Pulse check

How companies are responding to economic impacts in their CECL estimates in Q1'22

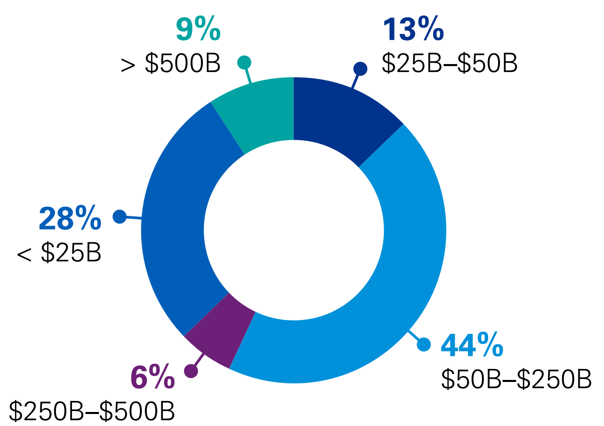
In the first quarter of 2022, we surveyed lenders to see how current economic conditions are likely to affect their Current Expected Credit Losses (CECL) process. We asked about their estimated impacts of CECL on reported earnings—including impacts to commercial and retail loan portfolios, challenges experienced in determining the estimate, outlook with regard to future economic conditions, methodology components, and disclosures.

Economic uncertainty persists in the first quarter of 2022 as the US reached the highest rate of inflation seen since the 1970s[1], supply chain disruptions continue and the Russian invasion of Ukraine impacts global markets.

To get a pulse check on how companies are reacting to and dealing with these issues—and how they influence CECL reporting—KPMG polled commercial and consumer lenders (including banks and finance companies). The survey results were obtained between March 4, 2022 and March 17, 2022 and reflect information known at that time. With the ever changing global economic and political landscape, we expect companies will be monitoring and reassessing the appropriateness of the assumptions used in their CECL estimate up to the reporting date.

Who we surveyed

We surveyed **26 banks** and **6 consumer finance** companies. They range in asset size from less than $25 billion to more than $500 billion.



Responses were obtained between March 4, 2022 and March 17, 2022, and reflect information known at that time.

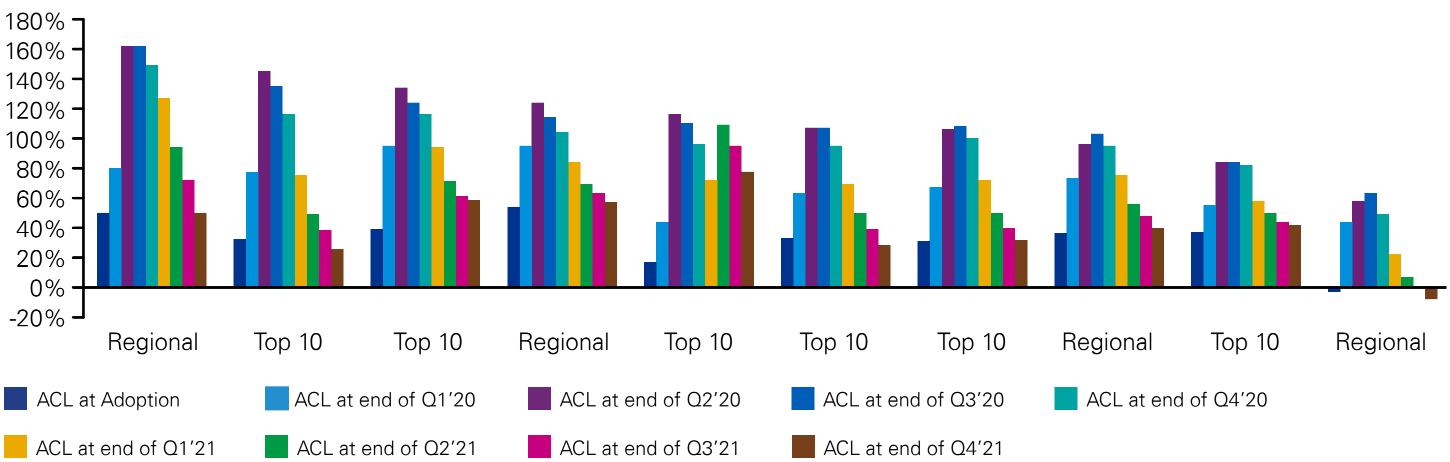
[1] Source: "Russia and Ukraine conflict: Economic implications," Office of the Chief Economist, KPMG LLP, March, 2022.

