Evolution of Current Expected Credit Losses

An Earth-shaking Accounting Standards for Financial Institutions

NC STATE UNIVERSITY

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– Financial Math Program

Introduction

The financial crisis of 2007-2008 demonstrated that the **Allowance for Loan and Lease Losses(ALLL)** accounting standard does not allow for timely adjustment of reserve levels based on reasonable expectation of future conditions.

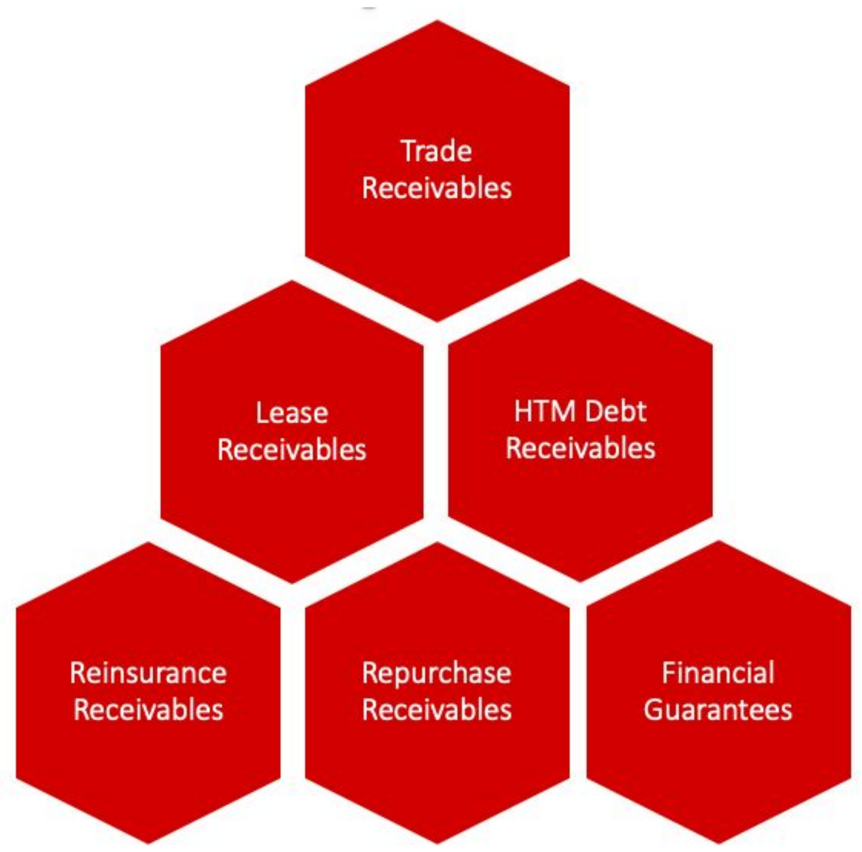
Incurred Losses Model: Currently the impairment model is based on incurred losses, and investments are recognized as impaired when there is no longer an assumption that future cash flows will be collected in full under the originally contracted terms.

CECL Model: Financial institutions will be required to use historical information, current conditions and reasonable forecasts to estimate the expected loss over the life of the loan

Comparison

	PD	LGD	Other Factors
Basel	One-year through-the-circle PD	Downturn LGD	Not prescribed
Stress testing	Stressed PD aligned with forecast horizon	Life of the loan	Forecast are 13 quarters in length
CECL	Life-of-loan Point-in-time PD	Life of the loan	Macroeconomic forecasts need to align with the same time horizons used in assessing PD and LGD; assumptions need to be documented and relationships to the portfolio and the allowance need to be demonstrated

Results



Conclusion

Criticism: Although the implementation of CECL is designed for making financial system to be improved in a positive way, not every players in the market like it. The Bank Policy Institute points out that CECL forces banks to recognize expected future losses immediately, but does not allow them to recognize immediately the higher expected future interest earnings banks receive as compensation for risk. This could result in a decrease in availability of lending to non-prime borrowers, stunting economic recovery following a downturn.

Advantage:CECL is less procyclical and more precise. Setting aside sufficient credit loss reserves may enhance a bank's ability to absorb future loan losses and thus continue to lend at a higher rate than if it had not done so.

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