Review of the first wave of credit impairment disclosures under the new standard

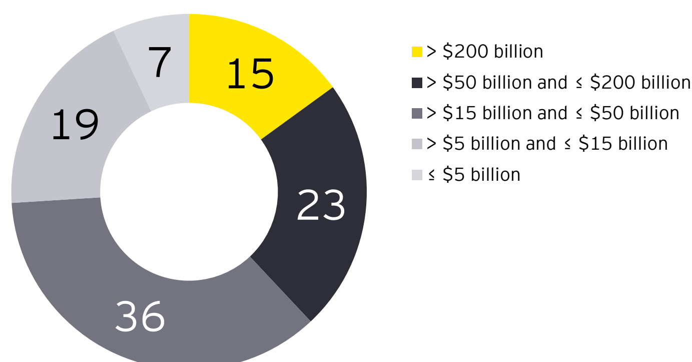
25 June 2020

Overview

Calendar-year Securities and Exchange Commission (SEC) filers that adopted the new credit impairment standard[1] on 1 January 2020 made their first disclosures under the new standard in SEC filings for the first quarter.

We reviewed the disclosures made by 100 entities that extend significant amounts of credit. **Our sample included the top 25 banks measured by assets, 69 other banks of varying sizes and six other companies with long-term financing receivables.**

Number of entities in our sample, by total assets



The guidance in Accounting Standards Codification (ASC) 326 significantly changes how entities account for credit losses for most financial assets and certain other instruments that are not measured at fair value through net income.[2] It requires them to create an allowance for lifetime expected credit losses rather than incurred losses, and it requires them to consider "reasonable and supportable" (R&S) forecasts of future economic conditions to estimate their expected credit losses.

The new standard, known as the current expected credit losses or CECL model, also requires entities to provide new disclosures about the credit quality of their financial assets and how they calculate their allowance for loan losses (ALL). However, the requirements are principles-based and give entities significant flexibility to determine the appropriate level of detail to provide users sufficient information to understand the credit risk related to the portfolio.

The standard says the requirements are intended to enable a user of the financial statements to understand:

- The credit risk inherent in a portfolio of financial assets and how management monitors the credit quality of the portfolio
- Management's estimate of expected credit losses
- Information about the changes in the estimate of expected credit losses that have taken place during the period

Among other things, entities are required to disclose:

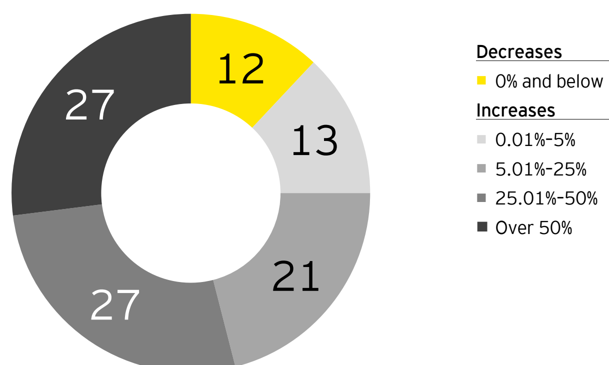
- An allowance rollforward by segment
- Amortized cost basis by credit quality indicator and by year of origination (i.e., by vintage) in addition to credit quality indicators by class, as was required under the legacy guidance
- A qualitative discussion of how the allowance was estimated
- Various accounting policy disclosures
- Credit risk and related items in management's discussion and analysis (MD&A)

Impact of CECL adoption

The entities in our 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.

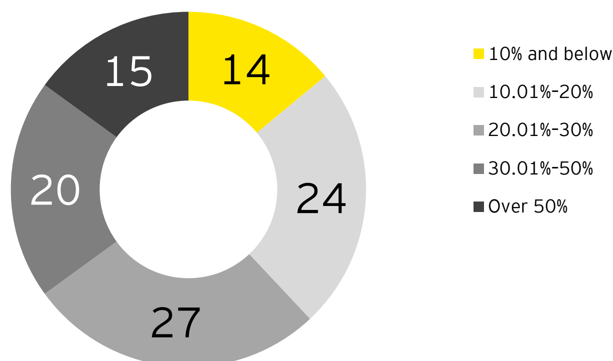
Impact of CECL adoption on ALL (change in ALL from 31 December 2019 to 1 January 2020)