Expected impact of continued uncertainty on CECL methodology and results

After a tumultuous start to 2020 with CECL adoption and the ongoing impacts of COVID-19 throughout 2020 and 2021, CECL reserves appeared to begin to stabilize toward the end of 2021. In Q4'21 filings, we saw a trend of reserve releases primarily attributable to improvements in economic forecasts, which included the ongoing expected impacts of government stimulus and overall market recovery as a result of easing COVID-19 restrictions.

Consistent with previous quarters, for most banks, CECL reserves as of Q4'21 remained in excess of CECL reserves at adoption. However, some are seeing their CECL reserves level off with, or fall below their CECL reserves at adoption. The chart below represents the percent change in allowance for credit losses (ACL) since CECL adoption for a sample of 10 different SEC filers ranging in asset size.

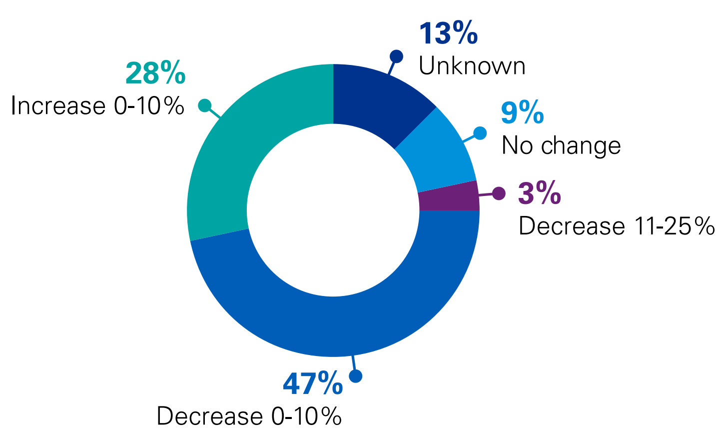
Continued decreases in ACL (percent change since CECL adoption)



Approximately 50 percent of survey respondents indicated that they expect a decrease in their ACL for Q1'22 compared with 64 percent in Q4'21. Conversely, 28 percent of respondents expect an increase in their ACL in Q1'22 compared with 11 percent in Q4'21.

We also surveyed lenders about their expectations of ACL changes disaggregated by commercial and retail portfolios. Approximately 50 percent and 41 percent of respondents expect a decrease in the ACL for commercial and retail loan portfolios, respectively, compared with 69 percent and 60 percent in Q4'21. In contrast, 22 percent and 25 percent of respondents expect an increase in the ACL for commercial and retail loan portfolios compared with 6 percent and 11 percent in Q4'21.

How much do you expect the allowance for expected credit losses (ACL) to change from December 31, 2021 to March 31, 2022?

