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ILM vs. CECL: What's the difference?

As US financial institutions have filed their allowance estimates for Q3 2020, we have compiled results from CECL adopters[1] that follow the Current Expected Credit Loss framework, and the non-adopter banks that follow the Incurred Loss Model (ILM) framework, to provide a view of the potential impacts of adoption. We present the analysis to show how the allowance fluctuated over the past three quarters overall and by high-level product category.

At first glance, the numbers reveal that CECL on average has increased the allowance set aside by 30% to 40% over the past three quarters, but we can already see differences start to emerge depending on bank size. A common interpretation among 2023 adopters is that CECL will be cost-punitive, so we should adopt at the last minute—but this may not always be true. This paper takes a deeper dive into product categories to elucidate that CECL may not be linear in the expected allowance increase, and that product category and concentration matter.

Figure 1 Total allowance by bank segments for Q1-Q3 2020[2]

All Portfolios Bank Allowance Comparison
Bank Segment Heatmap

1) $1 - $10 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	1.22%	1.22%	1.32%
CECL	1.59%	1.72%	1.71%
Delta	23.67%	29.21%	22.74%
2) $10 - $20 Billion	**Q1 2020**	**Q2 2020**	**Q3 2020**
ILM	0.88%	0.89%	1.01%
CECL	1.66%	1.76%	1.82%
Delta	46.93%	49.42%	44.34%
All Banks	**Q1 2020**	**Q2 2020**	**Q3 2020**
ILM	1.29%	1.38%	1.50%
CECL	1.99%	2.55%	2.57%
Delta	34.94%	45.90%	41.70%

We tracked each institution's allowance for loan loss estimates and amortized cost as reported in the FDIC Call Report (RI-C schedule) for both adopters and non-adopters. Off-balance sheet exposures and reserves for unfunded commitments are excluded from this analysis. The analysis focuses on the group of banks with less than $20 billion in assets, although we have compiled the statistics for the entire universe of banks across the United States.

We summarize the banks' weighted average[3] allowance results by the following categories based on total asset size as of September 30, 2020 (Figure 1).

» All banks—920, including banks with assets over $1 billion
» More than $250B—13 banks with total assets greater than $250 billion
» $50B to $250B—36 banks with total assets between $50 billion and $250 billion
» $20B to $50B—45 banks with total assets between $20 billion and $50 billion
» $10B to $20B—57 banks with total assets between $10 billion and $20 billion
» $1B to $10B—769 banks with total assets between $1 billion and $10 billion

[1] CECL adopters consist of all Public business entities as defined by the FASB, plus any early adopters of the CECL standard.

[2] Delta allowance represents the % difference between CECL and ILM allowance numbers.

[3] Note: all banks with zero balances for loans and leases in any product categories were not included in the weighted averages so as to not overly bias our results to the downside.

Distribution of allowance rates under both CECL and ILM

The allowance ranges across institutions—regardless of methodologies being used—can change drastically based on but not limited to portfolio composition, asset quality, loan contractual terms, management judgment, and (where applicable) scenario assumptions and mean reversion methodology. Although CECL model assumptions make it tough to compare directly with ILM, some of the key factors include weighted average life (WAL) vs. loss emergence period (LEP), which provides a direct comparison for how long one applies a credit factor to the portfolio. The lookback period upon which a probability of default (PD)/loss given default (LGD) is conditioned under the ILM approach is now contrasted with the forward-looking, scenario-conditioned PD/LGD that CECL requires. These two variances alone could help explain a lot of the differences we observe in our analysis.

