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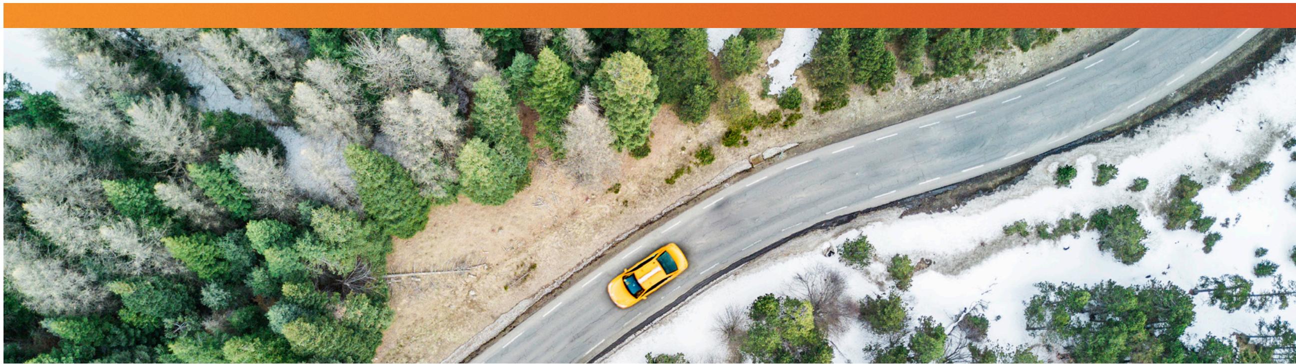

The Journey to Implementation Continues

Shifting from an "Incurred" Loss to an "Expected" Loss Model

Current Expected Credit Loss (CECL) is a new accounting standard that will replace ASC 450-20 (FAS 5) and ASC 310-10-35 (FAS 114). In June 2016, the Financial Accounting Standards Board (FASB) published ASC 326, *Financial Instruments – Credit Losses*, through ASU 2016-16 that defines the new CECL requirements. Under the new requirements, credit losses under GAAP move from an "incurred" measurement to a lifetime "expected" loss measurement. Whilst current rules generally observe a 12- to 36-month loss horizon for "probable" credit losses, CECL removes the "probable" loss threshold and requires a "lifetime credit loss" allowance to be established on day one.

The global financial crisis highlighted the need for timely response to, and financial reporting of, credit losses on loans and other financial instruments. Many believed the incurred loss approach identified losses "too little and too late" and suggested a more forward-looking "expected loss" approach for recognising and reporting credit losses sooner, and thus the need for a more forward-looking approach. Therefore, as defined under the new guidance (ASC 326-20-30-10), "[A]n entity's estimate of expected credit losses shall include a measure of the expected risk of credit loss even if that risk is remote."

Comparison of Changes Between Current and New Standard

Current — Incurred Loss Model	New — Expected Loss Model
A. General Allowance – ASC 450-20 (FAS 5) • Incurred Loss Estimate • Qualitative Factors • Nine (9) Qualitative Factor Categories **B. ASC 310-30 (SOP 03-3) Purchased Credit Impaired Loans** • Pooled based on similar risk characteristics • Pools accounted for as a single asset with a single interest rate and aggregate expectation of future cash flows **C. SC 310-10-35 (FAS 114)** Three acceptable methods for impairment analysis • Fair market value of collateral method • Discounted cash-flow method • Observable market price	**Lifetime Expected Credit Losses (Replaces ASC 450-20 (FAS 5) and ASC 310-30 (SOP 03-3))** • **Lifetime Expected Loss Estimate** — Pooled loans based on similar risk characteristics as granular as possible whilst maintaining statistical relevance — Nine (9) qualitative factors and underlying drivers to support analysis — Past, current and future events • Internal information • External information • Past events • Current conditions • Reasonable and supportable forecasts • **Individual Loan Loss Estimates (Replaces SC 31-10-35 (FAS 114))** — Performed when it's determined that a financial asset does not share risk characteristics with other financial assets/loan pools

CECL implementation dates

- *Public business entities that are SEC filers must adopt CECL guidelines for fiscal years beginning after December 15, 2019.**
- *All other public business entities must adopt CECL guidelines for fiscal years beginning after December 15, 2020.*

** Effectively, January 1, 2020, for calendar year SEC filers.*

Note: Early adoption is allowed for all entities starting with fiscal years beginning after December 15, 2018.

