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Benefits and Challenges of the “CECL” Approach

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I. Introduction

Since the 1970s, credit loss accounting has been based on the incurred loss approach, which defers the recognition of losses until it is probable that such losses have occurred.² This probability threshold effectively delays the recognition of credit losses on loans, and could result in allowances that are considered “too little, too late.” As noted in a 2009 Financial Stability Board (“FSB”) report, restricting the ability to include future conditions when establishing credit loss allowances increases volatility in the income statement and could result in allowances that are procyclical (i.e. overstated allowances at the trough of a cycle and understated allowances at the peak of a cycle).³ Accordingly, the FSB recommended that accounting standard setters reconsider how institutions account for credit losses in the wake of the financial crisis.

In 2016, the Financial Accounting Standards Board (“FASB”) issued the Current Expected Credit Loss (“CECL”) approach to ostensibly address some of the aforementioned limitations of the incurred loss approach.⁴ The CECL approach requires financial institutions to record allowances for credit losses for loans, leases, and certain other financial assets upon issuance or acquisition (i.e. on “day one”), and those allowances should reflect the credit losses expected to occur over the remaining contractual lives of those assets. The CECL approach differs from the incurred loss approach in that it requires financial institutions to consider their own “reasonable and supportable” forecasts when measuring credit losses, while the incurred loss approach does not. Therefore, the incurred loss approach theoretically reflects the current losses in the portfolio, whereas the CECL approach reflects both current and future credit losses. In addition, CECL is a “principles-based” accounting standard, while the incurred loss approach is mostly rules-based.

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² FASB, generally.

³ Financial Stability Forum (2009). “Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System.” Note: FSB was formerly known as the Financial Stability Forum.

⁴ The CECL approach is presented in FASB ASC Topic 326, *Financial Instruments — Credit Losses* (ASC 326). ASC 326 is a comprehensive new accounting standard for credit losses, replacing the existing credit loss accounting methods for loans and leases, debt securities, loan commitments, and financial guarantee contracts.

This note discusses the potential benefits and challenges of the CECL approach to financial institutions and the users of their financial statements. CECL could result in the timelier reporting of credit losses by (1) eliminating the “probable” threshold for recognizing loss provisions and (2) requiring institutions to consider forward-looking information when measuring credit losses. However, the CECL approach’s increased use of judgment and dependence on forward-looking information may result in an elevated risk of management bias affecting institutions’ financial statements, disclosures, and key financial and regulatory metrics. In addition, CECL’s reliance on forecasting models may further diminish the comparability of loss provisions and increase the costs associated with measuring and auditing credit loss provisions. Moreover, there is debate regarding the procyclical effects of CECL on loan loss reserves.

II. CECL Measurements and Management Bias

The CECL approach improves upon current accounting principles by expanding the range of information that institutions must consider when estimating credit losses. CECL requires consideration of not only past events and current conditions, but also reasonable and supportable forecasts that affect expected collectability. CECL measurements, however, are dependent on a wider range of idiosyncratic data, including management’s forward-looking estimates of key economic factors. As a result, CECL estimates may present an elevated risk of management bias affecting the financial statements and key financial and regulatory metrics, as the estimation process generally requires institutions to use more judgment than is required under the incurred loss approach. Accordingly, it is important that credit losses measured under CECL are determined in a well-governed environment.

An institution’s system of internal controls should address the development and selection of economic and other assumptions used in CECL measurements and the institution’s overall review of CECL allowances. It should also address the appropriateness of accounting policies and procedures, especially those requiring the exercise of judgment. Management must be able to support and document its position and appropriately apply the CECL approach to reach their best estimate of credit loss.

The key judgments and assumptions made when measuring an allowance for credit losses under CECL include the (1) historical “look-back” period, (2) adjustments made expected credit loss measurements to reflect current conditions and reasonable and supportable forecasts, (3) method used to revert to historical loss information, (4) effects of expected prepayments, and (5) aggregation of financial assets with similar risk characteristics. Each of these are described in detail below.