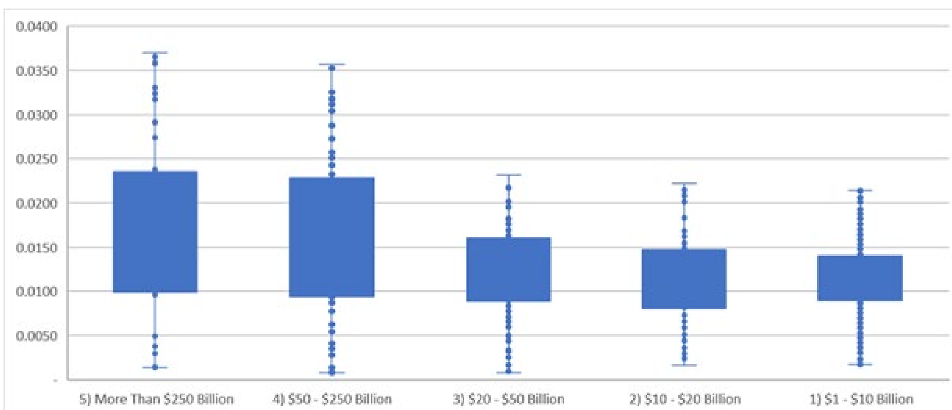
Distribution of all allowance rates shown in Figure 2 offers a glimpse of the bank-level allowance dispersion across category size. As noted in the introduction, the average allowance seems to be materially higher in the category predominantly applying the CECL framework for the allowance ($20 billion and above). However, we note the number of outliers in the smaller banking categories, which may not preclude the fact that some banks may actually have a level of allowance that could decrease under CECL upon adoption. The three questions we want to answer are:

1) Which portfolio concentration and what type of attributes may attract lower levels of allowance under CECL?

2) Does CECL increase volatility across all categories of the allowance portfolio?

3) Should 2023 adopters think about early adoption or at the very least parallel runs?

Figure 2 Distribution of actual allowance under both CECL and ILM methodologies



We now examine the product-level allowance statistics to better grasp averages across product types.

Construction loans

The All Banks category in our assessment for construction portfolios (Figure 3) saw allowance differences increase over the past three quarters from 14% to over 30%, but seems to be stabilizing as of Q3. We note the marked difference between the $10B to $20B category and the $1B to $10B category as of Q1, but both categories now fall in line with the overall bank average of a 30% increase between the CECL and ILM methodology. Typically, a bank moving from the ILM method to CECL should expect a significant increase in its allowance under similar conditions.

Figure 3 Construction allowance for Q1-Q3 2020 adopters (CECL) vs. non-adopters (ILM)

CRE Construction Bank Allowance Comparison			
Bank Segment Heatmap			
1) $1 - $10 Billion	0 Q1 2020	Q2 2020	Q3 2020
ILM	1.41%	1.70%	1.68%
CECL	1.94%	2.72%	2.45%
Delta	27.29%	37.53%	31.35%
2) $10 - $20 Billion	0 Q1 2020	Q2 2020	Q3 2020
ILM	1.45%	1.46%	1.54%
CECL	1.60%	1.99%	2.27%
Delta	9.45%	26.81%	32.12%
All Banks	0 Q1 2020	Q2 2020	Q3 2020
ILM	1.41%	1.69%	1.68%
CECL	1.65%	2.44%	2.41%
Delta	14.35%	30.86%	30.33%

Commercial real estate loans (CRE)

The All Banks category in our assessment for CRE portfolios saw allowance differences decrease significantly over the past three quarters. We note that the difference in this category showed that the CRE portfolios attracted much less allowance starting in Q1, but that the gap closed rather quickly. This led to a negligible difference of about 4.66%, which may indicate that overall, the ILM method was playing catch-up to CECL.

Figure 4 indicates that the $1B to $10B bank category drove most of the lower allowance from an ILM perspective. In the $10B to $20B bank category, the CECL allowance was and still is much higher than the smaller category. There may be an upward bias in the $10B to $20B bank category, which included only 13 ILM and 34 CECL banks with non-zero balances to the 337 ILM and 86 CECL banks in the $1B to $10B bank category.

Figure 4 CRE allowance for Q1-Q3 2020 adopters (CECL) vs. non-adopters (ILM)

CRE Bank Allowance Comparison			
Bank Segment Heatmap			
1) $1 - $10 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	1.48%	1.67%	1.72%
CECL	1.18%	1.53%	1.62%
Delta	-24.61%	-9.23%	-6.52%
2) $10 - $20 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	0.82%	0.91%	1.13%
CECL	1.19%	1.55%	1.70%
Delta	30.79%	41.33%	33.50%
All Banks	Q1 2020	Q2 2020	Q3 2020
ILM	1.51%	1.72%	1.80%
CECL	1.18%	1.60%	1.72%
Delta	-28.37%	-7.44%	-4.66%

Commercial loans

The All Banks category in our assessment for Commercial & Industrial (C&I) portfolios saw allowance differences decrease significantly over the past three quarters, similar to the CRE portfolios. We note that the difference in this category showed that C&I portfolios attracted much less allowance starting in Q1 but that the gap closed quickly. However, it remains elevated at over 14%, as opposed to what we saw in the CRE portfolios. We also note that the All Banks category allowance experienced an allowance reduction as credit spreads became tighter, driven mostly by Federal Reserve and Government support of the economy.

