Global Research & Analytics

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Understanding the Current Expected Credit Loss (CECL) model

In the aftermath of the 2007-2008 global financial crisis, regulators turned stridently critical of the methods used to calculate the provision for loan losses, which had come up woefully short.

Consequently, they announced new rules such as the International Financial Reporting Standards 9 (IFRS 9) and current expected credit loss (CECL) to determine appropriate levels of balance sheet reserves needed for such losses. We believe these regulations would have widespread, deep and long-lasting impact on the banking industry.

After the Financial Accounting Standards Board (FASB) announced CECL to recognize and measure credit losses for loans and debt securities, the refrain on Banking Street has been that it is the "biggest-ever change in bank accounting this decade".

Companies registered with the Securities and Exchange Commission will begin implementation of CECL in 2020 and others in 2021. For non-public business entities, the effective date will be December 31, 2021. Early adoption is allowed for accounting periods after December 15, 2018.

The most significant impact of both IFRS 9 and CECL is the introduction of the expected credit loss model in place of the incurred-loss model, which requires banks to set aside additional capital. Moreover, banks will need to make significant changes to their loss-forecasting methodology. While the incurred-loss model relies on past impairment, CECL is based on future expected loss.

Such a shift in assessment methodology means:

- Uniform accounting standards for loans of all credit quality
- Estimation of future losses on debt portfolios
- Accounting for losses at the inception of the instrument
- Special treatment for acquired loans with significant change in credit quality
- Requirement of new disclosures such as credit quality indicators

Highlights

Loss estimation	Accounting
• Replaces the current incurred-loss accounting with CECL, the expected loss model • Forward-looking loss estimation under CECL reflects the current risk in the portfolio, which includes both current and future credit losses • Does not rely upon annual loss rates, but on the life of a loan or life of portfolio loss rates	• Amounts that banks do not expect to collect will be recorded in the allowance for loan and lease losses (ALLL) and in an allowance for credit losses • Additions to the ALLL to be recorded as expenses • Potential volatility inherent in a long-term forecast will likely present cost of capital and make earnings more volatile to assumption changes

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