WELFA WEDNESDAY WEBINARS@1

CECL: A New Accounting Standard and a Challenging Credit Environment

July 22, 2020

Housekeeping

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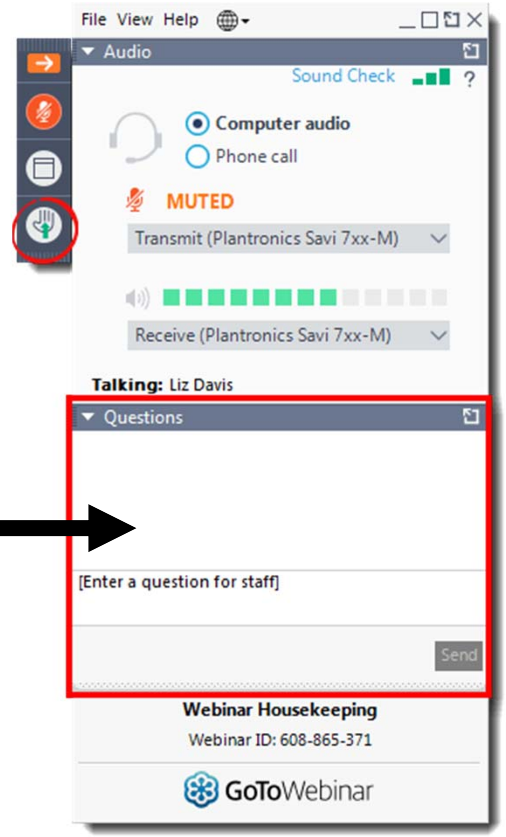

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Today's Topics

Polling question

What is the implementation status of your CECL adoption?

CECL Refresher

CECL Overview

- The credit loss standard (Accounting Standards Update (ASU) No. 2016-13) changed how entities account for credit losses for most financial assets and certain other instruments.
- The standard addresses the recognition, measurement, presentation and disclosure of credit losses for certain financial assets.
- Effective date: 2020 for SEC filers excluding SRCs and 2023 for other entities.
- The three new or updated models for estimating credit losses:

Current expected credit loss (CECL) model (ASC 326-20)
▸ Financial assets measured at amortized cost, including receivables (trade, reinsurance and other), contract assets, Held-to-maturity (HTM) debt securities and loans ▸ Net investments in leases recognized by a lessor ▸ Off-balance-sheet credit exposures not accounted for as insurance
Available-for-sale (AFS) debt security impairment model (ASC 326-30)
▸ AFS debt securities
Model for certain beneficial interests classified as HTM or AFS that are not of high credit quality (ASC 325-40)

IFRS 9 (ECL)	▸ IFRS 9 consolidates the financial instrument guidance related to classification and measurement, impairment (expected credit losses) and hedge accounting. ▸ Effective for annual periods beginning on or after 1 January 2018.

CECL Model

Core Concepts			
Based on asset's amortized cost	**Reflect losses over asset's contractual life**	**Consider available relevant information**	**Reflect the risk of loss**
Refers to the portion of a financial asset's amortized cost basis an entity does not expect to collect	Reflect losses that are expected over the remaining contractual life of an asset	Consider information about past events, current conditions, and reasonable and supportable forecasts about the future	Include a measure of the expected risk of credit loss, even if that risk is remote

Lessor – net investment in a lease

Lease receivable Right to receive future lease payments + guaranteed residual value Credit Risk	+	**Unguaranteed residual asset** *Unguaranteed* portion of estimated residual value Noncredit Risk	=	**Total Net Investment in the Lease**[1]

[1] If lease is a direct financing lease, any selling profit is deferred and the deferred selling profit reduces the net investment in the lease.