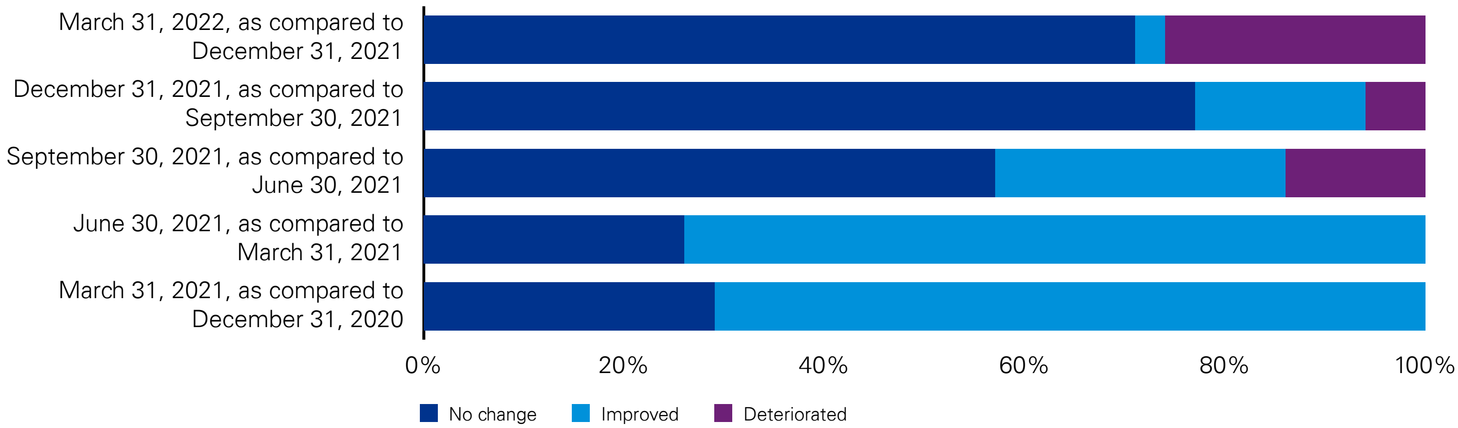


A majority of respondents expect the allowance to stay the same or decrease—59 percent in Q1'22, compared with 70 percent in Q4'21.[2] Approximately 59 percent and 47 percent of respondents expect their ACL for commercial and retail loan portfolios respectively to stay the same or decrease, compared with 71 percent in Q4'21. For the 50 percent of respondents who expect the allowance to decrease, the most important factors cited are shifting expectations (improvements) about the economy in comparison to their outlook during the peak of COVID-19. For the 28 percent of respondents who expect the allowance to increase, factors included changes in expectations about future economic conditions (deterioration). Further, a majority of survey respondents cited the ongoing Russian invasion of Ukraine as a critical point of uncertainty in their estimate.

Changes in capital relief deferral

We also surveyed lenders in relation to the end of the capital relief deferral period and noted 82 percent of respondents did not anticipate the end of the capital relief deferral period, where elected, would result in a change in capital for the Company.

How has your Company's outlook with regard to future economic conditions changed since the ACL estimate was derived on December 31, 2021?

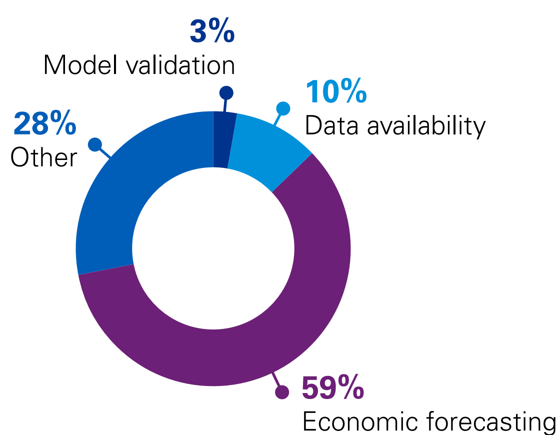


A majority of respondents, approximately 59 percent, are experiencing challenges in determining the ACL estimate due to economic forecasting. A number of respondents, 28 percent, are experiencing challenges in determining qualitative adjustments given the judgment associated with these adjustments. Approximately 26 percent of respondents acknowledged that a higher weight would be placed on more negative economic scenarios as compared to the estimate at Q4'21 in response to higher inflation, continued supply chain disruptions, uncertainty around legislative and monetary policy, and the unknown impact of the Russia-Ukraine war.

After CECL adoption, COVID-19 impacts and other global economic uncertainties, estimating lifetime losses has become a challenge. Approximately 41 percent of survey respondents indicated they intend to recalibrate CECL models for recent experiences and historical data.

Additionally, 94 percent of respondents indicated they do not plan to change their process or methodology to determine their ACL including automation or outsourcing.

What challenges are you experiencing in determining your Company's ACL estimate?

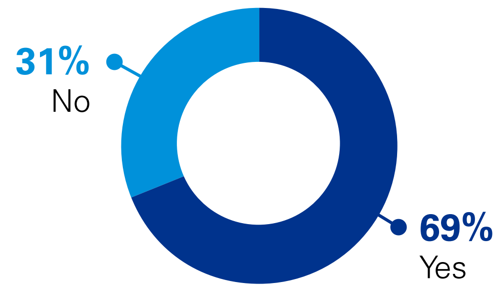


[2] In Q1'22, 9 percent of respondents indicated that they expect the ACL to remain the same; this compares with 6 percent in Q4'21.

CECL methodology components

To estimate losses over the reasonable and supportable forecast period, entities are permitted to incorporate one or more economic scenarios into their allowance estimate. Accordingly, many institutions have incorporated multiple economic scenarios into their allowance framework, particularly in response to economic uncertainty from higher inflation, continued supply chain disruptions and the unknown impact of the Russia-Ukraine war.

