at a portfolio or product-type level, even merely for the purpose of sharing that information anonymously in our survey. Our expectation is that most entities will definitely reach this level of insight during the second half of 2019, but we would note that in 2018 most entities had expected to spend all of 2019 in parallel run for CECL. This indicates that a very significant portion of entities are clearly behind schedule in their CECL project plans.

These insights are highly sought after because the only way to truly compare with peer entities is to understand the product-level impacts. That’s because the overall CECL increase or decrease relative to today disguises the fact that some products may drive significant increases while other products will drive significant decreases. The aggregate of these movements can hide some significant changes resulting from the adoption of CECL, and (potentially) drive meaningful differences in the CECL impact between entities with different balance sheet compositions (e.g. 100% commercial loans vs. 100% credit cards). On the other end of the spectrum are products such as demand loans (which for CECL modeling purposes may only have a life of one day if they can be called by the lender for repayment within one day); revolving lines of credit, which contractually may have shorter remaining lives than the Loss Emergence Period used today under current U.S. GAAP; or products with one to two year maturities (the nature of which could suppress loss estimates in a benign environment). Furthermore, entities that have used different reasonable and supportable period lengths, different forecast methodologies, different historical data, etc. will all cause variability within the results that needs to be taken into account in any peer comparison. One thing is certain—all entities will need to be able to produce an estimate of expected credit losses under CECL at a product level in order to be ready to comply with the standard on the date of adoption and, at this stage, many are not in a position to do this yet.

**Do you expect an increase or decrease with respect to your existing allowance for credit losses when CECL becomes effective?**

*By asset size*
One theme is clear from the survey responses: Entities still lack specificity over the impacts of CECL on accounting and the business as a whole. While entities have made progress broadly in the CECL implementation, a significant number of them face specific areas that remain unaddressed or unresolved. These unaddressed issues may also be a factor in the delays in the parallel runs being observed, as well as the inability of many entities at this stage to quantify the impact of CECL at an asset-specific level.

**How well is executive management (CEO/CFO) aware of the potential for volatility in the CECL estimate?**

**By FS sector**

- **Extremely well-aware of all modeled outcomes produced under stressed scenarios**
  - Total (n = 55): 26%
  - Banking (n = 46): 24%
  - Specialty Finance (n = 7*): 13%
  - Insurance (n = 8*): 26%

- **Aware of risk of volatility but not of company-specific results (or results not yet available)**
  - Total (n = 55): 73%
  - Banking (n = 46): 70%
  - Specialty Finance (n = 7*): 88%
  - Other (n = 5*): 100%

- **Not yet fully aware of volatility as a risk of CECL**
  - Total (n = 55): 20%
  - Banking (n = 46): 4%
  - Specialty Finance (n = 7*): 4%
  - Other (n = 5*): 0%

Among SEC filers, 80% of respondents noted that C-level executives still do not have specific or detailed results of the CECL impact, likely driven either by modeled results still not being available yet or the modeled results available need to be verified as reliable because they differ from management’s expectations going into the process.
While the survey shows that progress has been made since 2018, a surprising amount of uncertainty remains, even with the effective date mere months away. This uncertainty is illustrated by the number of significant accounting decisions that remain open. While the percentage of respondents reporting unresolved issues has fallen significantly, that 41% of SEC filers still have not determined the length of the reasonable and supportable period or that 46% have not defined the reasonable expectation of a troubled debt restructuring is a worrying indicator of delay in many CECL projects.

**Of the following important CECL accounting decisions, which decisions are still currently open?**

**By SEC filer**

<table>
<thead>
<tr>
<th>Decision</th>
<th>Total (n = 50)</th>
<th>SEC filer (n = 37)</th>
<th>Non-SEC filer (n = 13*)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Defining financial assets with zero expected credit losses</td>
<td>22%</td>
<td>16%</td>
<td>38%</td>
</tr>
<tr>
<td>Whether to maintain the pools of purchased credit impaired loans on transition to CECL or eliminate those PCI pools and apply CECL pooling guidance to those assets instead</td>
<td>16%</td>
<td>14%</td>
<td>23%</td>
</tr>
<tr>
<td>Determining how to pool financial assets based on similar risk characteristics</td>
<td>8%</td>
<td>12%</td>
<td>23%</td>
</tr>
<tr>
<td>Other</td>
<td>0%</td>
<td>8%</td>
<td>11%</td>
</tr>
<tr>
<td>Not applicable/Not sure</td>
<td>18%</td>
<td>11%</td>
<td>38%</td>
</tr>
</tbody>
</table>

Credit risk models are heavily dependent on resolving many of these open issues. This may be a partial explanation for the observed delays in the CECL parallel runs of many respondents. It may also be an indicator that some entities have decided to perform dress rehearsals and parallel runs with these issues unresolved, calling into question the value of such parallel runs and whether the objective of the exercise was achieved.