- **Lease receivable** and **unguaranteed residual asset** discounted using *rate implicit in the lease*
- The lessor's entire net investment in the lease is assessed for impairment using CECL

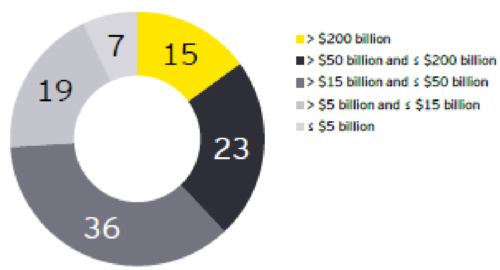
Note: Operating lease receivables are not in scope of CECL. Lessors should continue to apply the guidance under ASC 842 to determine collecbility of operating lease receivables.

CECL Disclosure Research

Summary of CECL Disclosures

100 sample entities - allowance for loan losses (ALL) (see Note)

Number of entities in our sample, by total assets

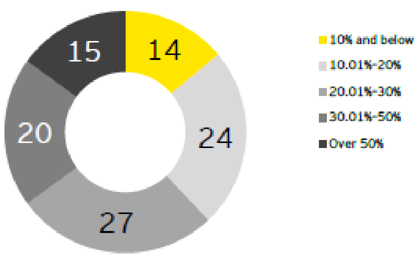


We reviewed the disclosures made by 100 entities that extend significant amounts of credit. Our sample included:

- **top 25 banks measured by assets**
- **69 other banks of varying sizes**
- **6 other companies with long-term financing receivables**

Change in ALL as of 31 March 2020 compared to 1 January 2020

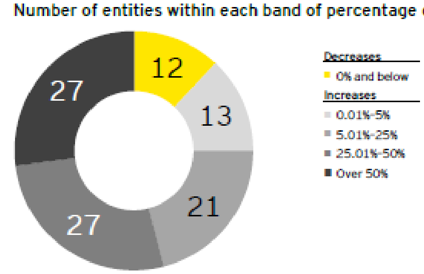
Number of entities in each band of percentage increase



- The entities in the sample were clear about what drove their ALL.
- They generally said they increased their reserves on 1 January 2020 to reflect the adoption of CECL, and they increased their reserves further in the first quarter to reflect the sharp deterioration of economic conditions due to the COVID-19 pandemic.

Impact of CECL adoption on ALL (change in ALL from 31 December 2019 to 1 January 2020)

Number of entities within each band of percentage change



- Many entities indicated that forecasts of economic conditions have worsened since 31 March 2020, suggesting that ALL coverage ratios could rise in the second quarter.
- Several entities provided the ALL coverage ratio at the segment level. Very few entities provided enough details to determine the ALL coverage ratio at the loan product level.

Note: ALL includes loss allowance for loans/financing receivables and net investment in leases.

Summary of CECL disclosures

100 sample entities – disclosures on the effects of COVID-19

- Most of the entities in our sample stated in their disclosures that the COVID-19 pandemic was the most significant driver of the ALL in the first quarter. However, the level of detail they provided varied by entity.
- Approximately **one third of the entities (35%)** quantified their exposure to certain industries that were more heavily impacted by the pandemic (e.g., retail, hotels, travel, oil and gas).

35% Quantified their exposure to entities in industries heavily impacted by the COVID-19 pandemic (e.g., retail, travel, oil and gas)

Example disclosure of COVID-19 exposure by industry

COVID-19 impacted industry	Loan balance o/s	% of total loans held for investment	ALL	ALL %
Retail	100	10%	3.5	3.5%
Restaurants	50	5%	1.25	2.5%
Travel	75	7.5%	3.0	4.0%
Oil and gas	25	2.5%	.875	3.5%

- Many entities said they made qualitative adjustments to their ALL to reflect the risks not captured in their allowance models but only five entities disclosed the amount of qualitative adjustments they made due to COVID-19. Those adjustments varied widely, ranging from 10% to 35% of the overall ALL as of 31 March 2020.