As Figure 5 shows, the $1B to $10B bank category drove most of the lower allowance from an ILM perspective; in the $10B to $20B bank category, the CECL allowance was and still is much higher than the smaller category. There may be an upward bias in the $10B to $20B bank category, which included only 15 ILM and 2 CECL banks with non-zero balances to the 328 ILM and 12 CECL banks in the $1B to $10B bank category. Our bias comment stands for this portfolio as well given the breadth of banks covered under the $1B to 10B bank category. However, we noticed the two granular segments seem to be moving in opposite directions, and the difference since Q1 between the two that was 37%+ is now over 44%.

Figure 5 C&I allowance for Q1-Q3 2020 adopters (CECL) vs. non-adopters (ILM)

CnI Bank Allowance Comparison			
Bank Segment Heatmap			
1) $1 - $10 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	2.27%	1.75%	1.77%
CECL	1.70%	1.57%	1.45%
Delta	-33.34%	-11.23%	-21.57%
2) $10 - $20 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	1.52%	1.07%	1.06%
CECL	1.58%	1.35%	1.37%
Delta	4.18%	20.28%	22.48%
All Banks	Q1 2020	Q2 2020	Q3 2020
ILM	2.22%	1.74%	1.77%
CECL	1.60%	1.58%	1.54%
Delta	-38.55%	-10.48%	-14.46%

Residential real estate loans

The All Banks category in our assessment for residential portfolios saw allowance differences decrease modestly over the past three quarters from -4% to -5%, but seems to be stabilizing as of Q3. These differences reflect a slightly higher allowance under the ILM framework than CECL.

Looking at Figure 6, the $1B to $10B bank category reflects similar differences to the All Banks category. However, in the $10B to 20B bank category, the differences are much more pronounced and go in the opposite direction, where reserves are significantly lower under ILM than CECL. Similar to the prior segments, there may be an upward bias in the $10B to $20B bank category, which included only 7 ILM banks with non-zero balances compared to the 140 ILM banks in the $1B to $10B bank category.

Figure 6 Residential allowance for Q1-Q3 2020 adopters (CECL) vs. non-adopters (ILM)

Residential Bank Allowance Comparison			
Bank Segment Heatmap			
1) $1 - $10 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	1.13%	1.27%	1.25%
CECL	1.10%	1.24%	1.19%
Delta	-2.45%	-2.55%	-4.98%
2) $10 - $20 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	0.66%	0.81%	0.90%
CECL	1.09%	1.23%	1.24%
Delta	39.20%	34.62%	27.70%
All Banks	Q1 2020	Q2 2020	Q3 2020
ILM	1.10%	1.26%	1.23%
CECL	1.06%	1.20%	1.17%
Delta	-3.78%	-4.93%	-4.93%

Credit cards

The All Banks category in our assessment for credit card portfolios saw the allowance differences increase significantly and remain elevated over the past three quarters from 22% in Q1 to 46% in Q2 to 40% in Q3. These differences reflect a significantly higher allowance under the CECL framework than ILM. This is consistent with many of the larger banks with material exposure to credit card portfolios that had to build reserves with the CECL adoption at the start of the year. Credit cards typically have higher losses than most other types of loans along with a longer average loan life.

As shown in Figure 7, the $1B to $10B bank category experiences a shift with much lower reserves under CECL than ILM by -32% in Q1. However, in Q2 reserves were much higher under CECL than ILM by 27%, and then in Q3 CECL reserves were still higher but decreased to a 16% difference. The opposite is reflected in the $10B to 20B bank category, where credit card reserves were initially higher for CECL filers in Q1, and then reversed in Q2 where the non-CECL adopters experienced higher reserves. This trend continued in Q3, although at a lower difference and converging.