Given the level of judgment required to implement CECL, these results suggest that many entities have either significant gaps in their documentation of their conclusions on CECL accounting topics, or worse, that the documentation required to provide transparency and comfort to auditors and regulators does not yet exist. There is an expectation that entities will be able to provide comprehensive documentation of their specific accounting decisions and judgments that drive the CECL measurement and, at this point, there appears to be many entities who are not at this stage of their project yet.
Aside from domestic retail credit cards, for products that have an undrawn component, do you have contractual language allowing you to unconditionally cancel the undrawn line of credit for any of the following?

By FS sector

In 2018’s survey, we found that many entities had yet to evaluate whether they had undrawn credit facilities that could be unconditionally cancelled by the lender. This is important because, under CECL, a credit facility’s contractual term includes only periods not subject to a lender call option. This year’s survey shows that many entities have come to grips with this topic, identifying products, where contracts permitted the undrawn credit facility to be cancelled for no reason, other than U.S. retail credit cards (there appears to be industry consensus that U.S. retail credit cards are unconditionally cancellable by the issuer). Given that this is extremely significant to the measurement of estimate of expected credit losses under CECL, it is positive to see entities have performed this scoping exercise.
How will you transition your existing PCI assets to PCD?

By FS sector

One of the most complicated and debated topics in CECL is that of purchased credit deteriorated assets, and a significant decision needs to be made by entities that hold purchased credit impaired assets today. That decision relates to how to transition the existing accounting for those assets to CECL, with the FASB permitting entities to keep their existing asset pools intact on transition to CECL as an election. Our survey found that, for those that have pools of purchased credit impaired assets today, only 10% were planning to retain their existing purchased credit impaired asset pools for CECL measurement. Also of interest: 33% of SEC filer respondents who have purchased credit impaired asset pools today are unsure at this late stage how they will transition these assets to CECL.
The FASB amended CECL to allow entities to elect fair value measurement for financial assets measured at amortized cost (other than held-to-maturity debt securities) from the transition date, and thus avoid CECL measurement for those assets. Our survey indicates that a minority of entities are considering using the fair value option at all for any assets - reverse repurchase agreements noted as being a potential asset class where the fair value option was attractive. Others considering the fair value option were either looking at applying it to specific individual assets or to align US GAAP accounting with IFRS reporting for one dual-filer.
One topic that has arisen from recent FASB deliberations on CECL, the concept of negative allowances, has been addressed by many entities. Among respondents, 49% have recognized that negative allowances may arise on the balance sheet as a result of considering expected recoveries associated with historical partial or full charge-offs. While it is positive that these entities are monitoring changes and clarifications being made to CECL, this data also suggests that half of respondents are either unaware that negative allowances may arise or have not yet addressed this topic in their implementation.
A topic that has caused some concern is the potential for diversity between the requirements of the regulators and the requirements of U.S. GAAP as it relates to CECL. A specific example of this is the Office of the Comptroller of the Currency’s (OCC) Bank Accounting Advisory Series (BAAS) guide requiring banks to use the fair value of collateral as the basis for measuring expected credit losses when a loan is collateral-dependent regardless of the likelihood of foreclosure, whereas that is an election in the U.S. GAAP guidance under CECL when foreclosure is not probable. 31% of SEC filers noted they would use the OCC’s guidance, 23% of SEC filers said they would use the U.S. GAAP guidance, while 18% were still uncertain. This may be an area where a lack of awareness of the issue may be driving the lack of alignment in the banking sector.
By FS sector

![Diagram showing the distribution of time between when anticipated a TDR and when a TDR is executed by FS sector.]

CECL requires entities to evaluate whether they reasonably expect troubled debt restructurings to occur for individual financial assets, and we asked this year what was the expected average difference between the time an expected troubled debt restructuring is identified and when the troubled debt restructuring is executed for both commercial and consumer products. In line with our expectations, commercial products tended to have a larger length of time between the two points. Among survey respondents with commercial products, 27% selected that there was no difference between the date an expected troubled debt restructuring is identified and when it is recorded as a troubled debt restructuring. For those with consumer products, 18% said there was no difference. There may be a number of explanations behind these responses, from entities that automatically perform a debt restructuring when certain triggers are met or entities that may simply lack the data or ability to identify when a troubled debt restructuring is reasonably expected prior to the date of restructuring. Those that answered zero may need to consider if their documentation around this topic is sufficient to satisfy an auditor that reasonably expected troubled debt restructurings have been adequately reflected in the CECL measurement.
Uncertainty around key accounting decisions has clearly affected the project plans of many entities, with 51% of SEC filers saying their parallel run has been delayed at least two months. In 2018, 49% of respondents had intended to perform parallel runs for 12 months in 2019 – only 41% of SEC filers in the 2019 survey indicated that they were planning four or more parallel runs. Another interesting change, year on year, is that 20% of respondents in 2018 indicated they would have two quarters of parallel run. In 2019’s survey, 31% of SEC filers say they will have two parallel runs. This difference may be an indication that the 10% of respondents who will no longer achieve four parallel runs are still planning on achieving two parallel runs. The answers also indicate that the respondents who delayed their parallel runs have had to either compress their parallel run periods into a shorter timeframe or to cancel one or more of the planned parallel runs. Interestingly, 8% of SEC filers are planning on going live with CECL without having performed any parallel run. This may be an early warning sign that the industry, as a whole, could have difficulty meeting the implementation timeline prior to 2020.

