CECL Implementation Challenges: The Life of Loan Concept

A Discussion Paper of the

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Background

As the Financial Accounting Standards Board (FASB) completes its deliberations on its Current Expected Credit Loss (CECL) model for accounting for the impairment of loans and held-to-maturity (HTM) debt securities, bankers and banking regulators have been urging FASB to ensure that CECL will not result in a requirement to implement complex financial models and processes. With this in mind, the American Bankers Association (ABA) believes it is critical to analyze the practical, operational differences between the current “incurred loss” model as practiced by banking institutions in the U.S. and the CECL model, as it is understood at this time. Although FASB has not completed deliberations on CECL, preliminary decisions related to the model framework have been made. Wording of the final standard, including implementation guidance, will be critical in influencing how CECL will be implemented.

The many constituents of FASB have different interests related to the implementation of CECL:

1. Investors seek to forecast capital levels that ultimately result in dividend payouts or capital-raising requirements. Thus, investors seek transparency as to management’s expectation of total losses (without a concern that the loss has actually been incurred or not). Investors also seek a standard that is easy to understand in order to execute proprietary forecast models that evaluate management’s expectations and compare expectations between companies.

2. In their enforcement of safety and soundness standards, regulators must ensure that the allowance for loan and lease losses (ALLL) recorded is a fair representation of the losses expected in bank loan and HTM debt security portfolios. In their supervisory roles, however, while regulators encourage bankers to be “forward-looking” in their analysis of credit risk management, they do not want bankers (especially community bankers) to be burdened with systems that are costly and complex.¹

3. Bankers seek to minimize cost and reduce complexity. Bankers must efficiently estimate the ALLL within tight regulatory reporting timeframes and also explain to investors and board members the results of their operations and how their estimates are derived. Bankers also are concerned with reliability of the CECL model -- and the volatility that is the result of that. This unreliability can, for practical purposes, result in building unneeded capital buffers on top of those already required.

¹ Both Comptroller of the Currency Thomas J. Curry (September 16, 2013) and Federal Reserve Board Chairman Janet L. Yellen (May 1, 2014) have spoken publicly of the need for an impairment model that does not require complex modeling processes for community banks.
The objective of this paper is to assist investors, regulators, bankers, and FASB in evaluating the various challenges of a conversion to CECL\(^2\). Some challenges are naturally a part of any change and can be addressed through an adequate time period for transition to the new standard, through industry-based discussions that focus on comparability and consistency of practice, and through appropriate educational efforts for all the parties involved. We believe, however, the biggest challenges may be avoided through thoughtful wording by FASB of the final standard. As a result, we provide recommendations that are intended to ease the burden of CECL implementation and practice while maintaining a forward-looking, expected loss provisioning model that we believe aligns with FASB’s intended impairment model.

**Scope**

The biggest challenges of CECL center on the “life of loan” (LOL) loss concept, whereby credit losses expected over the life of the loan are effectively recorded upon origination. While implementation of an expected loss impairment model will require significant work, the LOL concept appears to *require* certain changes that compound the challenges. There are other challenges with specific aspects of the CECL model as of the date of this paper.\(^3\) However, this paper focuses on the LOL concept, as it is the centerpiece of the CECL model.

We hope this paper is a first step that elicits discussions by all parties on these and other ideas and viewpoints for improvement prior to the issuance of a final standard. As a first step, we will also update this paper as feedback is received, questions are posed, and alternatives are proposed. After issuance of a final standard, the issues discussed in this paper can then be used to assist in the effective implementation by all constituents. Questions and comments can be sent to Mike Gullette at mgullette@aba.com.

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\(^2\) Auditors are also a key constituent within the financial reporting process. The key concern that auditors have is the auditability of the data and assumptions underlying the ALLL estimate. For the purposes of this paper, auditor concerns are similar to those of bankers in that bankers must provide auditors with appropriate reasonable and supportable evidence to support their ALLL estimate. Specific mention of auditor-related concerns is provided as needed.

\(^3\) For example, certain disclosures may require significant overhaul of many loan servicing systems.
Discussion

1. **Vintage analysis,** whereby loan portfolios are generally broken out into cohorts by each issuance year, could become a minimum requirement in order to support the ALLL estimate under CECL.

Other analyses may be more appropriate than vintage analysis as a basis for the ALLL estimate. However, because vintage analysis allows for review of loan activity from the beginning of the life of the loan (origination) to the end (pay-off or charge-off), it will likely be the minimum requirement\(^4\). This is a major change from current practice and, while it may not always involve unmanageable complexity, it could increase the amount of work required by many bankers by multiples. For example, an ALLL estimate for a portfolio of loans with an expected life of four years will necessitate four different ALLL estimates – one for each vintage.