For your models that utilize macroeconomic inputs, do you leverage multiple economic scenarios to inform your ACL estimates?



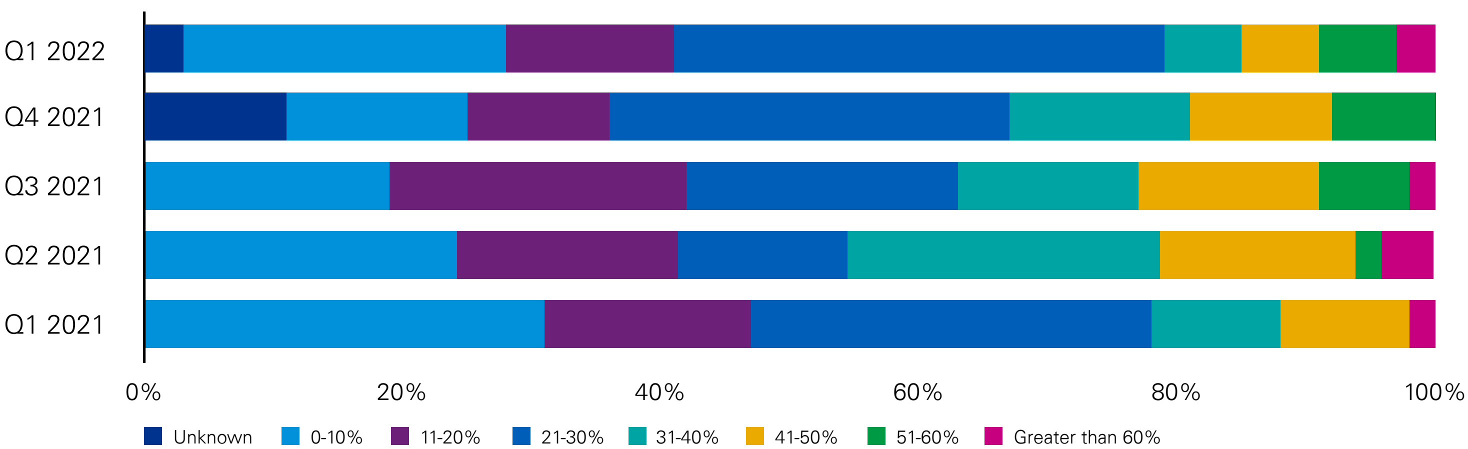
We also surveyed companies about their percentage probability weights used in their macroeconomic scenarios for both Q4'21 and Q1'22. We have summarized the average percentage probability by scenario below.

	Base case	Upside	Downside	Severe Downside	Other
Q4'21[3]	42%	11%	14%	2%	19%
Q1'22	45%	10%	14%	3%	16%

Many companies incorporate qualitative adjustments into their CECL estimate to capture changes in expectations, and we believe they will continue to do so.

The qualitative component continues to be integral to the allowance estimate under CECL, as 59 percent of survey respondents indicated they expect qualitative factors to comprise more than 20 percent of the total allowance estimate as of Q1'22 (as compared to 64 percent as of Q4'21).

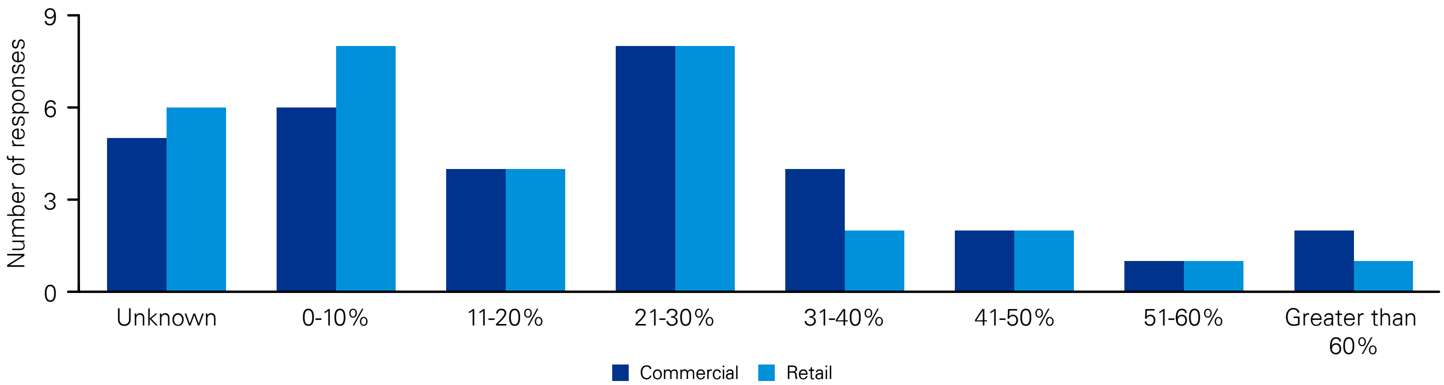
What percentage of your Company's ACL as of March 31, 2022 would you estimate to be based on qualitative factors?