Historical “look-back” period and methods of utilizing historical experience

The historical “look-back” period is the period of time that best serves as the basis for an institution’s historical loss experience. As past credit loss experience usually provides an appropriate starting point for a financial institution's assessment of expected credit losses, the look-back period is an important determination made by management. Such information can be internal or external historical loss data, or a combination of both. When appropriate, institutions must consider adjustments to historical loss information to reflect differences in current asset specific risk characteristics, such as differences in underwriting standards, portfolio mix, or asset term within a pool.

The CECL approach does not mandate a specific time period; rather, management must identify a period of time that results in the best estimate of credit loss. For example, if management expects an economic downturn, it might consider a number of alternatives, including using (1) historical credit loss information that reflects a downturn in a previous economic cycle, or (2) long-term historical credit loss statistics that include an economic cycle, adjusted for current economic conditions (including the current point in the economic cycle) and the forecasted direction of the economic cycle.

An institution’s choice of historical look-back period will likely be influenced by data availability, and how the institution’s management judges its ability to estimate the current point in the economic cycle and correlate it to previous economic cycles.

Adjustments to reflect current conditions and reasonable and supportable forecasts

As CECL is a forward-looking approach, the range of data considered in the estimation of an allowance for credit losses is generally broader than under the incurred loss approach. More specifically, CECL requires consideration of not only past events and current conditions, but also reasonable and supportable forecasts that affect expected collectability. Management must consider the need to adjust its historical information to reflect the extent to which they expect current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated. This aspect of CECL requires a significant degree of judgment, as the term “*reasonable and supportable forecasts*” is not defined. As the length of the reasonable and supportable forecast period increases, the degree of judgment involved in estimating allowances for credit losses will likely increase.⁵ Ultimately, the length of the reasonable and supportable forecast period should be based on the level to which the institution can support its forecast of economic conditions that drive its estimate of expected loss.

⁵ This is because the availability of detailed inputs for future period estimates would likely decrease. See ASU 2016-13, p. BC52

Reversion method to historical loss information

While some institutions may be able to generate reasonable and supportable forecasts through the contractual life of a loan or pool of loans, such forecasts are not required for periods in which they are not supportable. Thus, when an institution is no longer able to develop or obtain a reasonable and supportable forecast, it must revert to using historical loss information.⁶ However, the CECL approach does not prescribe a specific method for reverting back to historical loss information following the end of the forecast period; rather, it permits institutions to revert immediately, on a straight-line basis over a financial asset's estimated life, or through another rational and systematic method.

An institution's reversion method will likely depend on the depth of its historical loss information and its ability to use its systems or processes to efficiently and effectively redefine the calculation parameters for key historical loss statistics. Ultimately, management must develop a reversion method that is rational, systematic, and results in an appropriate measure of credit losses.

How expected prepayments affect the estimate of expected credit losses

Estimating expected credit losses over long periods of time generally require a significant amount of judgment. Under the CECL approach, institutions must estimate credit losses over the entire contractual term of the financial assets, considering the effect of prepayments, which directly impact the measurement of credit losses.⁷

An institution may utilize internal prepayment assumptions when estimating the remaining contractual lives of its financial assets. Internal prepayment assumptions used for CECL estimation purposes should be supported by historical data or industry research. In addition, management should consider whether these assumptions are internally consistent when the same or similar assumptions are used for other accounting estimates, such as fair value measurements. For example, management may consider whether prepayment and default assumptions used in an estimate of expected credit losses for non-agency residential mortgage-backed securities are consistent with the prepayment and default assumptions used to measure the fair value of those same securities.

⁶ ASC 326-20-30-9

⁷ Prepayments reduce potential loss by shortening the time period over which the lender (investor) is expected to be exposed to credit losses to a period of time less than the full contractual term. Under the CECL approach, prepayments may be considered explicitly (i.e. as a separate input in the method) or implicitly (i.e. embedded in the credit loss information).

