Pulse check

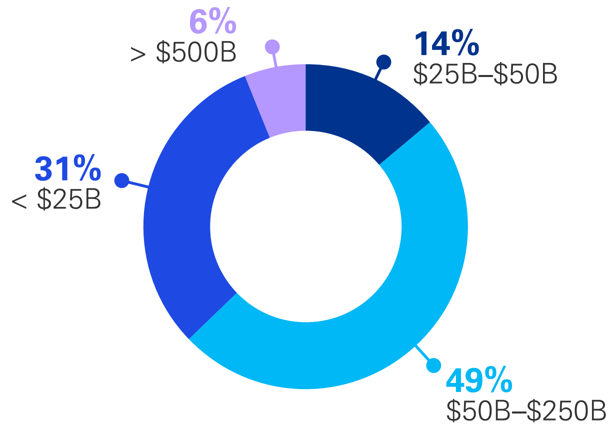
How companies are responding to economic impacts in their CECL estimates in Q3'22

We surveyed companies during the third quarter of 2022 to understand how current economic conditions are likely to impact their Current Expected Credit Losses (CECL) process. We asked about the possible impacts of high inflation, rising interest rates, and a potential recession on commercial and retail loan portfolios—and how these forces are likely to affect CECL allowances.

Economic uncertainty intensified in the third quarter of 2022 as inflationary pressures persisted and expectations of recession rose.[1] KPMG surveyed commercial and consumer lenders (including banks and finance companies) to understand how companies are reacting to and dealing with these issues and their impact on CECL reporting. The survey results were obtained between September 8, and September 20, 2022 and reflect information known at that time. However, because the global economic and political landscape are constantly evolving, we expect companies will monitor and reassess the appropriateness of the assumptions used in their CECL estimate up to the reporting date.

Who we surveyed

We surveyed **29 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 September 8, and September 20, 2022, and reflect information known at that time.

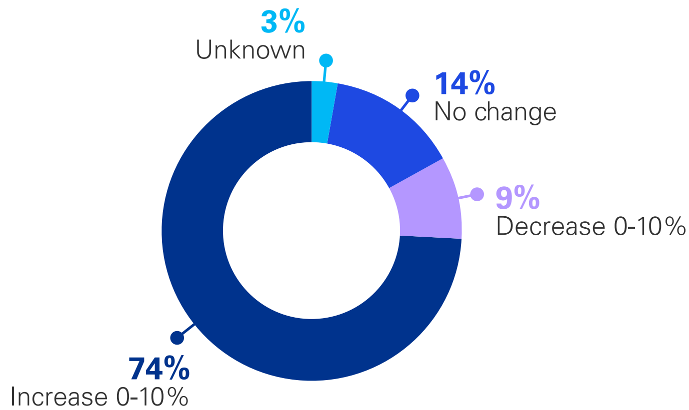
[1] Source: "Longing for "yesterday" federal reserve abandons hope of a soft landing", KPMG, September, 2022.

Expected impact of continued uncertainty on CECL methodology and results

Most respondents (74 percent) expect the overall allowance for expected credit loss (ACL) to increase in Q3'22 compared with 66 percent in Q2'22. Further, 9 percent of respondents expect a decrease in their ACL in Q3'22 compared with 15 percent in Q2'22.