The most significant disclosure-related finding of our survey was that 61% of SEC filers have yet to consider the content of the CECL disclosures in the financial statements that would aid readers, specifically analysts and investors, in understanding CECL.

This indicates that entities have not created their plan to address the CECL disclosures and more specifically how they will satisfy the demands of readers to understand how CECL was measured. One of the most common themes that investors and analysts bring up is how individual entities will provide sufficient information to allow readers to perform a comparability exercise themselves, given how CECL does not lend itself to easy comparability between peer entities.

This response may be understandable, given the amount remaining to be completed as seen in other responses. But C-level executives should be concerned that how and what entities will communicate to the readers of their financial statements related to what is the most significant estimate on many banks and financial institutions’ balance sheets is still uncertain.
Entities are feeling pressure to provide an indication of the impact of CECL prior to adoption, and SAB 74 disclosures are being watched closely for this quantitative disclosure. A small number of very large SEC filers in our survey had already disclosed the expected impact of CECL with the release of quarter two 10Qs. 51% of SEC filers indicated they would disclose the impact of CECL in SEC filings submitted in the third quarter of 2019. And 15% of respondents admitted they do not know when they will disclose the expected impact of CECL. These results are concerning, indicating that some SEC filers may not have a good sense as to the impact of CECL before the transition date.

Our 2019 survey shows that progress has been made on all accounting-related areas relevant to CECL, but there is still an uncomfortable amount of open items for many. For C-level executives, it may be a productive exercise to examine what items are still unresolved and assess their level of criticality.
In our 2018 survey results, we noted that “certain modeling decisions must be made prior to commencement of parallel run activities, while other decisions may be influenced by early parallel run results and modified accordingly.” We further identified that there were “early warning signs that some institutions may end up with an abbreviated parallel run period.”

Our 2019 survey shows that significant progress has been made … but is it too little, too late?

Although significant progress has been made, approximately 42% of respondents have acknowledged some level of delay in their parallel runs (approximately 30%, by about one quarter; 12% by two quarters or more). Further, only approximately 31% of respondents plan to complete four (or more) quarters of parallel runs. Clearly, the delays in being able to make decisions in prior years (and, potentially, in the early half of this year) has affected the ability of companies to begin the process of making parallel runs.

There is no indication at this time that preparers will not be ready by the go-live dates. However, the benefit of a long parallel run and the learning that may come from that may have been lost for many.

**What type of modeling approach have you selected for each of the following major asset classes (e.g., such as a loss-rate method, a roll-rate method, a migration method, a pool/vintage-level econometric model, probability-of-default method, aging schedule, logistic regression or survival/hazard model, etc.):**

**Commercial products**

![Diagram showing the selection of modeling approaches for different asset classes](image-url)
Model selection

One of the key areas of progress is model selection. 79% were able to identify the type of model they intend to use, by product. The most common type of model, regardless of product type, was a PD/LGD model. As shown in the following tables, PD/LGD models are the most highly utilized model solution across all sizes of preparers. In contrast, historical loss rates models are common only among smaller entities while larger entities are more likely to utilize other alternatives (like a transition matrix).

Loss driver variable selection

Another key area of progress identified through the 2019 survey was the selection of loss drivers. The survey found that 47 of 57 respondents were able to identify the loss drivers they will utilize to estimate CECL reserves across commercial loan pools, while 45 of 57 were able to identify the loss drivers they intend to utilize for consumer loan pools.

How many individual economic variables are utilized in your CECL estimates for:

Commercial products

For commercial portfolios, the most common variables identified include unemployment, GDP, interest rates and the Commercial Property Price Index (CPPI). Several interesting write-in responses were included among the 30% of respondents who identified an “other” variable. These included crude oil futures prices, stock market volatility, consumer confidence, and additional real estate price indices.
For consumer portfolios, the most common variables identified include unemployment (both changes in unemployment and absolute levels of unemployment), the Housing Price Index (HPI), GDP, and interest rates. Several interesting write-in responses were included among the 22% of respondents who identified an “other” variable. These included household income, disposable income, Manheim index (used care resale values), new vehicle sales, and employment growth.

Another interesting fact identified in our 2019 survey is that many preparers are utilizing far more economic variables to refine their CECL estimates than we would have anticipated.
How many individual economic variables are utilized in your CECL estimates for:

### Consumer products

<table>
<thead>
<tr>
<th>Total</th>
<th>Mean</th>
<th>n</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial products</td>
<td>64%</td>
<td>6.3</td>
</tr>
<tr>
<td>Consumer products</td>
<td>59%</td>
<td>5.5</td>
</tr>
</tbody>
</table>

Among 28 respondents, only one said that they would utilize a single variable for commercial products, with another four respondents indicating the use of two variables. Interestingly, more than 25% of respondents indicated they were using 10 or more variables.