Level of aggregation and the assessment of similar risk characteristics

Management’s judgement is likely when aggregating financial assets with similar risk characteristics for the purposes of measuring credit losses under the CECL approach. Institutions are required to measure expected credit losses of financial assets on a collective basis (i.e. pooled basis) unless the assets do not have similar risk characteristics. If the assets do not have similar risk characteristics, the financial asset must be evaluated on an individual basis. The CECL approach generally provides flexibility on how institutions can choose to pool their financial assets, including by internal or external credit ratings.⁸ Therefore, institutions may utilize their internal risk management policies and practices to determine which assets to aggregate. Smaller and less complex institutions may continue to follow the practices they have used for appropriately segmenting the portfolio under an incurred loss methodology or they may refine those practices.⁹

III. Comparability of Loss Allowances

Historically, the FASB has taken a more “rules-based” conceptual methodology when developing their accounting standards, which often include prescriptive rules and bright-line tests that apply to very specific transactions and/or areas of accounting. In contrast, principles-based accounting standards are generally limited to broad-based guidelines. Therefore, principles-based standards often require the use of significant judgment when applying them in practice.

The guidance for credit loss measurement under the existing incurred loss approach is generally rules-based and requires several different measurement approaches for various types of financial assets. In contrast, CECL is considered a principles-based approach, as it does not mandate the use of a specific measurement method (e.g. the discounted cash flow method). Rather, it presents a single measurement objective that serves as the underlying principle for the credit loss measurement methods applied by institutions. Under this measurement objective, the allowance for credit losses should represent the portion of the amortized cost basis of a financial asset that an institution does not expect to collect. An institution will be permitted to apply any reasonable method to measure an allowance as long as its estimate achieves the CECL measurement objective.

The flexibility of CECL means that it is not a “one size fits all” accounting method. It is expected that CECL will be scalable to institutions of all sizes.¹⁰ This flexibility will probably allow institutions to apply judgment in developing estimation methods that are appropriate and

⁸ Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency (2016). *Joint Statement on the New Accounting Standard on Financial Instruments – Credit Losses* (The “*Joint Statement*”). Page 5.

⁹ Other suggestions include aggregation by financial asset type, effective interest rates, etc. See ASC 326-20-55-5.

¹⁰ *Joint Statement*. Page 2 (“Scalability”).

practical for their circumstances. In general, the complexity and sophistication of the CECL impairment analysis should be proportional to the complexity and sophistication of the institution itself. While this decision-making flexibility is considered a benefit, particularly to smaller, less complex institutions, it could result in institutions with similar loan portfolios and risk profiles utilizing different methodologies to estimate credit losses, which could reduce comparability of these estimates.

The choice of modeling assumptions may further reduce the comparability of loss provisions for those institutions using models in their expected credit loss estimation process. In a 2016 report, the International Auditing and Assurance Standards Board (IAASB) observed that large ranges of expected credit loss estimates can result in only minor differences in modeling assumptions due to the sensitivity of the output to changes in the assumptions.¹¹ Similarly, Chae et al. (2018) found that, controlling for portfolio composition, differences in the methodology used to construct forecasts and differences in the timing of revisions to those forecasts can have a nontrivial effect on loan loss allowances.

Both the IAASB report and Chae et al. (2018) illustrate the extent to which modeling decisions may impede the comparability of expected credit loss allowances, particularly if the users of financial statements are unable to identify the degree to which the variation in such provisions is driven by credit risk versus model uncertainty. Under the incurred loss approach, higher provisioning levels typically correspond directly to increased losses. By incorporating idiosyncratic modeling decisions, the strong correlation between loan loss allowances and realized loan losses may be weakened. Higher risk portfolios under optimistic expectations could be confounded with lower risk portfolios with more conservative expectations. Users of bank financial statements could face difficulty in disentangling the degree to which variation in loan loss allowances is driven by modeling assumptions as opposed to differences in underlying risk.

IV. Modeling, Data, and Documentation Requirements

The U.S. banking regulatory agencies stated in their Joint Statement that they will not require institutions to engage third-party service providers to assist management in calculating allowances for credit losses under CECL.¹² Institutions that utilize models to internally estimate these allowances will need to develop new CECL-compliant credit loss models, or update their existing models to conform to the CECL measurement objective. This may require significant

¹¹ Given the complexity and uncertainty implicit in an expected credit loss model, and the significant level of judgment that is involved in measuring expected credit losses, the IAASB report notes that it is possible that the auditor's range, or difference between management's estimate and the auditor's point estimate, may be multiples of performance materiality.