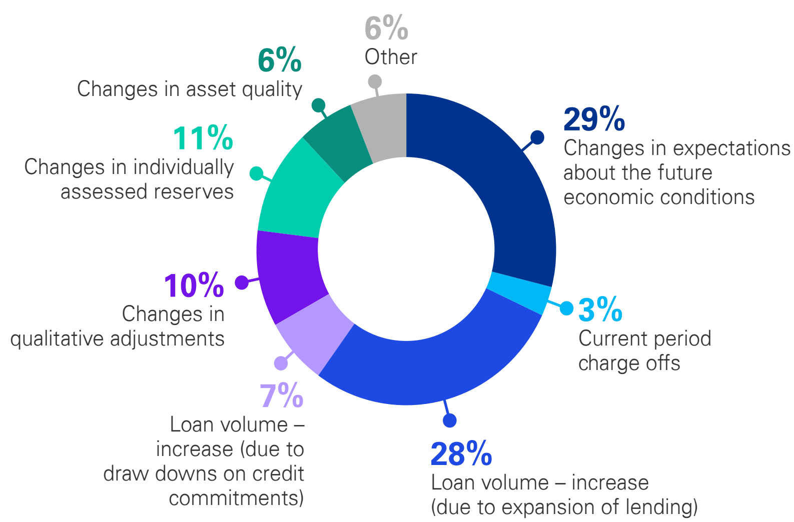
We also surveyed companies about their expectations of ACL changes disaggregated by commercial and retail portfolios. Approximately 51 percent and 63 percent of respondents expect an increase in the ACL for commercial and retail loan portfolios, respectively, compared with 50 percent, respectively, in Q2'22. In contrast, 26 percent and 20 percent of respondents expect a decrease in the ACL for commercial and retail loan portfolios, respectively, compared with 18 percent and 15 percent in Q2'22.

1. How much do you expect the allowance for expected credit losses (ACL) to change from June 30, 2022 to September 30, 2022?



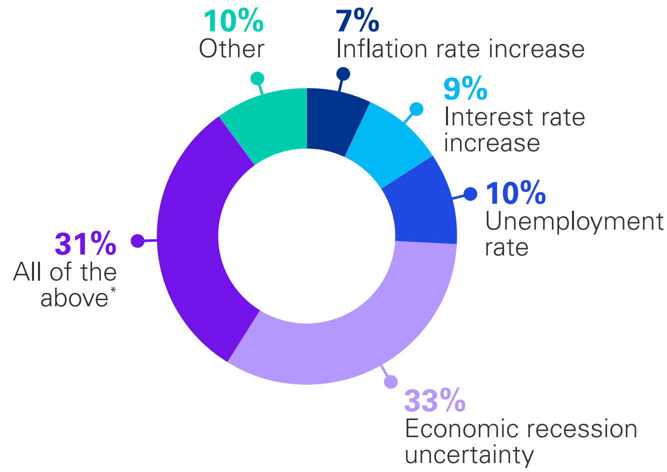
Approximately 29 percent of respondents said expectations about future economic conditions was the largest driver of change in their ACL and 28 percent cited loan volume increases as the second largest driver.

2. What do you expect the largest driver of change to be in the ACL balance from June 30, 2022 to September 30, 2022?



Approximately 33 percent of respondents cited economic recession uncertainty as the economic condition having the greatest impact on their ACL whilst 57 percent of respondents cited either inflation rate increases, interest rate increases, the unemployment rate or all of these conditions, including economic recession uncertainty in combination as having the greatest impact on their Company's ACL in Q3'22.

3. Which economic condition is having the greatest impact on your Company's ACL estimate?

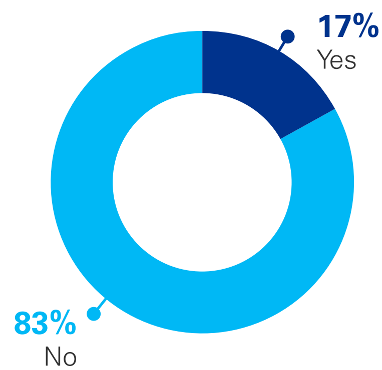


*All of the above: Includes all choices except "other."

Responses were obtained between September 8, and September 20, 2022, and reflect information known at that time. The economic conditions selected may not reflect the impact of the Federal Reserve Bank's recent response to inflationary pressures.

Although the majority of respondents cited either one or all of the aforementioned economic conditions as having the greatest impact on their ACL only 17 percent of respondents are recalibrating their CECL models in Q3'22.

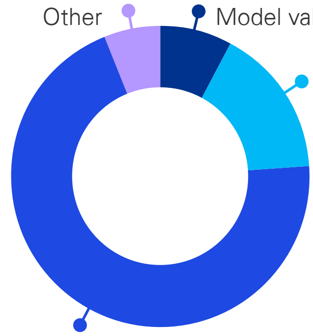
4. Are recent experiences as a result of the higher inflation rate, increased interest rates, unemployment rate and/or the potential of an economic recession being used to reassess/recalibrate CECL models?