Among 27 respondents, only two said that they would utilize a single variable for consumer products, with another six respondents indicating the use of two variables. As with the results for commercial products, more than 25% of respondents indicated they were using 10 or more variables.

### Use of multiple scenarios

One area where we have identified an evolution of thought is in the use of multiple scenarios. While historically, only the largest banks intended to use multiple scenarios, our 2019 survey indicates that smaller banks are shifting towards the use of multiple scenarios or are at least still in the process of considering this option.

*We excluded a small number of responses in both commercial and consumer results for this question where the answer provided was greater than 50 variables. We believe that these responses related to variables considered rather than utilized.*
Have you determined if you will use multiple scenarios for economic forecasting?

By asset size

As the chart above shows, there may be some diversity in practice in the use of multiple scenarios, especially based on asset size. While none of our 12 respondents that were over $200 billion in asset size indicated they would not use multiple scenarios for any portfolio, 4 of our 10 respondents in the less than $10 billion asset size category indicated they would not be using multiple scenarios. However, it seems many smaller banks are still in the process of considering this option as 5 of the 10 respondents indicated they are either “still considering” or “not sure.”

Among 19 respondents that provided additional details about the use of multiple scenarios, 11 indicated that they would be using three scenarios; three indicated the use of four or more scenarios, and three indicated the use of a base scenario with other scenarios contemplated through a qualitative factor adjustment.
If you plan to use more than a single scenario, how many scenarios will your entity use for economic forecasting?

By FS sector

The 2019 survey has revealed one area for concern, in particular for smaller institutions. Our survey results have indicated that 60% of smaller entities (<$10 billion) and 32% of mid-sized entities ($10 billion to $50 billion) have segmentation (pooling), which does not utilize a borrower credit risk factor (such as FICO scores or credit risk ratings). In contrast, less than 10% of entities larger than $50 billion replied that they were not using such factors for segmentation.

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Our client experience indicates that this phenomenon is a by-product of using publically available industry/proxy data that is not available at a loan level (such as call report data). Effectively, in solving one problem (a lack of historical data), a new problem was created (a lack of loan-level data). We note that this is not an impossible hurdle, nor an error unto itself. However, it will create challenges in the design and execution of the qualitative framework as credit risk factors must be taken into account somewhere within the overall CECL estimation process.

It is very clear that a significant amount of progress on the modeling component of CECL has been made in the last year. The 2019 survey showed far fewer “not sure” responses than the prior year’s survey, and respondents were generally able to answer some fairly detailed questions with regard to the design of the quantitative modeling process.

However, those with greater resources are clearly further along in the design and implementation phase of this process. While larger institutions seem to be closer to ready, smaller institutions are still more likely to be debating such topics as the use of multiple scenarios. Further, smaller institutions may have additional delays as they struggle finding data and building a qualitative framework which addresses the lack of borrower credit risk characteristics in segmentation.
Over at least the past decade (if not longer), preparers have generally utilized qualitative adjustments to address a one-sided risk – that the quantitative estimate was lower than loss experience might prove to be. The requirements of GAAP’s incurred loss model (which is being replaced by CECL) were not aligned with the length of the period remaining until the maturity of the asset – the primary requirement was that the loss event (or loss-triggering event) had occurred by the balance sheet date. This lack of specificity, combined with the pressures experienced by many preparers operating in regulated industries concerned with “safety and soundness” led to an interesting phenomenon – preparers utilizing significant qualitative adjustments (also commonly referred to as Q-factors) to align allowance estimates with conservative expectations. Although perhaps not aligned with economic forecasts of future conditions, these estimates were not inconsistent with the incurred loss model.

However, the requirements of CECL create somewhat of a “paradigm shift” – GAAP under CECL is very specific that reasonable and supportable forecasts of future conditions must be considered. Further, the need for a triggering event (and the resultant concept of a loss emergence period) has been replaced with a lifetime loss concept wherein future loss is predicted from the day a loan (or commitment) is extended to a borrower. These changes to many of the key concepts have a knock-on impact on the suitability of those qualitative methodologies previously used. Further exacerbating the difficulty of transition, changes in modeling will also drive changes to the qualitative frameworks in order to ensure that relevant risk factors are addressed without redundancy. Therefore, preparers are utilizing more sophisticated modeling techniques that may eliminate the need for the qualitative adjustments they used under the current incurred loss framework. For these reasons, it is widely anticipated that there will be significant changes to an entity’s qualitative process even though factors for which an entity made qualitative adjustments under the incurred loss model generally are also considerations under CECL.
Our 2019 survey results clearly show that smaller institutions are behind their larger counterparts in terms of modeling progress and parallel runs. Knowing that, it is not surprising to see that larger institutions are more likely to have already completed their design of the qualitative framework they expect to utilize when estimating credit losses under CECL.

With that said, more than 42% of larger institutions responding to our survey indicated that they still have not designed a qualitative framework for CECL (this ranged to as high as 70% of smaller institutions - defined as less than $10 billion total assets). Delays in modeling progress have clearly affected preparers’ progress in constructing a qualitative framework.

