Pulse check

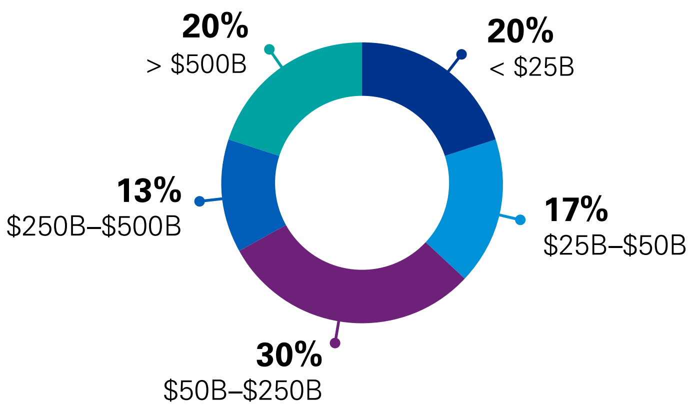
How companies are responding to changes in CECL due to COVID-19

Over the last two months, the world has undergone unprecedented economic and public health shocks, presenting particular challenges to the financial services and banking industries. The U.S. Government and banking regulators have responded with an array of measures meant to alleviate the expected ramifications on the banking system, including both legislative and regulatory actions.

To get a pulse check on how companies are reacting to and dealing with issues that have arisen related to the adoption of the new Current Expected Credit Losses (CECL) accounting rule, KPMG has polled a number of entities in the commercial and consumer lending business, including banks and finance companies, to get their insights on key issues. Topics covered include recent regulatory updates and the expected impact of these uncertain times on the CECL methodology and estimates for the first period of publishing earnings under CECL.

Who we surveyed

We surveyed **25 Banks** and **5 Consumer Finance Companies** ranging in size:



Note: Responses were obtained between March 30th and April 6th, and reflect information known at that time.

CECL delay under the CARES Act and regulatory capital relief

Two significant events occurred on March 27th. First, the US Government passed the CARES Act, which includes a provision to allow specific entities[1] to delay the implementation of CECL until the earlier of two dates: either the day on which the national emergency is terminated or December 31, 2020. Second, a consortium of banking regulators[2] issued a revised regulatory capital transition rule, which permits entities that implement CECL during the 2020 calendar year to delay the full expected impact of adopting CECL on regulatory capital for an

[1] Insured depository institutions, bank holding companies, or any affiliate thereof

[2] Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; and the Federal Deposit Insurance Corporation.

additional two years past its initial capital transition rule, which included a three-year phase-in of capital impacts. Under the revised rule, this three-year phase in would take place after the initial two-year delay period.

In our survey, we found:

88 percent of all respondents, including all of the large banks surveyed (greater than $50 billion in assets), will not elect the delay permitted under the CARES Act.

86 percent of respondents[3] will elect the Interim Final regulatory capital transition rule, which permits entities to delay the expected impact of adopting CECL over an additional two years (for a total of five years). The remaining 14 percent will elect the original rule, which permits entities to transition the capital impact of CECL over three years.

The most commonly cited reason for not electing the CECL delay was perceived operational risk, which stems from concerns over reviving retired legacy GAAP models, governance, calculations, and executing processes in a controlled manner in a short period of time. However, the revised regulatory capital transition rule may provide some of the relief banks were hoping to gain from a CECL delay, mitigating the potential constraints on business lending activities.

Expected impact of the impending recession on CECL methodology and results

At a minimum, for any calendar year-end entity that will not elect to defer the adoption of CECL, the impact of the economic deterioration that has occurred over the first quarter of 2020 will be recognized in Q1 earnings. That's because in January, most publicly available economic forecasts did not predict a recession in the near term. We believe that the economic disruption and dimmed future outlook which has developed over the last month of the first quarter should not be reflected in a company's estimate of credit losses under CECL as of the transition date – and instead, should be recognized through first quarter earnings.[4]

Based on a review of the SAB 74 disclosures in 20 public banks' year end SEC filings,[5] we saw a wide range of disclosed expected impacts to the allowance upon adoption to CECL from as low as a 14 percent decrease to as high as a 103 percent increase. Generally, consumer finance lenders expected larger allowance increases upon adoption as compared with banks that are more heavily focused in commercial lending, primarily due to longer maturities and greater sensitivities to general macroeconomic conditions. The median expected increase was approximately 32 percent. However – within these same disclosures – none of these banks predicted an impending recession of the magnitude now expected.