Approximately 66 percent of respondents are factoring in an impact of the COVID-19 pandemic within their ACL whilst only 29 percent of respondents are factoring in an impact from the ongoing Russia-Ukraine conflict within their ACL estimate in Q3'22. For the 66 percent of respondents who are factoring in an impact of the COVID-19 pandemic within their ACL, the majority of respondents cited this is performed qualitatively (non-modeled) with others acknowledging that trailing impacts of the COVID-19 pandemic are impacting the ACL estimate via their quantitative (modeled) results given forecasts utilized by the Company.

Approximately 70 percent of respondents stated that economic forecasting as a result of the higher inflation rate, increased interest rates, the unemployment rate and the potential of an economic recession represented the greatest challenge in estimating their ACL.

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

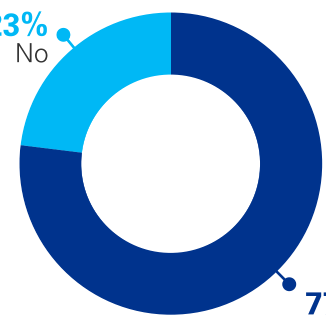


*Economic forecasting as a result of higher inflation rate, increased interest rates, unemployment rate and/ or the potential of an economic recession

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 recession uncertainty, inflation rate increases, interest rate increases, and the unemployment rate.

6. 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 Q3'22 and Q2'22. We have summarized the average percentage probability, where a percentage probability is applied other than zero, by scenario below.

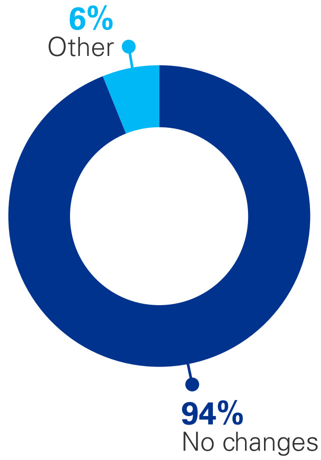
	Base case	Upside	Downside	Severe downside	Other
Q3'22	59%	19%	30%	18%	45%
Q2'22[2]	58%	17%	34%	19%	54%

[2] The average percentage probability by scenario for Q2'22 is based on actuals for Q2'22 as provided by companies surveyed in Q3'22.

Examples of where the "Other" scenario has been selected include specific adjustments to reflect economic conditions such as interest rate increases by the Federal Reserve Bank.

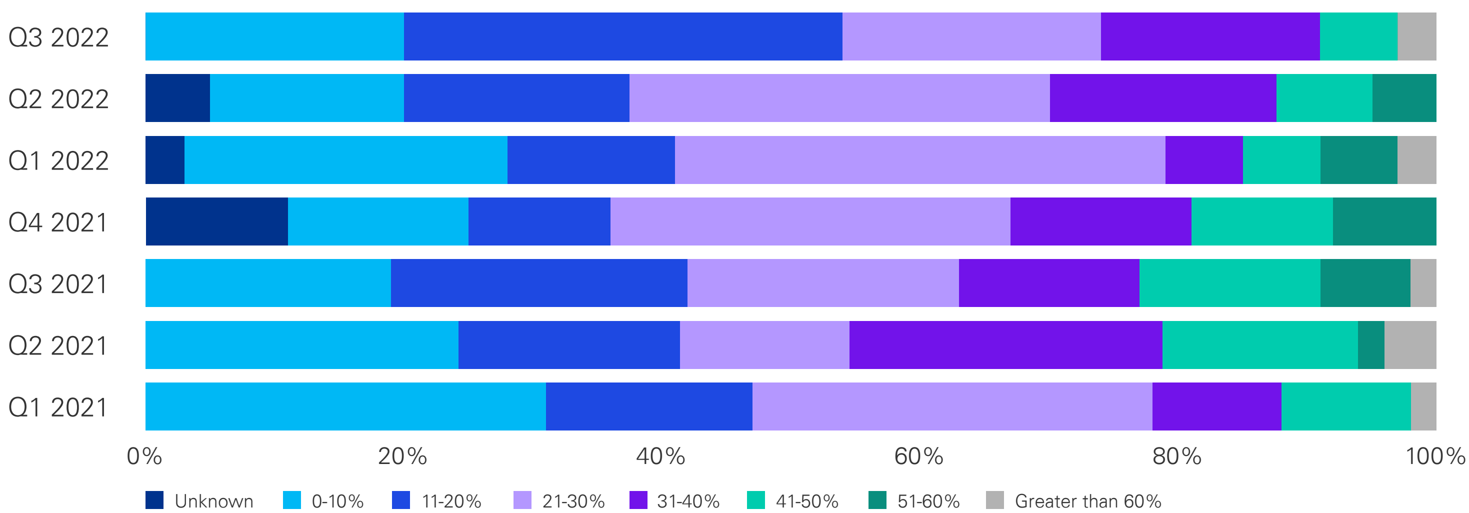
The majority of respondents (94 percent) are not currently considering making changes to the reasonable and supportable period, reversion period or reversion technique. In addition, 83 percent of respondents utilize a reasonable and supportable period of 18 months or greater.