¹² *Joint Statement*, page 5 ("Use of Vendors").

expertise and judgment in order to deliver reasonable estimates of expected credit losses on an ongoing basis. In applying CECL, management has to make decisions about modeling principles, which could have a material impact on the allowance for credit losses.

In addition, institutions will be required to collect and maintain relevant data to support estimates of lifetime expected credit losses in a way that aligns with the method(s) used to estimate its allowances for credit losses. In many cases, the data used in estimating loss allowances under the current incurred loss approach are not based on a “life-of-loan” concept. For example, charge-off ratios, probabilities-of-default, loss-given-default, and other data currently used to estimate the loan loss allowances are based on activity during specific time periods (such as one year), and not the lives of the financial assets.¹³ In this regard, the agencies have encouraged institutions to discuss the availability of historical loss data internally and with their core loan service providers because system changes related to the collection and retention of data may be warranted. Depending on the estimation method (s) selected, institutions may need to capture additional data and retain data longer than they have in the past.

Finally, it is likely that institutions will be required to provide substantially more documentation supporting their qualitative factor adjustments under CECL. While the complexity and sophistication of the CECL analysis will be consistent with the complexity and sophistication of the bank itself, the practical requirement of additional data and analysis will still need to be addressed, and the level of detail is expected to be greater than under current accounting standards.

V. Procyclicality Considerations

As discussed, credit loss recognition typically occurs under the incurred loss approach when it becomes *probable* that a loss has been incurred, based on past events and conditions (such as loss of employment, disability, or bankruptcy). When this probability threshold has been met, an institution’s net income is reduced through the recognition of loss provisions. In contrast, the CECL approach does not specify a probability threshold for the recognition of loss provisions. Rather, institutions are required to recognize provisions for new financial assets immediately on “day one” (e.g. upon origination of new loans) in anticipation of a future loss event, regardless of the event’s probability of occurring. All else equal, this change will accelerate the recognition of loss provisions, but it will not change the total amount of net charge-offs realized on the financial assets.

The potential benefits of removing the “probable” threshold from the credit loss accounting guidance include the earlier recognition and timely reporting of credit losses and reduced

¹³ American Bankers Association (2016). “*CECL Implementation Challenges: The Life of Loan Concept.*” Gullette, Michael L. Page 5.

procyclicality of loss provisions. There are, however, differing views on the latter. For example, Chae et al. (2018) examined the degree to which the future path of house prices affects the size and timing of loss provisions for first-lien residential mortgages under the existing incurred loss model and the CECL approach, assuming perfect foresight regarding future economic conditions.¹⁴ The authors find that CECL is generally *less pro-cyclical* than the incurred loss approach. Assuming that institutions have at least a limited capacity to predict near-future macroeconomic trends, they conclude that CECL should achieve its goals and lead to a less procyclical, more forward-looking provisioning behavior than the incurred loss approach. This would dampen the degree to which allowances are overstated at the trough of an economic cycle and understated at its peak.

Similarly, based on applying CECL to the housing market prior to the financial crisis, deRitis (2018) finds that CECL will be less procyclical than the incurred loss approach, as lifetime loss estimates for new originations would have risen as lending standards loosened from 2004 through 2007. deRitis identifies other potential sources of countercyclical loss reserving, including adjustments to reflect differences in asset-specific characteristics and reasonable and supportable forecasts.

In contrast, Covas et al. (2018) find that CECL would have been highly procyclical had it been in place during the 2007-2009 recession. The authors estimated loss allowances using the CECL approach and incorporating contemporaneous macroeconomic forecasts. Specifically, they note that CECL allowances based on such forecasts would not have increased significantly relative to allowances determined using the incurred loss methodology until the beginning of 2007. Thereafter, loss allowances would have increased significantly over the period between the first quarter of 2007 and third quarter of 2008.