5 Disclosed the amount of the qualitative adjustment made due to COVID-19

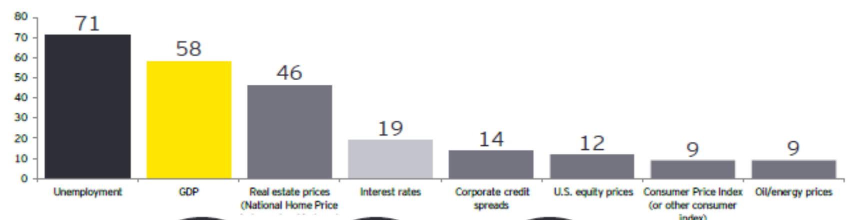
Summary of CECL disclosures

100 sample entities – forecasts and reversion

- The guidance requires a reasonable and supportable forecast of future economic conditions to be based on management's forecast, not a market-consensus view.
- Therefore, it is important for entities to provide disclosures that allow users to understand management's view of future economic conditions. This is even more important when management's view differs from the consensus and when economic conditions are rapidly shifting, as they were in the first quarter of 2020.

Macroeconomic factors used in the CECL estimate

Number of entities that disclosed the following factors used to develop a reasonable and supportable forecast of future economic conditions



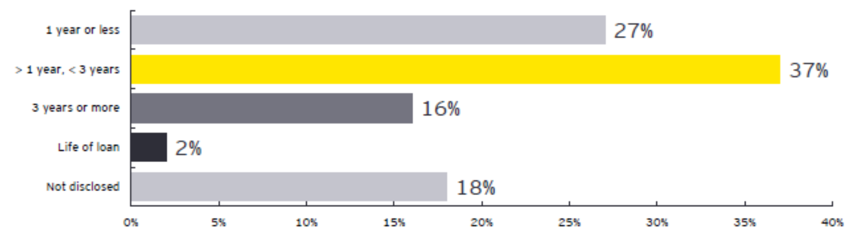
42% Disclosed use of a third-party forecast

21% Quantified macroeconomic inputs used in their forecasts

26% Disclosed a probability-weighting of forecasts

- The majority of entities that said they could develop a reasonable and supportable forecast for only one year or less had assets of less than $50 billion.
- A few entities disclosed that they reduced their reasonable and supportable forecast period to determine the allowance at 31 March 2020 from the period used in calculation at 1 January 2020.
- A few entities said they may change their reversion methodology (i.e., how they revert to basing the ALL on historical information when they can no longer make reasonable and supportable forecasts) and when they revert to using historical losses, depending on economic conditions.

Reasonable and supportable forecast period



Summary of CECL disclosures

100 sample entities – other disclosures

- Approximately 21% of the entities in our sample disclosed a material change to internal control over financial reporting related to the adoption of ASC 326, as required by the Sarbanes-Oxley Act of 2002. Another 8% of the entities in our sample disclosed that they added new controls that did not have a material impact.

21% Disclosed a material change to internal control over financial reporting

COVID-19 Considerations

Recent Developments

CARES Act

- The CARES Act allows insured depository institutions, bank holding companies, credit unions and their affiliates to defer the adoption of the new credit losses standard. <u>Note that this relief does not apply to any other types of companies (not available for corporates/lessors that do not meet the banking/depository institution definition).</u>
- These entities would not have to apply the new credit losses standard from March 27, 2020 (the date the CARES Act was enacted) until the earlier of the date the national emergency related to COVID-19 ends or December 31, 2020.

COVID-19

- Companies applying ASC 326, who are affected by COVID-19, will need to consider whether the effects of the pandemic could change their forecast of future economic conditions.
- See next slide for a number of key CECL points to consider under the uncertain times of the pandemic.