7. Is your Company currently considering making changes to one or more of the following key ACL assumptions or components?



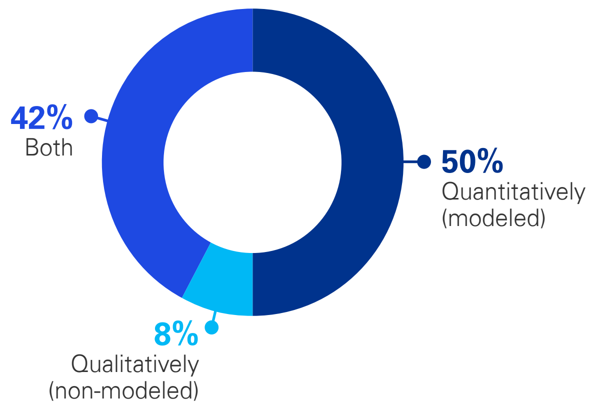
Many companies incorporate qualitative adjustments into their allowance estimate to capture changes in expectations, and we believe they will continue to do so. Approximately 46 percent of respondents indicated they expect qualitative factors to comprise more than 20 percent of the total allowance estimate in Q3'22 as compared to 63 percent in Q2'22.

8. What percentage of your Company's ACL as of September 30, 2022 would you estimate to be based on qualitative factors?



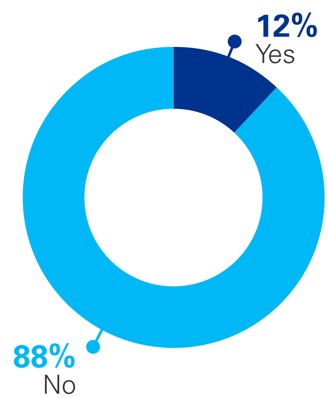
Approximately 50 percent of respondents are factoring in impacts from the high inflation rate, increased interest rates, unemployment rate and a potential economic recession within their ACL estimate quantitative (modeled) whilst 42 percent of respondents are factoring in these conditions both quantitatively (modeled) and qualitatively (non-modeled).