**Have you designed a qualitative framework expected to be used in your CECL estimate?**

**By asset size**

<table>
<thead>
<tr>
<th>By Asset Size</th>
<th>Total (n = 57)</th>
<th>Less than $10B (n = 10*)</th>
<th>$10B to $49.9B (n = 21)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yes</td>
<td>46%</td>
<td>58%</td>
<td>70%</td>
</tr>
<tr>
<td>No</td>
<td>54%</td>
<td>42%</td>
<td>30%</td>
</tr>
</tbody>
</table>

*Small base size. Findings directional only

**Magnitude of the qualitative estimate**

A common question among preparers is, “Do you expect the qualitative adjustments to decrease as we move from the incurred loss model to CECL?” This question is so common because many institutions are moving from less sophisticated modeling techniques that do not capture a significant part of the overall risks to much more sophisticated techniques, including regression to macro-economic data. In doing so, many of the risks that previously had to be accounted for through a qualitative adjustment may now already be contemplated in the quantitative modeling methodology, thus rendering further adjustment in the qualitative framework unnecessary.
How does the CECL qualitative adjustment compare to the qualitative under incurred loss as a percentage of the nonqualitative reserve:

By FS sector

<table>
<thead>
<tr>
<th>How does the CECL qualitative adjustment compare to the qualitative under incurred loss as a percentage of the nonqualitative reserve:</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Significantly less, regardless of economic conditions as such conditions are already contemplated in the quantitative approach</td>
<td>36%</td>
</tr>
<tr>
<td>Comparable, regardless of economic conditions</td>
<td>24%</td>
</tr>
<tr>
<td>Greater, regardless of economic conditions</td>
<td>4%</td>
</tr>
<tr>
<td>Not applicable/ Not Sure</td>
<td>20%</td>
</tr>
</tbody>
</table>

Our 2019 survey results generally demonstrate consistency with the speculation that future qualitative adjustments will represent a smaller portion of the total allowance estimate. Only 1 of 24 respondents indicated an expectation that future qualitative adjustments would be expected to be larger than under the current methodology.

Of note, however, while smaller and mid-sized institutions generally were more likely to indicate future qualitative adjustments would be smaller than under the current methodology, the largest institutions (those with over $200 billion in assets) indicated an expectation that qualitative adjustments would likely be similar to current levels. It is reasonable to think that this is likely because institutions of this size already use reasonably sophisticated modeling under the incurred loss model (that is similar in sophistication to what will be used under CECL).

However, it is also interesting to note that the chart above only provides the responses of those 25 respondents who indicated that they do have a qualitative framework designed to prepare the CECL estimate. Yet, almost a third (including over half of large/200 billion+ respondents) indicated that they are “not sure” whether qualitative adjustments will be greater or lesser under CECL. It would seem that this indicates many are still suffering from a lack of sufficient parallel run to inform their expectations about the realities of CECL—even those who are a little “ahead of the pack” and have been able to think through the design of a qualitative framework. For those who are behind, this should serve as a notice of the difficulty and extended timeframe required to truly gather meaningful information about what to expect under CECL, including the impacts of assumptions made. Further, it may give an indication that “industry” level information about CECLs transition impact should not be expected to be available by the time of Q3 disclosures.
Negative qualitative adjustments

As financial statement preparers move to more sophisticated models, another common observation about potential changes in the qualitative frameworks utilized in the CECL estimate is that negative adjustments (adjustments which decrease the estimate) may, from time to time, become necessary. Room for such adjustments currently exists in only a small fraction of preparers’ qualitative frameworks. However, many have noted that the specific requirements of CECL (most notably, the requirement to take into account a specific forecast of loss conditions) could drive many to utilize a negative adjustment to ensure alignment with the new standard.

Will your qualitative framework allow for a negative qualitative adjustment:

By asset size

<table>
<thead>
<tr>
<th>Asset Size</th>
<th>Yes, based on historical backtesting, under similar conditions to where the model is expected to overpredict losses</th>
<th>Yes</th>
<th>No, never</th>
<th>Not applicable/Not Sure</th>
</tr>
</thead>
<tbody>
<tr>
<td>$10B to $49.9B (n = 10)</td>
<td>38%</td>
<td>33%</td>
<td>40%</td>
<td>33%</td>
</tr>
<tr>
<td>Less than $10B (n = 3)</td>
<td>33%</td>
<td>33%</td>
<td>75%</td>
<td>33%</td>
</tr>
<tr>
<td>$50B to $200B (n = 6)</td>
<td>30%</td>
<td>15%</td>
<td>27%</td>
<td>33%</td>
</tr>
<tr>
<td>Over $200B (n = 7)</td>
<td>27%</td>
<td>10%</td>
<td>15%</td>
<td>33%</td>
</tr>
<tr>
<td>Total (n = 26)</td>
<td>33%</td>
<td>20%</td>
<td>50%</td>
<td>33%</td>
</tr>
</tbody>
</table>

Based on the results of our 2019 survey, over half of respondents will likely permit some form of negative adjustment. For 38% of respondents, those adjustments are calibrated as a response to the backtesting of models – this helps create additional precision without the undue burden of building a model which is equally precise in any economic environment. Another 19% of respondents simply articulated that their frameworks would allow for a negative qualitative. Notably, only 4 of 26 respondents identified that their frameworks would not allow for such an adjustment.