Given the inherent uncertainty around the ultimate magnitude and duration of a possible recession, we anticipate that entities will cite a wide range of expected impacts to the allowance for credit losses. Just how much an entity expects its allowance to change will depend on a number of factors, including its measurement methodologies, assumptions at each measurement date, and the breakdown of its portfolio by asset type, industry, borrower credit-worthiness, and other factors. When surveyed, approximately 32 percent of respondents[6] did not yet know the extent of the ultimate impact the recent unprecedented shocks will have on the allowance.

[3] 18 of 25 surveyed banks

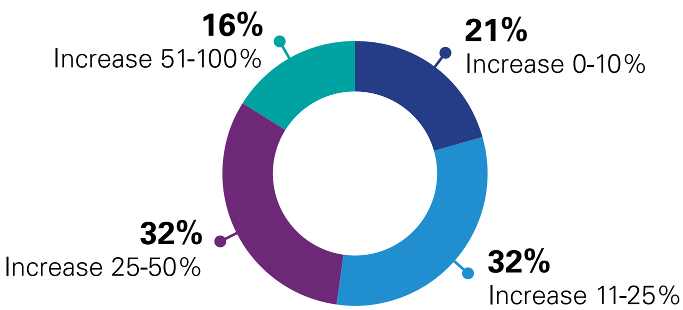
[4] For more information on this topic – see KPMG's Hot Topic: Q1 Economic events

[5] Including a mix of top 10 banks and regional / super-regional banks

[6] 28 of 35 surveyed entities

For the remaining participating respondents, as anticipated, there was a wide range of expected impacts:

How much will the impending recession affect your CECL allowance?



For entities with diversified lending portfolios, the largest expected increases are likely to be seen in commercial real estate, commercial & industrial, and energy sectors, and in credit cards within consumer sectors.

In addition to affecting the amount of the allowance recognized as of March 31, 2020, the impending recession may also influence the methodology an entity employs to estimate its expected credit losses. CECL is a principles-based standard that allows preparers flexibility in how they approach measuring expected credit losses. As a result, there will be no single acceptable approach to factoring in changes in expectations about expected losses. We found that most participating respondents plan to incorporate a mix of approaches:

The majority of respondents (77 percent) plan to use some combination of the approaches shown below. Entities not planning to use a combination of approaches generally plan to adjust their estimates by considering macro-economic scenarios that explicitly factor in the potential impact of an impending recession alone.

In addition, given the unique nature of the current economic environment and the impending recession, there are a number of considerations that entities should consider when measuring their allowance, including:

— The period over which a company can derive a "reasonable and supportable" forecast may change as a result of changes in the economic environment and, in turn, the reversion methodologies and/or the historical information that is reverted to should change.