Number of entities within each band of percentage change



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

Number of entities in each band of percentage increase

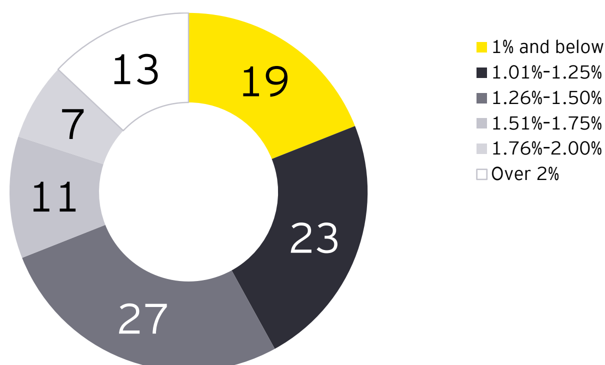


The most common range of ALL coverage ratio disclosed as of 31 March 2020, which expresses the ALL as a percentage of the loan portfolio, was 1.51% to 1.75%. Only 13% of the entities in our sample disclosed that their ALL coverage ratio was greater than 2%. However, many entities indicated that forecasts 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.

ALL coverage ratio (ALL as a percentage of the loan portfolio) on 31 March 2020

Number of entities in each band



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 in our sample (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)

However, those entities reported a variety of metrics to quantify their exposure. For example, some entities disclosed the total balance for loans to entities in a hard-hit industry, while others disclosed the percentage of loans to a hard-hit industry. Some entities in our sample also disclosed the amount of their ALL that relates to loans to entities in a hard-hit industry or presented the ALL for that industry as a percentage of their total ALL. Below is an example of the type of disclosure we observed for certain entities in our sample.

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 in our sample said they made qualitative adjustments to their ALL to reflect the risks not captured in their allowance models. Several of them indicated that these adjustments were used to reflect or partly reflect the impact of the COVID-19 pandemic. While some of the entities in our sample disclosed the types of factors they considered to develop those qualitative adjustments, only five entities in our sample 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

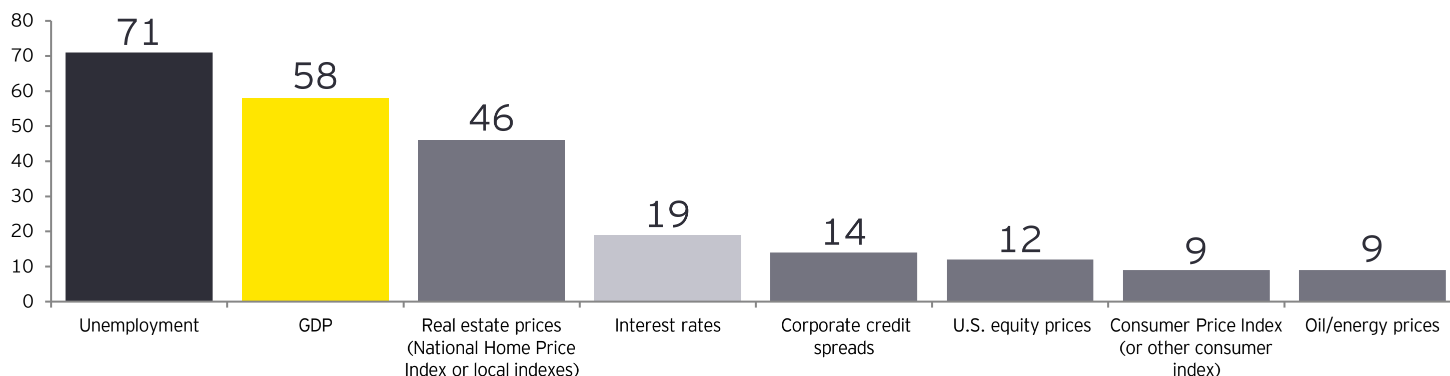
Forecasts

ASC 326 requires an entity to incorporate reasonable and supportable forecasts of future economic conditions into the estimate of expected credit losses, considering factors that would affect the assets or borrowers. Entities are required to provide a discussion of the factors that influenced management's current estimate of expected credit losses, including past events, current conditions and reasonable and supportable forecasts.