Changing from an incurred loss approach to an expected loss approach is expected to have significant ramifications across the financial services industry, such as the following:

- **Changes to Accounting Methodologies:** Current practices estimate expected credit loss that has already been incurred, primarily driven by historical experience. In contrast, CECL requires expected credit losses for the life of the exposure and adjustments based on historical information, current events, and reasonable and supportable projections.
- **Increased Data Requirements:** Companies will need to assess their existing data and IT systems and take steps to enhance their data warehouses, IT systems and controls accordingly. Depending on the types of products and the model framework, in general, more data is required to be collected to support CECL calculations.
- **Measurement and Modeling Approaches:** Companies will need to review their current model inventory and determine if new models need to be implemented or if retooling of existing models is needed to comply with CECL requirements.
- **Capital Adequacy:** CECL may impact the regulatory capital institution's need to hold to meet solvency requirements. To address the capital impact, an interagency proposed rule[1] published in May 2018 will allow banking organisations to phase in the day-one regulatory capital effects of CECL adoption over three years. The proposal does not change the timing or amount of the initial GAAP accounting entries under CECL. Instead, it changes the way regulatory capital ratios are calculated for three years (12 quarters) following CECL implementation.

[1] The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (board) and the Federal Deposit Insurance Corporation (FDIC) proposed a rule on May 14, 2018, titled, "Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations."

- **Changes to Business Processes, Internal Controls and Systems:** Companies will need to redesign their current loss reserve processes and systems to reflect changes from CECL. For example, business processes will need to be assessed to identify potential new risks and the assessment of internal controls to mitigate those risks.
- **Governance/Oversight and Policy/Procedures:** Companies need to establish effective governance and oversight practices to manage the transition. This includes clearly defining the roles and responsibilities of the board and senior management, as well as establishing policies and procedures that will integrate the CECL model into their ALLL process and existing credit risk management functions.

In this paper, we summarise key similarities and differences between ASC 310-10-35 and CECL and key challenges and considerations that companies should be aware of as they continue their journey in implementing CECL.

The Changes to Expect from Implementation of CECL

Changes to the Impairment Approach

The existing standard under ASC 310-10-35 defines loans classified as "impaired" when, based on current information and events, it is probable[2] that the company will be unable to collect all amounts due according to the terms of the contractual loan agreement. After a loan is identified as impaired, the loan is removed from its respective ASC 450-20 pool and analysed on an individual basis. An impairment analysis is performed to determine if the collateral value is greater or less than the recorded outstanding balance.

The new standard under CECL removes the notion of impairment as previously defined under ASC 310-10-35 and replaces it with less prescriptive guidance under ASC 326-20-30-2, as follows:

"If an entity determines that a financial asset does not share risk characteristics with its other financial assets, the entity shall evaluate the financial asset for expected credit losses on an individual basis."

When an institution identifies a loan as defined above, the loan should be removed from the lifetime expected loss pool and evaluated in a manner similar to that of an impaired loan under the old standard when the characteristics of the credit are unique to the existing pool or if liquidation of collateral is probable or in process. However, the loan will not be termed "impaired" as defined under FAS 114, as the ASC eliminated this terminology in the new standard.

Under CECL, as with the requirement under ASC 310-10-35 (FAS 114), collateral dependent loans should be analysed individually and should be excluded from the lifetime expected loss loan pool. Collateral-dependent financial assets occur when foreclosure or liquidation of the collateral is probable.

Changes to Troubled Debt Restructuring (TDR) Approach

The approach for estimating expected credit loss for TDR loans, which was previously conducted under the various methods prescribed under ASC 310-10-35, will change under CECL. Financial institutions will continue to account for a modification as a TDR if the institution, for economic or legal reasons, grants a concession to the borrower that it would not otherwise consider (related to a borrower's financial difficulties).