2. **Internal control requirements over the loan origination function are likely to expand under CECL.**

Because loan originations will create immediate accounting events – loss expectations – under CECL, it is expected that additional detailed processes will be required to ensure that factors underlying loss expectations are appropriately identified and tracked. Such factors may include appraisals underlying loan-to-value ratios on collateral and analyses performed during underwriting. While work like this may currently be performed operationally at many banks, this is expected to be a new process within a financial audit, as it is not currently assumed that the loan origination transaction creates a loss expectation.

*(Update added April 2015)*

In August 2014, the PCAOB issued a Staff Consultation Paper *Auditing Estimates and Fair Value Measurements* and is also expected to issue another discussion paper in 2015 specifically on the use of specialists during an audit. Any new auditing standard that ultimately results from these PCAOB proposals\(^5\) could significantly increase the extent of

\(^4\) While bankers may use “origination-to-charge-off” loss information (without a break out by vintage) on all loans issued during a specified period, vintage analysis will likely be requested by auditors in order to identify “loss curve” patterns and to evaluate exposures that may result from changing underwriting standards or the progression of an economic cycle.

\(^5\) Modifications to PCAOB standards are subject to a formal due process. The PCAOB evaluates feedback received on staff consultation papers and, if necessary, issues a proposal that also is subject to public feedback. Any approved standards are then subject to approval by the Securities and Exchange Commission. Therefore, it may be years before such changes go into effect.
auditing procedures related to the loan origination process. While an increase could result under the current incurred loss impairment accounting model, it would likely be significantly greater under CECL. For example, the work of appraisers and the related data that the appraisers use often are key factors in estimating a loss expectation. As a result of any additional PCAOB standards, under certain circumstances, testing of the work of third-party property appraisers (including the validity of the price data that the appraiser utilizes) could be treated as though the appraiser was not independent of the company, thus increasing the required audit procedures over that area.

3. **Data used to support ALLL estimates will likely change under CECL.**

Data underlying most current ALLL estimates are not based on a LOL loss concept. In other words, current charge-off ratios, probabilities of default, loss given default, and rates based on past due status are based on yearly charge-offs. These rates, based on activity during specific time periods (such as one year), do not satisfy the LOL loss expectation requirement. Therefore, systems must be reconfigured and static pools must be maintained to adequately provide appropriate LOL loss rates. Depending on the individual portfolio and accompanying loan administration system, origination data – a key part of the LOL loss analysis – may not exist and must be retrieved amidst hard-copy documents for the initial years of implementation.

4. **Use of historical data must be reconsidered under CECL.**

   a. As current annual charge-off data will no longer be relevant under CECL, discussions will be necessary to determine what charge-off periods will be used for the ALLL analysis. For example, many banks currently use, as a starting point for their estimate for commercial loans, average charge-off rates based on the most recent two to four years of data. Assuming a loan portfolio with a four year expected life, using the most recent four years of fully-developed LOL data (vintage data) will require the bank to rely on data that is three years old (this will be the latest vintage to mature). Due to its age, the relevance of such underlying data is put into question.

   b. Economic cycles tend to be exhibited by several years of low levels of charge-offs, followed by short periods of high charge-offs. The resulting averages, with extremely wide ranges of outcomes, puts into question the statistical validity of much historical data. If historical averages are used as a starting point for the ALLL estimate, large

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6 While the outstanding consultation paper addresses a similar requirement related to only to specific circumstances related to the use of third-party pricing services, the same auditing requirement can be anticipated when the PCAOB specifically addressed in their forthcoming paper on specialists.
adjustments, based on management’s judgment will often be required in order to arrive at an actual loss expectation. This will challenge both bankers and auditors.

5. **Asset/Liability management (ALM) systems may be subject to audit under CECL.**

Prepayments will be considered in determining an expected life of a loan portfolio under CECL. As a result, new internal controls over the ALM systems will likely be necessary in order to comply with Sarbanes-Oxley and FDICIA-related internal control attestation requirements. In most cases, this will necessitate integrating the timing of charge-off expectations with prepayments. ALM is performed at many smaller institutions by third-party service providers, thus introducing additional costs relating to third-party verification for community banks.

6. **Traditional relationships of credit metrics to ALLL levels and loss provisions will change under CECL. (Update added April 2015)**

Because expected losses are recorded at origination, there will be no natural relationship between the levels of key credit metrics to the current ALLL or the loss provision. Metrics like this will include:

- current delinquencies,
- loan-to-value ratios,
- impaired loans,
- annual charge-offs or annual loss rates, and
- troubled debt restructurings (TDRs)

The historic relationship of “credit performance improves, credit losses decrease (and vice versa)” will no longer be a relevant theory. Metrics related to current period performance may help identify concerns related to future net interest income. However, they will not necessarily be used to forecast credit losses. For example, a period-to-period increase in defaults may, nevertheless, result in a decrease in the credit loss provision if the level of defaults is lower than expected and already provided for at the time of origination.

