CECL Q&A with Anna Krayn

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Anna Krayn, Senior Director at Moody's Analytics, is responsible for solution structuring for regulatory and accounting solutions.

American Banker spoke with Anna Krayn from Moody's Analytics about CECL, the new FASB accounting standards on current expected credit loss.

Why did the CECL standard come about?

Going into the financial crisis, banks' reserves were too low in part because the accounting standards only recognized losses when we knew someone was going to default.

CECL forces incorporation of forward-looking information to calculate reserves. We are moving from measuring reserves based on incurred losses to reserves based on the expected losses over the life of the instrument.

What's wrong with establishing reserves based on incurred losses?

Under the existing rule, the bank reserves against future losses based on the indication of customer's probable default using its historical experience for similar loans. Let's say the bank has a portfolio of mortgage loans that are all paying on time. Historically, this portfolio had minimum losses to the bank. Under the current accounting rules, the bank is not putting a material reserve against these loans as historical and current conditions do not indicate any significant losses in the future. Even if the bank expects severe economic downturn in the near future, it may not put aside additional reserves under current rules.

How far along is the industry in implementing CECL?

The industry is in nascent stages. In our recent survey of regional banks, ⅓ of respondents are still learning about the CECL standard and about ⅓ are beginning to plan their projects, forming governance structures, and deciding, who in the organization will take responsibility. About ¼ of the firms are working on scoping and budgeting, so very few (about 10%) have begun implementation.

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Can banks use their existing processes as a starting point?

Absolutely. Some banks will develop CECL frameworks using their current loan loss allowance models. Those that have stress-testing capabilities may start there and others may use their internal credit risk management and risk rating models as a starting point. That said, the ability to access historical information, to adjust for current conditions and forecast future losses over the life of the instrument will be crucial to becoming compliant with the CECL standard.

What are some of the key decisions involved with selecting an approach to CECL modeling?

One of the first order decisions is granularity of the credit loss estimation approach. At one end of the spectrum, many firms look at peer ratios and reserves at a coarse level (e.g. call report categories). By contrast, a more granular approach looks at the credit picture for each borrower and each loan. Granular approaches offer new benefits under CECL, as banks that can better differentiate credit risk may justify recording lower allowance at origination and therefore keep more deployable capital, as ABA noted in June.

The new standard is principle-based, but it does specify that institutions should forecast based on pools of similar borrowers' risk profile, with the ability to move borrowers between pools as their circumstances change. That aggregation is easiest to accomplish using a granular approach.

Next, figure out how you're going to incorporate forward-looking information, such as economic conditions, into your decision-making. One way to do that is with qualitative, expert judgment as an overlay to the existing incurred loss process.

An alternative that many banks seek to employ (from our recent survey), is to statistically link macroeconomic variables to loss estimates. While this approach requires appropriate historical data to the modeling effort, it does allow for more granular differentiation of risk.

What are some of the expected effects of CECL on the industry?

Most firms have not yet been able to assess the full impact of the standard, but one early assessment anticipates loan-loss reserve balances going up as much as 30 to 50 percent. Banking product mix may change as well, since the requirement to set aside allowance for the entire life of a financial instrument creates incentives toward shorter-term loans.

Also, CECL expands the scope of financial assets for which an credit loss allowance is set. Held to maturity debt securities will be assessed under the CECL standard. The expansion of scope, lifetime expected loss calculations, as well as demands for robust disclosures presents a dramatic overhaul of the banks' processes, controls, systems, modeling methodologies and reporting. The banks will want to utilize tools that would allow them to make educated decisions to improve business decision making and to supply appropriate disclosures to the investors.

Moody's Analytics supports institutions in their CECL implementation

Moody's Analytics credit risk data, models, economic forecasts, advisory services, and infrastructure solutions support implementation of the Current Expected Credit Loss (CECL) model.

Learn more: http://www.moodysanalytics.com/cecl

About Moody's Analytics

Moody's Analytics, a unit of Moody's Corporation, helps capital markets and credit risk management professionals worldwide respond to an evolving marketplace with confidence. The company offers unique tools and best practices for measuring and managing risk through expertise and experience in credit analysis, economic research and financial risk management. By offering leading-edge software and advisory services, as well as the proprietary credit research produced by Moody's Investors Service, Moody's Analytics integrates and customizes its offerings to address specific business challenges.

CONTACT US
Visit us at **moodysanalytics.com** or contact us at a location below:

AMERICAS
+1.212.553.1653
clientservices@moodys.com

EMEA
+44.20.7772.5454
clientservices.emea@moodys.com

ASIA (EXCLUDING JAPAN)
+852.3551.3077
clientservices.asia@moodys.com

JAPAN
+81.3.5408.4100
clientservices.japan@moodys.com

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