Under CECL, TDRs will be calculated under the same method applied to other financial assets carried at amortised cost (e.g., on a pool basis). The new standard replaces the methods prescribed in ASC 310-10-35, which previously required TDRs to be identified as impaired under FAS 114 and measured using specific methods applicable to individually impaired loans (e.g., discounted cash flow and fair value of collateral). As previously mentioned, the notion of the term "impaired" is removed under CECL as previously defined under FAS 114 guidance.

Financial institutions will need to consider pooling TDR loans to estimate expected credit loss collectively based on common risk characteristics or, if warranted and justified, will need to exclude these loans from common pools and evaluate on an individual loan basis.

Additionally, the new accounting standard requires:

- The value of concessions made by the creditor in a TDR loan to be incorporated into the allowance estimate; and
- The pre-modification effective interest rate to be used to measure credit losses on a TDR loan when applying the discounted cash flow method.

[2] The FASB defines "probable" as meaning "The future event or events are likely to occur." The judgemental determination of the "probable" threshold should be applied by the company by using their normal loan evaluation procedures.

Increased Emphasis on Pooling

Because the new standard does not provide prescriptive guidance on when a loan should be individually evaluated, institutions will need to develop policies, procedures and controls to define when it is reasonable to:

- Remove a loan from a loan pool for individual analysis; and
- Develop a new loan pool if loans removed from a loan pool share similar risk characteristics.

Management will need to understand clearly the risk characteristics within the institution's loan pools to differentiate between characteristics of using the collateral method versus the expected loss method. It is likely that auditors and regulators will require clear documentation supporting why loans are being analysed individually versus remaining in pools. If the characteristics of the credit warrant removal from the pool to be analysed individually, management should determine if other loans meet characteristics whereby an additional segment is required.

Other Changes and Considerations

Establishing Loan Segmentation (or Loan Pools)

The old guidance disclosed in FASB ACS 450-20 addressed "evaluating loan losses for loans in homogeneous portfolio segments with similar risk characteristics." The new standard will continue to require companies to evaluate losses based on segments with similar characteristics, with the additional requirement that those segments be as granular as possible while still maintaining statistical relevance (FASB Topic 326). The guidance also requires companies to analyse historical losses and current conditions and establish reasonable and supportable forecasts for each portfolio segmentation.

The new CECL accounting standard brings fundamental changes to how organisations account for credit losses as the requirements shift from incurred loss to lifetime expected loss measurement.

Management will need to evaluate the appropriateness of the current portfolio segmentation and determine if more granular segmentation is needed to provide a more predictable measure of losses while still maintaining statistical relevance. For example, a company with a commercial real estate loan portfolio segment may require further granularity by segmenting the portfolio by underlying products within the portfolio (e.g., multifamily loans, owner-occupied RE loans, condominium loans, etc.). Management should be prepared to support the appropriateness of portfolio segments by performing and documenting periodic assessments to support why further granularity within the segmented portfolio would not provide greater statistical relevance.

Financial Statement Disclosures

Under CECL, financial institutions are challenged by the FASB to provide investors with more transparency into an organisation's credit risk health, including the information needed to understand management's methodology and estimates at each reporting period. The source of this data is in the form of the financial statement footnotes, MD&A and risk factor disclosures.

While some disclosure changes are significant, requiring new presentation such as the amortised cost of financial assets by origination year (vintage), others require more qualitative changes explaining the inputs used to estimate credit losses, such as for off-balance sheet credit exposures. Many legacy disclosures were retained with minor adjustments; however, others are to be superseded, such as the impaired loans disclosures, since the concept of impairment no longer exists under CECL.