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7 This situation can exist under the current incurred loss impairment model, but is greatly amplified by the much longer forecast period required under CECL.

8 A significant portion of audit deficiencies noted by the Public Company Accounting Oversight Board (PCAOB) relate to accounting estimates (of which the ALLL is one). The greater judgment required under CECL (as compared to the current ALLL process) is expected to put more pressure on auditors in complying with PCAOB standards.
Bankers, auditors, and investors must, therefore, devise and rely on other types of metrics in order to evaluate the reasonableness of credit loss forecasts. It will likely be necessary for bankers to insert “tipping points” to credit metrics in order to determine levels in which changes in the expected loss will be necessary. Otherwise, bankers may be increasingly subject to criticisms of “earnings management”.

7. **Credit quality disclosures may increase significantly under CECL.**

As vintage analysis may become the basis for credit quality evaluation, disclosures related to credit quality may need to expand to address each critical vintage\(^9\). This could increase the current GAAP-based disclosures four-fold or more. For SEC-registered institutions, disclosures will also need to address those concerns raised under the previous point on traditional credit metrics.

8. **Investors may need more guidance related to capital buffers.**

As with other models used for financial decision-making, a new model used to estimate the ALLL under CECL will be subject to regulatory model risk management standards. Those standards detail expectations related to model validation procedures, including the evaluation of back-testing results.\(^{10}\) Any new process naturally introduces questions of model reliability and may result in unwarranted volatile ALLL estimates. Further, a new process that requires long range forecasting compounds those concerns and may make back-testing validation of the model very challenging.

Increased ALLL volatility may require an increased capital buffer, which will limit the dividend-paying capability of the bank. Investors will require more information of the impacts in order to make their own forecasts of dividends.

9. **Support for the length of “forecastable futures” may be needed. (Added April 2015)**

Under CECL, for future periods beyond which the entity is able to make or obtain reasonable and supportable forecasts, the proposal requires the bank to revert to unadjusted historical credit loss experience. While such a requirement appears to necessitate vintage analysis as a primary basis for the ALLL estimate\(^{11}\), it also appears to then require banks to maintain

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\(^9\) Under Accounting Standards Codification 310-10-50, disclosures are broken out by class of financing receivable. Among other things, Class is determined by the entity’s method for monitoring and assessing credit risk. In this case, it appears that a vintage will often qualify as a class.

\(^{10}\) Vintage analysis also will play an important role in back-testing, as original expectations (at origination) will be a significant part of the CECL model.

\(^{11}\) If unadjusted historical credit loss experience is used for periods beyond the forecastable future, double-counting of loss rates will likely occur unless the loss experience is broken out by age of asset (vintage). As an example, a
documentation of the process to determine the length of the foreseeable future, including how the length is determined and why it is limited.

We understand that this decision was made to allay concerns that smaller institutions voiced on their capabilities to forecast the future. However, such a bifurcation of the portfolio life might also require further audit focus and testing. Bankers are noting that accounting firms are requiring detailed supporting documentation on the length of “loss emergence periods” under the current incurred loss accounting model. Thus, we are concerned that the firms may also want an analysis to support the length of the forecastable period. Given that in times of stress the unadjusted historical average loss rates outside of the forecastable future could be perceived by investors to be significantly different from an actual expectation, detailed documentation that supports this forecastable future may become a critical piece of audit evidence. This could add to both complexity and cost.

10. Accurate quarterly financial reporting may need more time. (Added April 2015)

Banking institutions normally are the first companies to report their financial results each quarterly earnings reporting season in the U.S., with the largest banks conducting their earnings calls within days after the end of the fiscal period. Under the incurred loss method of impairment accounting, losses on newly-issued loans normally are considered to be insignificant (as a rule, banks do not make loans that are impaired at origination) and, thus, new loan commitments and disbursements are not a critical measurement in quarter-end financial reporting of ALLL. Under CECL’s LOL concept, however, new loan commitments are expected to have an impact on profit and loss and must be closely tracked.

Because of the relatively large “day 1” impact to net income and capital, quarter-end cut-off procedures will now be a larger focus of the audit. As a result, banks may require longer closing periods from the current reporting timeframes.