Concepts captured in the qualitative estimate

The CECL model requires an entity to adjust historical loss information for differences in current conditions and reasonable and supportable forecasts and for asset-specific risk characteristics. It provides examples of factors an entity may consider, and those factors include the type of concepts typically captured in qualitative frameworks under the incurred loss model.
This leads to a bit of continuity in the sense that many of the same risks must continue to be addressed. However, due to changes in the quantitative process as well as the requirement to reflect the effect of reasonable and supportable forecasts, certain changes have emerged as being common additional considerations.

**Does your qualitative framework include any of the following elements?**

**By asset size**

<table>
<thead>
<tr>
<th>Adjustment</th>
<th>Not applicable/Not Sure</th>
</tr>
</thead>
<tbody>
<tr>
<td>Economic conditions</td>
<td>0%</td>
</tr>
<tr>
<td>Credit quality indicators</td>
<td>8%</td>
</tr>
<tr>
<td>Additional probability events</td>
<td>11%</td>
</tr>
<tr>
<td>Total (n = 24)</td>
<td>Overall (n = 24)</td>
</tr>
<tr>
<td>Less than $10B (n = 3*)</td>
<td>$10B to $49.9B (n = 9*)</td>
</tr>
<tr>
<td>$50B to $200B (n = 6*)</td>
<td>Over $200B (n = 6*)</td>
</tr>
</tbody>
</table>

It is interesting that we observe very high consistency in the responses to this question, including across institutions of varying asset size. Notably, almost 80% of respondents intend to have consideration in their qualitative framework for both economic conditions and credit quality indicators not contemplated in the quantitative modeling process. Additionally, more than 50% of respondents intend to have a potential adjustment for additional probability events (multiple scenarios, tail risk, etc.).

Of note, a number of respondents indicated they would consider credit quality indicators when they also articulated that credit risk indicators would be contemplated in their quantitative segmentation. This could indicate a consideration of additional credit indicators or consideration of such indicators at a more granular level (e.g., an entity whose model contemplates FICO bands may qualitatively address how the portfolio may shift within those bands).

Overall, the responses to this question indicate that preparers are pretty well-aligned in terms of their expectations about specific risks the qualitative framework might need to cover.

There is no doubt that the change from an incurred loss method to CECL will have a significant impact on the design of qualitative methodologies. The 2019 survey results seem to indicate that many are struggling with this aspect of implementation - in part, it may be driven simply by the fact that the qualitative estimate is inherently a response to the weaknesses and limitations of the quantitative process and there have been delays in completing the design of those quantitative processes. However, the unique requirements of CECL clearly present additional challenges – preparers will need to ensure that they allow time in their implementation timeline to address these nuances and not underestimate the effort required to design a CECL qualitative methodology.
In this year’s survey, we tried to obtain insights into how entities are developing their forecasts and the approaches and judgements they are applying in their models. The goal was to see if there were areas where entities are significantly behind in their implementation, or to see if consensus or a lack thereof was emerging on specific topics.

If you have determined the period of the initial reasonable and supportable forecast, how long is that period? (If multiple answers apply, please select the option that encompasses most of your portfolio)

By SEC filer

When asked how prepayments would be considered in the CECL measurement, 45% stated that they would include prepayments as an input into the credit risk model, and the model as a whole would be subject to the forecasting methodology applied. In the survey, 26% and 21% respectively said they would use a forecasting model and a non-forecasting approach for calculating expected prepayments.
The diversity in approach for incorporating prepayments into the calculation of CECL indicates that entities are looking at prepayments in different ways, some not applying any forecast to expected prepayments (which is curious, as considering prepayments is a CECL requirement – this may be indicative that the impact of prepayments for some is considered to be negligible).

The appropriate length of the reasonable and supportable forecast period has been hotly discussed since the release of CECL, with the average fluctuating as the financial services sector becomes more familiar with the new rules. At this stage, with the transition date to CECL in sight for SEC filers, there are still many who are uncertain as to their approach to forecasting, especially as it pertains to the length of the forecast. For example, 41% of respondents said they were still evaluating whether they would use a single forecast period length for all assets or different forecast period lengths for different asset classes/portfolios.

For those who have determined the length of the reasonable and supportable period, 65% are planning to use a period greater than one year up to three years as the forecast period for the initial CECL measurements. Among respondents, 17% plan to use a forecast period of or less than one year, while 6% are planning to use a forecast period longer than five years.

A key finding from the survey was that 33% of SEC filers were planning to support and justify the appropriateness of the forecast period length without a quantitative analysis. While a qualitative approach may be appropriate in certain circumstances, entities should consider whether a nonquantitative approach will provide them with enough comfort and furthermore whether this will be sufficient to satisfy the concerns of an external auditor or regulator. Another interesting finding from the survey was that 10% of respondents were not planning to reevaluate the forecast period after it is initially defined. Given that CECL is composed of inputs including the forecast length that are subject to judgement, periodically reconsidering the appropriateness of decisions and judgements should be a fundamental part of developing the allowance estimate post CECL transition. Notably, the majority of preparers understand that this is a key assumption, as 62% of respondents were planning to revisit the appropriateness of the forecast period length at least annually.