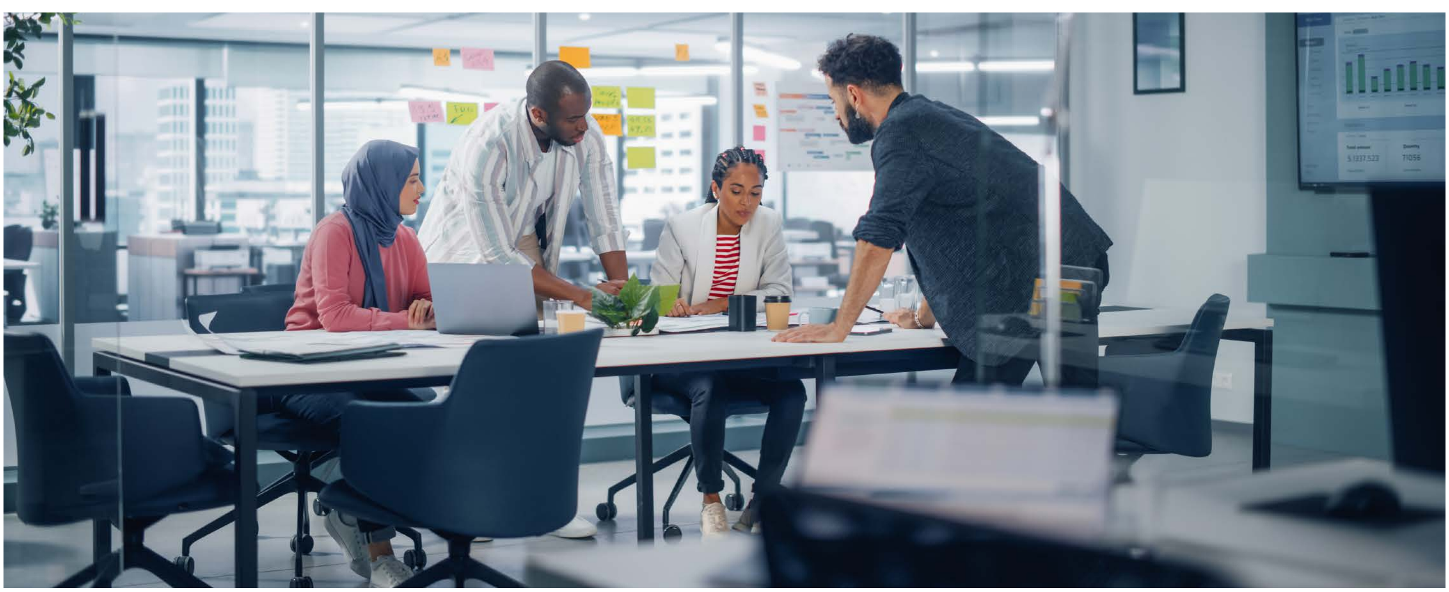
9. How are economic conditions such as higher inflation rate, increased interest rates, unemployment rate and/or the potential of an economic recession being factored into your Company's ACL estimate?



The majority of respondents (88 percent) are not contemplating the introduction of new qualitative components within the ACL estimate for Q3'22.

10. Is your Company contemplating the introduction of new qualitative components within the ACL estimate as of September 30, 2022?

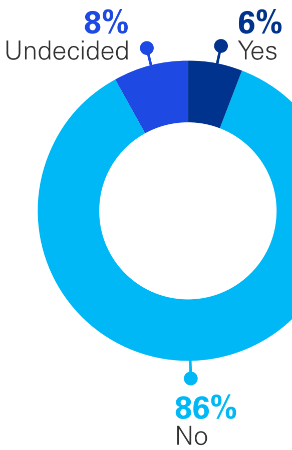




FASB amendments

Similar to prior quarter, the majority of respondents (86 percent) have not adopted and do not plan to early adopt ASU 2022-02, which eliminates the accounting guidance for troubled debt restructurings (TDRs) by creditors in ASC 310-40, Receivables—Troubled Debt Restructurings by Creditors. The lack of early adoption by companies is likely a result of companies having established TDR ACL calculations and processes and are currently understanding the new measurement and transition guidance. Additionally, companies are collecting data and designing processes and controls over the new disclosure requirements.

11. The FASB issued ASU 2022-02, which eliminates the accounting guidance for troubled debt restructurings (TDRs) by creditors in ASC 310-40, Receivables— Troubled Debt Restructurings by Creditors. Have you adopted or do you plan to early adopt the amended guidance?



Conclusion

The uncertainty surrounding the economy due to high inflation, increased interest rates, the unemployment rate and a potential economic recession continues to be a challenge in determining CECL estimates. Analysts and investors will want to understand the key drivers behind the CECL estimates, which include a significant level of estimation and judgment. Companies 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 third quarter of 2022.

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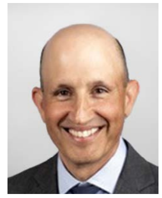

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