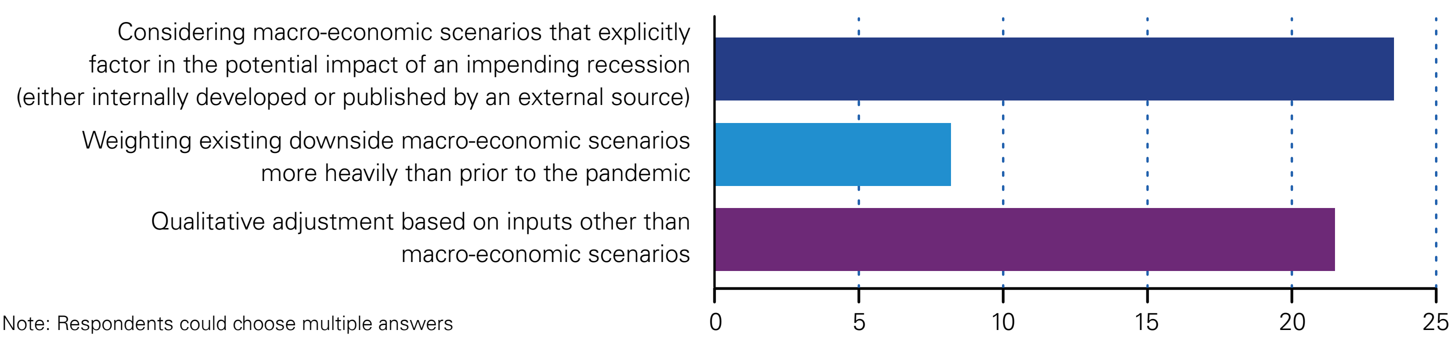
— The impact of any elective or government mandated modification or payment deferral programs

— Reassessment of collateral values given the current state of markets for relevant collateral (e.g., used cars, commercial real estate, etc.)

— Where adjustments are necessary because historical data does not include a comparable event to the current economic environment (e.g. the unprecedented, precipitous and sudden increases in unemployment claims)

— How to adjust estimates that are derived using lagged information (particularly lagged credit risk indicators or macroeconomic forecasts) given rapidly changing conditions.

What approaches will you use to measure updates to expectations?



Note: Respondents could choose multiple answers

Earlier in the year, there was significant discussion in the industry about a potential shortening of the "reasonable and supportable forecast period," since supporting expectations over longer periods of time in a volatile environment is generally more difficult.

However, we found that 78 percent of participating respondents[7] had no plans to amend their reasonable and supportable forecast period, and 91 percent had no plans to amend either their reversion methodology or historical data that it reverts to. Entities planning to amend their reasonable and supportable forecast period indicated that they would decrease it to a period of less than 12 months.

Finally, given the speed at which the economic indicators and loan data are changing in the current environment, many institutions have been challenged to deviate from their original plans around using lagged data. Using more up-to-date economic forecasts and risk ratings could lead to more precise estimates, but could also put more pressure on the close process and stretch the limits of existing controls and governance processes.

Loan modifications and troubled debt restructurings

In addition to granting an optional CECL delay, the CARES Act also offers relief to lenders who grant modifications to borrowers meeting specific conditions in applying TDR accounting requirements, including impairment accounting requirements. A consortium of banking regulators, with the support of the Financial Accounting Standards Board, also issued an Interagency Statement offering similar relief.[8]

This relief is great news for lenders, borrowers, and liquidity, but it could pose an unintended operational burden. Specifically, lenders may now be required to assess whether the modifications are significant or not under ASC 310-20 and apply modification guidance which they never before had to consider because similar modifications were considered TDRs. In our polling, we found that only 57 percent of respondents had the infrastructure necessary to meet these accounting requirements for all asset types, and 30 percent only had the infrastructure necessary for commercial loans. With the broad elective modification programs being offered to consumer borrowers, this requirement could be a significant operational burden.

Banks are already feeling a strain on resources as they attempt to keep up with loan applications related to other provisions of the CARES Act (such as for loans granted under the Paycheck Protection Program), so they should consider this potential additional operational burden as they plan their resources for what is sure to be a busy few months.

Conclusion

Only a short time remains until the first wave of 10-Qs with CECL-compliant financial statements are issued. As companies close their books on a turbulent first quarter and head into a highly uncertain second quarter, they will need to think through unprecedented and complex issues, while remaining flexible as the landscape continues to change. Analysts and investors will be keenly interested in understanding the drivers of change in the CECL allowance, and institutions will need to rise to the challenge of explaining and supporting their new U.S. GAAP results to their stakeholders in a changed world.

[7] 23 of 35 survey respondents

[8] Consortium members: Board of Governors of the Federal Reserve, Federal Deposit Insurance Corporation, National Credit Union Administration, Office of the Comptroller of the Currency, Consumer Finance Protection Bureau, Conference of State Bank Supervisors

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