12 In current practice, the ALLL for unimpaired loans is based on the outstanding balance of unimpaired loans, which includes newly-issued loans. However, this is consistent with the notion that some losses have been “incurred but not reported” and not because there is a loss expectation on these loans. As a result, the ALLL that would be proportionately applied to such loans would also be much smaller than a LOL-based ALLL.
11. Guidance related to individual vs. pool analysis is critical. (Added April 2015)

Within the current incurred loss model, the ALLL for impaired loans is generally estimated using a detailed loan-by-loan analysis of expected loss, while the ALLL for unimpaired loans is estimated collectively (using pools of loans) for what is incurred, but not reported (IBNR). Such a distinction between individual vs. collective analysis and impaired vs. IBNR allowances goes away with CECL, as the ALLL for all loans is evaluated and measured based on an expected loss concept. Guidance will now be needed to determine whether collective evaluation or individual evaluation will be appropriate, for the following reasons:

a. FASB has preliminarily decided that the expected life of a loan should consider expected prepayments, but should not consider expected extensions, renewals, or modifications, unless the institution anticipates executing a troubled debt restructuring (TDR). Anticipating a TDR is relatively straight-forward when evaluating individual loans. However, it is not clear on how to integrate such an expectation into a collective loss analysis. Guidance will be needed on whether historic TDR patterns should be considered in estimating the portfolio life. If historic TDR patterns will be required, then additional data points are needed within loan servicing systems.

b. Impairment on debt securities is currently evaluated on a security by security basis. CECL will generally require impairment on held to maturity (HTM) securities to be evaluated on a collective basis, unless there are no multiple assets with similar risk characteristics. ABA believes that some HTM investments, such as many municipal securities, may not be appropriate for collective analysis. However, the work that may be required for a bank to prove/document that individual analysis is more appropriate on an ongoing basis could be substantial.

c. The overall requirement to first consider collective (pool) analysis causes concerns for many community banks because there may often be insufficient data that supports “statistically valid” loss assumptions. The lack of a critical mass for specific portfolios, accentuated by any need to break the life of loan performance of those portfolios into vintages, may result in average loss rates that are not meaningful.

13 Losses on unimpaired loans that are individually significant may also be evaluated and measured individually.

14 ABA is not saying that all ALLL models must strictly be based on “statistically valid” data. However, generally speaking, the lower the sample size, the less reliable and precise the estimate. There naturally becomes a point where low reliability and precision are not acceptable. In these cases, market data may be available, though market data will not often be relevant to specific local communities.
12. Banks may be encouraged to discount their ALLL (Added April 2015).

Discounted cash flow analysis (DCF) is one of the currently prescribed methods for measuring impairment on an individual impaired loan, and is a method that complies with CECL. DCF could have a significant impact on ALLL levels for certain loan products, but the cost to perform DCF – generally performed in practice today on a detailed and individual loan basis only on large or impaired loans – is generally considered to be prohibitive if all loans are included in the analysis. Given the significant other changes that ALLL systems will require (and because discounting will likely result in lower allowances and higher capital), banks may be encouraged by investors to perform some form of DCF. In other words, if banks are required to spend so much on new ALLL systems, some may view it as a time to acquire systems that can perform DCF.

Certainly, based on how DCF is implemented, the information technology resources required can be significant. It may be possible, however, that the “loss curves” produced by some high-level vintage analyses will be considered an adequate basis for the expected timing of the cash flows in specific portfolios. With this in mind, if the acceptable processes of discounting of cash flows are defined relatively broadly, this could encourage more banks to use the DCF method. On the other hand, a strict definition of allowable practice could limit discounting only to those institutions that are large and/or sophisticated enough to perform such analysis.

Bankers should be ready to evaluate whether using the DCF method is feasible for their institutions, and sophisticated investors may want to know the rationale for the decision (the assumption would be that the bank is accepting effectively higher capital levels). This could be raised as an issue by bank investors because of inconsistencies when comparing the ALLL levels and provisions between institutions, since some may perform DCF and some may not.

15 Of course, there will be operational challenges on how forecasts of the future are integrated into these analyses, as well as reconciling the actual timing of cash flows to charge-off data if such data is relied upon.
**Conclusion:**

Based on the challenges described above, ABA recommends:

1. Either eliminate the “life of loan” concept to CECL or insert language that alleviates the strict life of loan concept. For example,

   “Banks may not ignore foreseeable conditions, in light of contractual terms, all the way until the end of the expected life. However, banks are not necessarily required to perform detailed life of loan analysis.”

   Such language may allow for flexibility in using methods that may not strictly satisfy the LOL concept, but would likely result in ALLL levels that are not significantly different from those that do.

2. Eliminate the required consideration of prepayments within the definition of expected life of a portfolio. Since the impact of prepayments on historic portfolio losses are reflected within a portfolio’s “loss curve,” a requirement to consider prepayments introduces complexity for community banks and their auditors that should not significantly impact the ALLL estimate. Omitting this requirement (though including it as a possible factor in the analysis) alleviates many banks the burden to consider prepayments within their CECL models.

3. Provide five years of transition toward the CECL implementation. This can be generally broken out by:
   a. Eighteen months for banking regulators, with input from the auditing and banking industry, to determine and communicate specific practice expectations.
   b. Two years for banks to reconfigure systems, including gathering data not currently collected.
   c. Eighteen months of parallel testing by banks, feedback by bank examiners, and education of investors and bank directors.