[3]The average percentage probability by scenario for Q4'21 is based on actuals for Q4'21 as provided by Companies surveyed in Q1'22.

We also surveyed lenders' estimates of qualitative reserves specific to commercial and retail loan portfolios.

What percentage of your Company's ACL as of March 31, 2022 would you estimate to be based on qualitative factors?



FASB amendments

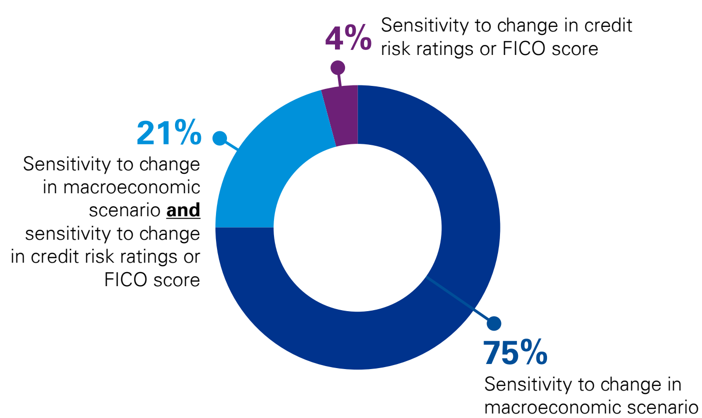
This quarter, we also surveyed lenders about the impact of the FASB decision to consider amending the accounting for acquired financial assets to apply the purchased credit deteriorated (PCD) gross-up accounting model to all acquired financial assets, with certain exceptions. Approximately 93 percent of survey respondents indicated that this potential guidance would not be challenging to implement.

Disclosure

The amended Reg S-K requirements in Item 303(b)(3) were required for fiscal years ending December 31, 2021. This quarter, we analyzed the critical accounting estimate disclosures specific to the ACL in the December 31, 2021 Form 10-K filings of the top 50 banks[4] by asset size[5] to evaluate how banks complied with the amended requirements, specifically the requirements around a sensitivity disclosure. We observed that greater than 70 percent of these filers included commentary as to the sensitivity of the ACL estimate with more than a majority disclosing a sensitivity that was quantitative in nature and reflecting the impact at the total quantitative ACL level.

The majority of banks with a quantitative sensitivity disclosure analyzed the impact of a change in the macroeconomic scenario used in the ACL estimate. A smaller number included an additional non-macroeconomic variable, sensitivity to a change in credit risk ratings or FICO score, which was disaggregated between commercial and retail, respectively. Where a sensitivity to a change in macroeconomic scenario was disclosed, the most common change to the scenario was a 100 percent weighting to a downside scenario, which was observed in 68 percent of filers with a quantitative sensitivity analysis. The remaining filers also considered changes in baseline and upside scenarios.

Percentage of filers with a quantitative sensitivity disclosure



[4] Include banks from SIC codes 6021 – National Commercial Banks and 6022 – State Commercial Banks that file a Form 10-K.
[5] The population included banks with assets in excess of $25 billion in assets whose 10-K was filed prior to March 16, 2022.

Conclusion

The uncertainty surrounding the overall pace of the economic recovery due to impacts of the Russia-Ukraine war, the pull-back of government stimulus, continuing impacts of COVID-19, and inflation coupled with increasing interest rates are anticipated to be a challenge in determining CECL estimates, particularly due to lack of similar historical events. Analysts and investors will want to understand the key drivers behind the CECL estimates which include a significant level of estimation and judgment. Lenders will need to explain and support their assumptions and estimates of the CECL methodology components, including quantitative models and qualitative factors. We encourage companies to work closely with their boards of directors, auditors, and advisors as they prepare for reporting in the first quarter of 2022.

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