Covas et al. faults the “day one” recognition of credit losses as a substantial cause for the increased procyclicality of CECL. The study notes that institutions will be required to record expected lifetime losses for newly originated loans without recognition of a corresponding gain that would reflect their expected higher future interest income. “As a result, institutions will book an immediate loss, with no compensating gain, for each loan they make, and that loss will be highest for bank dependent borrowers that are most vulnerable in an economic downturn. Institutions struggling to maintain profitability in a downturn will have a strong incentive to stop lending to such borrowers.”¹⁵

¹⁴ Chae, Sarah, Robert F. Sarama, Cindy M. Vojtech, and James Wang (2018). “*The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves*,” Finance and Economics Discussion Series 2018-020. Washington: Board of Governors of the Federal Reserve System.

¹⁵ Covas, Francisco and William Nelson (2018). *Current Expected Credit Loss: Lessons from 2007-2009*. Bank Policy Institute, Staff Working Paper 2018-1 Pgs 6-7.

Chae et al. suggests that the procyclicality of CECL is reduced when financial institutions have at least a limited capacity to provide ‘reasonable and supportable’ forecasts of credit losses during periods of changing economic conditions. However, the authors’ acknowledge that there are many challenges with forecasting that could complicate this process. For example, institutions may choose to rely on consensus economic forecasts when estimating their allowances for credit losses under the CECL approach, but such forecasts can vary significantly and are regularly revised during periods of recession. In addition, certain economic indicators, such as the unemployment rate, may be inaccurately measured during the early days of a recession. Indeed, Covas et al. notes that the unemployment rate was significantly underestimated at the start of the 2007-2009 recession. In this instance, it is questionable whether an institution relying on such data would have sufficiently increased credit loss provisions on a timely basis when applying the CECL approach.

Although these studies reach varying conclusions, the authors generally agree that the CECL approach’s impact on cyclical of loss allowances will depend on institutions’ ability to predict changing economic conditions.

There are two aspects of CECL approach that may temper procyclicality of loss allowances. First, “reasonable and supportable” forecast is not defined in the accounting standard. Therefore, institutions are free to develop their own perspectives and policies when interpreting this term. Given the previously discussed difficulties associated with economic forecasting, institutions may opt to apply relatively short “reasonable and supportable” forecast periods. This could mitigate the extent to which CECL impacts the procyclicality of loss allowances, although the magnitude is an empirical question. Second, as previously discussed, forecasting is not required for periods in which a forecast is not supportable. When an institution is no longer able to develop or obtain a reasonable and supportable forecast, it must revert to using unadjusted historical loss information. If institutions choose to apply relatively short forecast and reversion periods, the overall measurement of expected credit losses will remain largely consistent with their historical loss information and the incremental cyclical effects of economic forecasting will likely be diminished.

VI. Conclusion

The CECL approach was created as a simpler, principles-based accounting alternative that addresses the procyclical shortcomings of the incurred loss approach. In one respect, CECL succeeds in being a simpler approach by presenting a single measurement objective that serves as the underlying principle for credit loss measurement. However, the CECL’s reliance on forward-looking information could introduce new costs and complexities to credit loss accounting. Institutions may incur additional costs to support adjustments made to historical loss information to reflect changing economic conditions, including financial modeling, data, and

documentation costs. Institutions may also be required to use considerably more judgment when performing these adjustments, which may increase the risk of management bias in loss allowances and decreases their comparability across institutions and time periods.

The CECL approach's success or failure in reducing the procyclicality of credit loss allowances may ultimately depend on institutions' ability to reasonably forecast changing economic conditions and adjust credit loss estimates accordingly. Chae et al (2018) study concludes that CECL reduces procyclicality when institutions have at least a limited capacity to provide such forecasts. However, Covas et al (2018) argues that economic forecasting is inherently difficult and often inaccurate. As a result, institutions may opt to revert to historical loss information after relatively short forecast periods, which could reduce the extent to which CECL addresses the "too little, too late" concerns of stakeholders.

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