Most entities described the macroeconomic factors they used in their forecasts, as highlighted in the illustration below.

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



Many entities in our sample disclosed that they used multiple probability-weighted scenarios to develop their forecast, while some said they used a single scenario. Approximately 26% of the entities in our sample indicated that they used probability-weighted scenarios, but only 4% of entities in our sample disclosed the weight they assigned to each scenario.

Many entities in our sample (42%) disclosed that they used third-party information in their reasonable and supportable forecast of future economic conditions. Some disclosed the third-party vendor and certain details of the forecast used in their calculation.

While entities were clear that the forecasts were a key driver of their ALL and described the types of macroeconomic factors used in the forecasts, 21% of the entities in our sample quantified at least some of the macroeconomic inputs they used.

EY observation

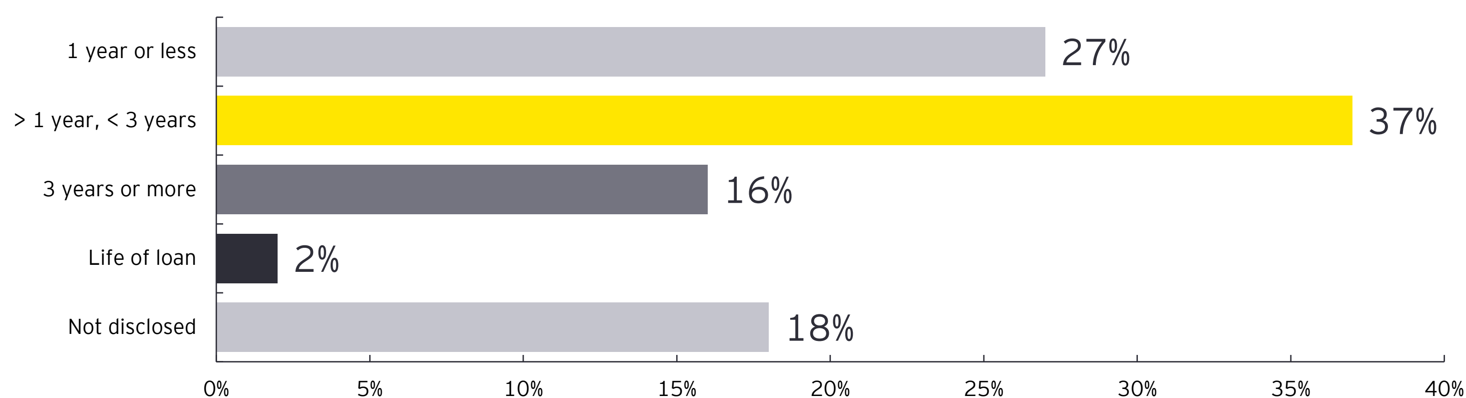
The guidance requires a reasonable and supportable forecast of future economic conditions to be based on management's forecast, not a market-consensus view. Therefore, it is important for entities to provide disclosures that allow users to understand management's view of future economic conditions. This 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.

Reasonable and supportable (R&S) period and reversion

Most entities in our sample disclosed the period covered by their reasonable and supportable forecasts, and most indicated that the forecast period did not differ across the entity's segments and classes of loans. The majority of entities in the sample said their reasonable and supportable forecasts covered a period of one to three years.

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.

Reasonable and supportable forecast period



Some entities reported a range for the R&S period; for those entities, we used the high end of the range.

The rapid deterioration in economic conditions in the first quarter of 2020 made it difficult to forecast economic conditions. A few entities in our sample disclosed that they reduced their reasonable and supportable forecast period to determine the allowance at 31 March 2020 from the period used in their calculation at 1 January 2020.

Separately, a few entities in our sample 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.

EY observation

Entities need to reevaluate the key methods and assumptions that drive the allowance for credit losses to make sure that the estimate best reflects the amount the entity expects to collect.

The new standard clearly states that for periods for which an entity is no longer able to forecast economic conditions, the entity cannot estimate zero credit losses. When the reasonable and supportable forecast is no longer a better estimate of expected credit losses than using historical loss information, entities should revert to historical loss information for the remaining contractual term of the financial asset. Most entities in our sample that disclosed a reversion method (64%) said they would use a straight-line reversion method to go from their forecast to historical loss information. A few entities said they would use an immediate reversion technique.