Under CECL, held-to-maturity (HTM) debt securities are measured at amortised cost; therefore, disclosures previously applicable only to loans and receivables are now applicable to HTM debt securities. An assessment of an institution's credit loss disclosures today, compared to the requirements of CECL, is imperative to identify superseded as well as the required changes to disclosures, or new disclosures. As part of this assessment, institutions will need to inventory data points necessary to satisfy the requirement, inclusive of the qualitative comments required by CECL. Additionally, changes to data

warehouses or other repositories may be required so that historically based data, such as vintage, may be presented. In conjunction with data-mapping assessments, institutions should assess the sufficiency of their current-state internal controls, as well as revisions required to ensure the accuracy, integrity and completeness of their credit-related data. A close working relationship with the institution's external and internal auditors is one of many keys to success.

Removal and Replacement of Key Terms and Concepts

Key term and word changes are required within disclosures due to the ASC 326 impact, such as revising "impaired loans" to "expected credit losses for all loans and held-to-maturity debt securities" and "provision for loan and lease losses" to "expense for credit losses" to highlight the expected credit loss terminology.

New terminology and qualitative drivers have also been introduced as part of CECL. New definitions and terminology referenced within ACS 326-20 Financial Instruments Measured at Amortised Cost and ASC 326-30 AFS Debt Securities are listed below:

Credit Quality Indicators – A statistic about the credit quality of the financial asset, of which the entity applies judgement in identifying appropriate credit quality indicators for each class of asset, including class of financing receivable and major security type. Examples of credit quality indicators include borrower FICO score (i.e., a score representing the creditworthiness of a potential borrower), credit risk rating (internal or third party), debt-to-value ratios, and collateral or other internal metrics such as historical collection experience (ACS 326-20-55-15 to ACS 326-20-55-16).

Class of Financing Receivable – ASC 326-55-11 provides guidance on the determination of class of financing receivable, stipulating that an entity should base its determination of class of financial receivable by disaggregating the level that the entity uses when assessing and monitoring credit risk and performance of the portfolio. Examples of factors an entity should consider are (a) categorisation by borrower, (b) type of financing receivable such as mortgage loans, credit cards and finance leases, (c) industry section, (d) type of collateral, and (e) geographic distribution.

Major Security Type – Similar to the determination of class of financial receivable, a major security type is a group of securities based on the nature and risk of the securities.

In Closing

The new CECL accounting standard brings fundamental changes to how financial institutions and other non-financial organisations (e.g., those that hold financial instruments like accounts and notes receivable) account for credit losses as the requirements shift from incurred loss to lifetime expected loss measurement. CECL will also directly impact numerous functions and departments, as it requires key changes to current processes, systems and internal controls.

As the January 1, 2020, CECL effective date for first-wave (calendar year) SEC filers quickly approaches, impacted organisations should already be completing a gap assessment to evaluate the impact and preparing an implementation plan to develop the required future state. Implementation tasks should be prioritised and should cover activities such as changes to accounting and financial reporting disclosures, current business processes, systems, and internal controls; retooling or implementing new credit loss models; creating a plan to collect additional data to support CECL calculations; and training impacted employees. Second-wave calendar year filers with an effective date of January 1, 2021, should be working now to perform gap assessments and develop implementation plans, as compliance with CECL is a large-scale effort that requires significant planning and brings fundamental changes to key financial and operational processes.

How Protiviti Can Help

Protiviti's dedicated professionals can help clients identify key areas of change needed to meet CECL requirements and assist with implementation of changes to business processes. Protiviti has deep subject-matter expertise and experience in allowance and credit risk processes and internal controls over financial reporting (SOX), project management support, accounting and financial reporting compliance, and other risk management skills needed to identify and address gaps in order to comply with the expected implementation timeline.

Protiviti can help assess an institution's models and provide recommendations to calibrate or redesign existing models, or build new ones. Protiviti also provides independent model validation services to assess compliance of the models with CECL requirements and consistency with industry standards, and assists with new accounting and financial reporting compliance initiatives and disclosures.

We help institutions enhance their overall data infrastructures, streamline data-collection processes and ensure proper governance over the required data assets. These data improvements will be needed to meet the requirements of CECL methodologies and produce timely financial disclosures.

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