**What criteria will be considered in reevaluating and updating the R&S period?**

**By FS sector**

![Bar chart showing the criteria considered in reevaluating and updating the R&S period by FS sector.](chart.png)
Factors that would influence the decision relating to the forecast period length selected by respondents include: the business cycle stage the entity considers itself to be in; credit loss model performance over time; and changes in the macro-economy. These factors could be integrated into a framework.

**How do you plan to estimate expected prepayments?**

**By FS sector**

![Bar chart showing the distribution of responses by financial sector.]

- **By incorporating prepayments directly into CECL model where all inputs are subject to a common forecasting approach**: 45% (Total), 45% (Banking), 50% (Insurance), 29% (Specialty Finance), 40% (Other).
- **By using a model that includes forward looking estimates consistent with your CECL models**: 26% (Total), 30% (Banking), 20% (Insurance), 13% (Specialty Finance), 29% (Other).
- **By using a simplified approach that does not incorporate forward looking estimates**: 25% (Total), 21% (Banking), 20% (Insurance), 20% (Specialty Finance), 43% (Other).
- **Not applicable**: 5% (Total), 13% (Banking), 20% (Insurance), 8% (Specialty Finance), 20% (Other).

*Small base size. Findings directional only. May not equal 100% due to rounding.*
Have you determined the manner in which your forecast will revert to historic loss information after the initial reasonable and supportable forecast period?

By FS sector

- Yes, straight-line reversion: 26% (Banking 26%, Specialty Finance 22%, Other 28%)
- Yes, immediate reversion to historic loss information: 29% (Banking 33%, Specialty Finance 36%, Other 25%)
- Yes, with other methods: 20% (Banking 18%, Specialty Finance 20%, Other 22%)
- Yes, but using different methods for different assets and/or inputs: 8% (Banking 7%, Specialty Finance 6%, Other 9%)
- No, still evaluating: 38% (Banking 35%, Specialty Finance 40%, Other 40%)
- The reasonable and supportable period will cover the life of the asset: 29% (Banking 25%, Specialty Finance 30%, Other 34%)
- Not applicable/Not Sure: 20% (Banking 20%, Specialty Finance 20%, Other 20%)

While diverse reversion methods will be used for CECL, the result that 33% of SEC filers are still evaluating what reversion method to use for the initial CECL measurement may be concerning to some. While this result may be indicative that entities have identified different methodologies and will apply one at transition to achieve the best estimate of CECL, our view is that the respondents in this category are most likely delayed in their implementation efforts and for differing reasons have been unable to make a decision on this critical part of the CECL measurement.
Reversion to loss data outside of the CECL models at 57% is more popular than using historical data as inputs into the model to accomplish reversion to historical data after the end of the reasonable and supportable forecast. These results appear to be consistent across respondents regardless of total asset size, indicating that size is not a factor in applying input-versus output-level reversion. Another topic where entities have not resolved specific issues is that of what specific data to revert to. Reversion to a historical average is overwhelmingly popular; however, 22% of SEC filers and 27% of all respondents said they were still not sure what specific data they were going to revert to or that this was not applicable (this being appropriate for the small number of entities planning to forecast for the full life of the assets they hold).

For SEC filers in particular some of these results will be concerning in that some of the fundamental components relating to CECL measurement are still not fully resolved. Determining the forecast period length, reversion methodology, and use of a single scenario or multiple scenarios are all critical factors in order to be able to run the CECL models, and it is clear that many entities still have not decided on what they will use on the adoption date.
When publishing our 2018 survey results, we noted, “as CECL projects become more developed, the impacts of the new standard on operations may become a more significant issue.”

In the current year, as noted in the earlier sections, financial statement preparers have made progress in implementing and understanding CECL. It would seem that this is contributing to an increased appreciation of the impacts of CECL on such issues as portfolio mix, pricing, and terms and conditions. Notably, the banking industry is clearly beginning to see the potential impact of CECL on their business and to identify where it might specifically impact the nature of a bank’s relationship with its customers. Our “banking” respondents showed the highest expectation of CECL impact by comparison to other industries. The “insurance” respondents, by comparison, had a much lower expectation for the impact of CECL on their business practices. This makes sense as the banking industry relies on a concept of regulatory capital which is expected to be potentially significantly impacted by CECL estimates.

We asked respondents to rate each of several key business impact areas on a scale from 1 to 5, with 5 being the most significant. This question was the same question asked in the prior year survey. This allowed for comparability, providing insight into shifts in perspective that have occurred as industry participants have grown in their understanding of CECL and developed a more meaningful quantitative perspective of what it could mean to their business.
Aside from impacts to regulatory capital or income volatility, which of the following do you consider having the most significant downstream business impact as a result of CECL? Rate on a scale of 1 to 5:

By FS sector

Overall, we saw a decrease in the expected impact of CECL in almost every category. However, when looking at banking on its own, we saw almost every category increase.
Have you substantially completed your design of the control environment as it pertains to the generation of your allowance for credit losses and related disclosures?