Output versus input

Some entities in our sample disclosed additional details about their reversion technique, including whether the reversion would be to historical losses (reverting to outputs) or to each key macroeconomic figure (reverting to inputs). Most of the entities in our sample that provided this level of disclosure (57%) said they would use outputs rather than inputs.

Allowance rollforward and qualitative discussion of changes in the allowance

ASC 326 requires entities to disclose a rollforward of the ALL by portfolio segment. The rollforward is required to include:

Beginning balance of the allowance for credit losses as of 31 December 2019

+

Impact of adopting the CECL standard on 1 January 2020

+

Current-period provision for expected credit losses

+

Initial allowance recognized in the period for purchased financial assets with credit deterioration

−

Any write-offs charged against the allowance

+

Any recoveries of amounts previously written off

=

Ending balance of the allowance for credit losses as of 31 March 2020

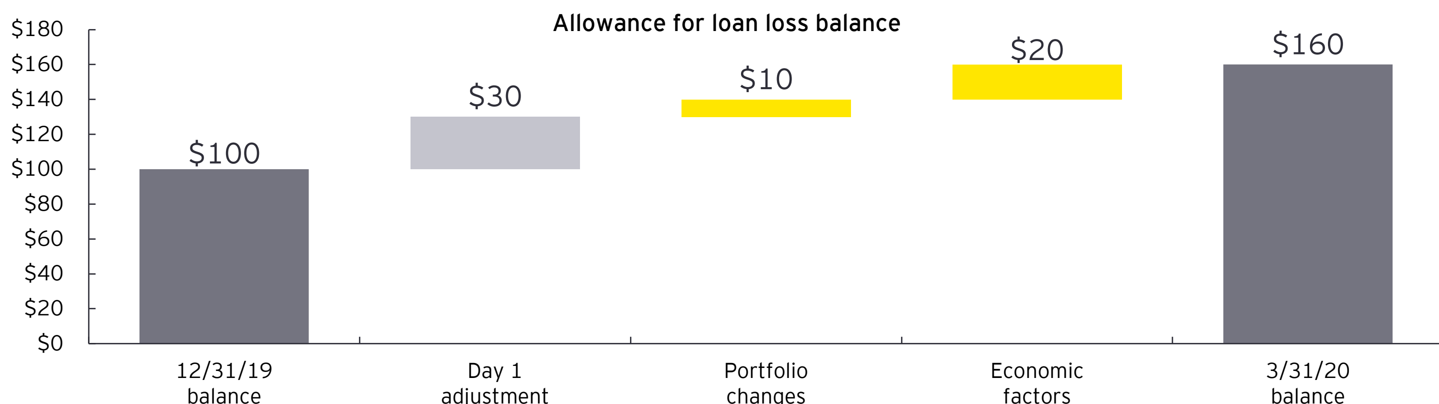
Some entities in our sample provided the rollforward information in more detail than what is required (i.e., by portfolio segment). For example, some entities provided a rollforward by class. Some entities also disclosed how much of the change in the ALL was caused by various factors such as changes in their economic forecasts. However, a majority of the entities in our sample qualitatively disclosed (either in the notes to the financial statements or in management's discussion and analysis) the drivers of the changes described with the rollforward.

13% Provided rollforward by class

8% Provided additional detail on the changes in provision for credit losses such as portfolio changes and economic factors

Below is an example of what a more detailed attribution might look like:

Example of allowance rollforward with additional details



Provision for unfunded commitments

While ASC 326 does not require a rollforward of the allowance for unfunded commitments (i.e., off-balance sheet commitments), some entities in our sample (23%) included such a rollforward in their disclosures.

Some of the entities in our sample illustrated sensitivity by disclosing the impact of changes in economic variables and risk ratings on their ALL. Other entities shared regulatory stress testing results to help users understand how the ALL would change if economic conditions deteriorated further.