Recent Developments

- COVID-19 (continued):

Pooling	▸ Re-challenge grouping / pooling methodology ▸ Consider geographic differences (most impacted relative to other geographies) ▸ Consider more severely impacted industries (travel, entertainment, brick and mortar dependent retail)
Reasonable and supportable forecast	▸ Consider significant government support expected ▸ Monitoring of rapid change and updated facts and circumstances ▸ Consider sensitivity analysis with various economic scenarios ▸ Re-consider reversion period
Data and methodology	▸ Revisit models and assumptions as those may no longer hold in the current environment ▸ Consider if current models incorporate the effects of payment holidays, breaches of covenants, TDRs or increases in drawdowns ▸ Consider possible more reliance on overlays when the effects cannot be reflected in the models ▸ Consider sensitivity analysis and looking back to 2007/2008 data
Disclosures	▸ Consider disclosures highlighting the risks ▸ Consider disclosures about input, assumption or forward-looking adjustment associated with the outbreak, and if the effect is significant or it is otherwise useful to understand the uncertainty of future cash flows
Others	▸ Consider the requirement to adjust for reasonably expected TDRs considering providing more time for borrowers / customers to pay, assuming that additional time is more than inconsequential

Hot Topics for Lessors

Hot Topics for Lessors

- **Data and models**
  - Models lessors - PD/LGD and DCF
  - Historical data – consider information dating back to last financial crisis (if data is available)
  - Estimate recoveries
- **Macro economic factors considered**
  - Factors typically considered by lessors (may not want to consider all these factors simultaneously, given correlated)
    - Unemployment rates
    - GDP or other economic indicators
    - CPI or other inflation related index
  - Developing estimates in house vs. utilizing third party vendors
    - Driven by in-house capabilities of the entities and the level of complexities of the models chosen
  - Reversion to historical losses after macro economic period
- **Unguaranteed residual asset**
  - Required to be considered in estimate and should be monitored through the life
  - Consider extensions when determining lease term

Hot Topics for Lessors

- **Other implementation considerations:**
  - Program governance
  - Resources
  - Technology and systems
  - Internal controls
  - Disclosures


Q&A

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This web seminar has been recorded and will be available, along with the slides, on the ELFA website.

To request a certificate for CPE, please contact Janet Fianko at jfianko@elfaonline.org.

Please complete the post-event survey – it will be sent to you shortly after today's web seminar.

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Appendix

Effective Date and Transition

Effective dates

	New effective dates			Prior effective dates		
	SEC filers excluding SRCs	All other entities		SEC filers	Other PBEs	Other entities
Credit losses	2020*	2023*		2020*	2021*	2022*
	Early adoption is permitted in fiscal years beginning after 15 December 2018, including interim periods in those fiscal years.					

* Including interim periods within the fiscal year.

Modified retrospective approach

- Cumulative-effect adjustment as of the beginning of the first reporting period in which the guidance is effective
- Prior periods will not be comparative

New Disclosure Requirements

Forecasts
Discuss the factors that influenced management's reasonable and supportable forecasts and reversion method applied in the allowance calculation (may not be as significant for short-term assets)

Qualitative disclosures
Discuss how the allowance was developed, including the factors that influenced management's estimate, such as past events and current conditions, as well as the changes in those factors

Vintage analysis for certain in-scope assets
Disclose the amortized cost amount within each credit quality indicator by year of origination for the most recent five years (public business entities (PBEs) only, does not apply to receivables due in one year or less)

Rollforward of the allowance
By portfolio segment and major security type, provide quantitative disclosures of the activity in the allowance for credit losses for financial assets

Manage Changes to Process and Controls

- Increased data requirements
  - Accumulating historical loss information, measuring charge-off amounts and applying qualitative factors or adjustments outside of those already incorporated in the expected credit loss model (i.e., inclusion of forecasted information)
- Implementation of new or existing controls
  - Reviewing inputs to allowance calculation against accounting policy, including review of forecasts or economic measures to adjust historical loss percentages
- Changes to support potential increased disclosure
  - Design of existing disclosure-related controls may need adjustment for changes in the process for expected credit loss estimations