By FS sector

The timely implementation of controls was identified, in retrospect, as being a problem area during the adoption of IFRS 9 by IFRS reporting companies. The implementation of controls over the credit loss measurement process was either completed very late in the process or not completed prior to the transition date. We are seeing indications that history will repeat itself with 71% of SEC filers confirming that the design of the CECL controls environment is not yet complete. Given that the control environment needs to be designed and planned before the new or enhanced operational and process controls and related governance structure can be built and implemented, this should be a significant concern for a C-level executive. The design and implementation of a new or updated controls environment is a time consuming and labor-intensive process, and the lack of readiness in this area raises concerns whether management can support its own SOX assertion, or that auditors will struggle to obtain comfort over SOX controls. As SOX controls are key for accurate and complete financial reporting, the fact that many are reporting that CECL SOX controls are in a poor state of readiness is concerning. With limited time left until the transition to CECL, entities will need to evaluate that there are sufficient resources available to complete the controls and governance design and implementation in response to CECL.

We were not able to obtain statistically reliable responses to the question “how many of each of the following control types have you identified as being material to your control environment over the CECL estimate.” This makes sense in context of the status of the CECL SOX controls implementation but also serves as a warning for C-level executives that a critical component of the CECL project is either not started or that implementation is still significantly a work in progress for those who have completed the design of the new controls environment. External auditors are starting to look at CECL and one of the predominant questions is around the control environment. Further, the external auditors are not just focused on operational and process controls post transition date, but also on the governance around the implementation of CECL.
If you have identified deficiencies in your loss history data for CECL, will you utilize proxy data, including the following?

By SEC filer

Among survey respondents, 60% indicated that they would be using some form of proxy data in their CECL modeling process as a result of data gaps. Of these, 21% overall and 22% of SEC filers said that publically available external data would be used to fill gaps in their data. Overall, 28% of respondents said they were looking to purchase data from data vendors to plug gaps in the internal data on historical losses. The purchase of external loss history data was more prevalent for financial institutions with total assets between $10 billion and $200 billion. For financial institutions with more than $200 billion in total assets, 67% said they either did not have deficiencies in their loss history or that identified deficiencies would not result in having to use proxy data instead. This finding is noteworthy given past surveys had indicated that data quality was a serious concern for all entities. If this result is representative, it means that large entities have made significant progress in resolving data deficiencies that could have been a source of concern for CECL.

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How have you addressed the use of external data in your process?

By SEC filer

One of the most important considerations when using external data either from a publicly available source or purchased from a third party is how an entity would establish that the data is complete, accurate, and relevant to the assets that will rely on that data. Only 8% said that no specific controls would be applied to external data, which shows that the financial services industry has understood the importance of making sure adequate control processes are in place to test external data used in the CECL process. Among SEC filers, 42% said they plan to integrate the controls over external data into the SOX controls environment. While this is very positive and will be welcomed by auditors, C-level executives should also note that respondents broadly said that implementation of the SOX controls processes for CECL has not started yet.

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When asked how entities would ensure the relevance of external loss history data, there was no clear indication as to whether qualitative or quantitative testing would be applied. Respondents in our survey could also select both, meaning that some respondents may use a combination of qualitative and quantitative testing. This also means that many respondents did not select either of these options, meaning that they are currently not planning to test external data for relevance to their actual portfolios of assets at all. Obtaining evidence that external data used in the CECL modeling process is relevant is a key concern for auditors, and entities should consider how they will demonstrate that the data they have used is a relevant substitute for data they otherwise do not have.
Significant uncertainty remains in accounting, modeling, and forecasting functions. Some of this uncertainty is concerning to us as many of the topics respondents admitted were incomplete are fundamental to CECL, which raises questions as to the true state of readiness of some entities if models for example have been built based on incomplete decisions.

There are some red flags for C-level executives in this year’s survey. In particular, most entities have yet to start implementing their SOX controls, with some having not even started designing what the new controls environment would look like. Similarly, the CECL qualitative framework is not yet ready, despite being a vital component of today’s ALLL process.

FASB has proposed delaying the adoption of CECL to 2023 (for calendar year-end reporters) for small reporting companies, private companies, and public business entities that are not SEC filers, and nonprofit entities. With that delay, there will be a temptation to slow down or lose momentum for those affected by the proposed extension date. This will need to be managed carefully, as there could be additional costs incurred by entities if the additional time available is mismanaged. Obviously for SEC filers that are not small reporting companies, there is no delay proposed by the FASB, and based on our survey it is clear that many will need to significantly accelerate their implementation to be ready for adoption in 2020.

As a final note, we received many insightful additional comments on the lack of perceived value in CECL in our survey last year from respondents, but very few this year. Does this mean people have started to see the value of CECL or are simply fatigued with the implementation (or the length of our survey!)? Time will tell.
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