23% Included a rollforward of the allowance for unfunded commitments

10% Disclosed quantitative sensitivity analysis

Sensitivity

Small changes to key assumptions could result in significant changes to the ALL. The new standard doesn't require entities to make disclosures about sensitivity analyses they perform, but 10% of the entities in our sample chose to disclose (either in MD&A or the notes to the financial statements) how those changes would impact their ALL.

Vintage table

A few entities included gross write-offs and recoveries by year of origination in their vintage tables, even though this is not required. The Financial Accounting Standards Board (FASB) has a project on its agenda to determine whether to require the disclosure of gross write-offs and gross recoveries by vintage.

Accrued interest receivable

Generally, entities disclosed that they excluded accrued interest receivable from the amortized cost basis of loans and also excluded accrued interest receivable from the measurement of the ALL because they apply a timely write-off policy. Additionally, entities generally elected to exclude accrued interest from their loan disclosures.

Prepayment assumptions

Detailed disclosures of prepayment considerations were limited. While most entities in our sample simply stated that prepayments were estimated as part of their ALL, some entities described their process to develop the estimate and the items they considered in making their prepayment assumptions.

Material change in internal control

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

Pooling considerations

Many entities in our sample provided limited information about how they pooled financial assets that share similar risk characteristics. Some disclosed that they pooled assets by portfolio segment, class or product type. The most detailed disclosures in our sample included the attributes the entity used to determine the pools, such as which industry the borrower is in or collateral values. Under the CECL model, entities are expected to reconsider whether assets grouped in a pool continue to share similar risk characteristics at each measurement date.

Purchased credit-impaired assets

Entities can make an accounting policy election to either maintain a pool of purchased credit-impaired (PCI) assets created under the legacy guidance in ASC 310-30 for transition accounting and ongoing reporting or to use the pool only for transition accounting. Many entities in our sample did not disclose their accounting policy election for PCI assets.

Available-for-sale debt securities

Accounting Standards Update (ASU) 2016-13, which created the CECL model, made targeted amendments to the existing available-for-sale (AFS) debt security impairment model. Generally, entities in our sample that had AFS debt securities disclosed their adoption of the new guidance and the new process used to recognize impairment. They also disclosed whether they recognized a credit impairment for the quarter.

Looking ahead to next quarter

For a majority of entities, implementing ASC 326 involved significant effort and required enhancements to processes and controls. The timing of the COVID-19 pandemic complicated their accounting and disclosures for the first quarter. We expect disclosures to continue to evolve, as the needs of users and the views of regulators become more clear.

Endnotes:

[1] ASU 2016-13, *Financial Instruments — Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments* — issued June 2016.

[2] The standard is effective for SEC filers, other than Smaller Reporting Companies, for annual periods beginning after 15 December 2019. For all other entities, the standard is effective for annual periods beginning after 15 December 2022. The Coronavirus Aid, Relief, and Economic Security (CARES) Act provided optional temporary relief from ASU 2016-13. From the date of enactment of the CARES Act to the earlier of December 31, 2020 or the date on which the COVID-19 national emergency terminates, no insured depository institution, bank holding company or affiliate thereof will be required to comply with ASU 2016-13.

EY | Assurance | Tax | Transactions | Advisory

About EY
EY is a global leader in assurance, tax, transaction and advisory services. The insights and quality services we deliver help build trust and confidence in the capital markets and in economies the world over. We develop outstanding leaders who team to deliver on our promises to all of our stakeholders. In so doing, we play a critical role in building a better working world for our people, for our clients and for our communities.

EY refers to the global organization, and may refer to one or more, of the member firms of Ernst & Young Global Limited, each of which is a separate legal entity. Ernst & Young Global Limited, a UK company limited by guarantee, does not provide services to clients. Information about how EY collects and uses personal data and a description of the rights individuals have under data protection legislation are available via **ey.com/privacy**. For more information about our organization, please visit **ey.com**.

Ernst & Young LLP is a client-serving member firm of Ernst & Young Global Limited operating in the US.

© 2020 Ernst & Young LLP.
All Rights Reserved.

SCORE no. 09718-201US

This and many of the publications produced by our US Professional Practice Group, are available free on AccountingLink at **ey.com/en_us/assurance/accountinglink**.

This material has been prepared for general informational purposes only and is not intended to be relied upon as accounting, tax or other professional advice. Please refer to your advisors for specific advice.