Figure 7 Credit card allowance for Q1-Q3 2020 adopters (CECL) vs. non-adopters (ILM)

Credit Cards Bank Allowance Comparison			
Bank Segment Heatmap			
1) $1 - $10 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	4.35%	3.07%	3.56%
CECL	3.31%	4.20%	4.23%
Delta	-31.36%	26.78%	15.80%
2) $10 - $20 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	5.24%	5.54%	4.59%
CECL	6.09%	4.10%	4.10%
Delta	13.98%	-35.07%	-11.83%
All Banks	Q1 2020	Q2 2020	Q3 2020
ILM	4.45%	3.33%	3.85%
CECL	5.70%	6.15%	6.37%
Delta	22.05%	45.86%	39.56%

Other consumer loans

The All Banks category in our assessment for the other consumer loan portfolios saw allowance differences begin to increase over the past three quarters. These differences reflect a higher allowance under the CECL framework than ILM. The allowance difference was minimal in Q1 as both allowances under both ILM and CECL adopters were fairly close. CECL reserves started to build more in Q2 whereas ILM stayed consistent, so the difference increased 10%. In Q3, the allowances declined for both ILM and CECL, although at a greater percentage decrease for ILM. Therefore, the difference was 14% in Q3.

In Figure 8, the allowance difference under the $1B to $10B bank category decreased throughout the past three quarters. Differences went from -14% in Q1 to -45% in Q3, in favor of much higher reserves under the ILM framework than CECL. The opposite is reflected in the $10B to 20B bank category, where reserves are significantly higher under CECL than ILM.

Figure 8 Other consumer allowance for Q1-Q3 2020 adopters (CECL) vs. non-adopters (ILM)

Other Retail Bank Allowance Comparison			
Bank Segment Heatmap			
1) $1 - $10 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	2.21%	2.45%	2.12%
CECL	1.94%	2.02%	1.47%
Delta	-14.25%	-21.54%	-44.70%
2) $10 - $20 Billion	Q1 2020	Q2 2020	Q3 2020
ILM	1.86%	1.79%	1.79%
CECL	2.83%	3.68%	3.66%
Delta	34.32%	51.42%	51.04%
All Banks	Q1 2020	Q2 2020	Q3 2020
ILM	2.43%	2.43%	2.16%
CECL	2.40%	2.70%	2.52%
Delta	-1.05%	10.12%	14.05%

Conclusion

Our analysis helped us dig deeper into whether CECL always leads to levels of allowance that are larger and more volatile than under the Incurred Loss Model (ILM). The data presented in this paper shows that it is highly dependent on the portfolio type, where we found that C&I, CRE, and other retail portfolios attracted lower levels of allowance in the aggregate.

We also ran some analysis (over a three-quarter period which, admittedly, is a very small sample) to show that CECL is not always more volatile than ILM. Specifically, CECL is more volatile overall, but for the C&I, residential, and credit card portfolios, we found that ILM produced higher levels of volatility across all three categories presented in the analysis. Conversely, construction and CRE CECL estimates were more volatile than ILM. In the remaining categories, we found a split across categories in terms of volatility.

We looked into the role that portfolio concentration played in the level of the allowance and found that the more concentrated the bank, the lower the allowance level (particularly for the C&I and residential portfolios but slightly different for CRE where very concentrated portfolios where most reserved for). The less concentrated the bank, the higher the allowance level. Intuitively, this would represent that banks with no concentration of C&I loans, for example, tend to be more conservative in their assessment of allowance for that portfolio than the more concentrated banks. Those banks should, on average, be much better at managing risk in those portfolios, thereby requiring a lower allowance buffer.

The preceding analysis is meant to help 2023 adopters digest the potential impact that the new accounting standard may have. It is also intended to give a high-level assessment to assuage concerns over delaying CECL adoption because it is cost-punitive. CECL is much more than just an accounting standard; when implemented with conviction, it serves as a catalyst to begin a transition toward better credit risk management that can help fine-tune strategies and drive enhanced return on capital.

Bank results

Individual financial institution results are available. Contact Phillip Lai (Phillip.Lai@moodys.com) or Laurent Birade (laurent.birade@moodys.com) for detailed breakouts of the bank-level results.

Additional resources from Moody's and Moody's Analytics

» Moody's Topic Page on COVID-19

» Moody's Analytics – CECL Benchmark Q3 2020

» Moody's Analytics – CECL Q2 Results Amid COVID-19

» Moody's Analytics – CECL Q3 Results Amid COVID-19