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Staying ahead

Allowance for loan losses

A holistic approach to navigating the ever-changing financial and regulatory reporting landscape

In the aftermath of the financial downturn, there has been an increased level of scrutiny on the estimation of a financial institution's Allowance for Loan Losses (ALL). As a consequence, institutions are making continual efforts to meet heightened financial and regulatory reporting expectations related to forecasting credit losses. This regulatory scrutiny, combined with the new global accounting requirements for a forward-looking approach to loan loss estimation (i.e., the recently issued IFRS 9, Financial Instruments, and the Financial Accounting Standards Board's (FASB) soon-to-be-issued Credit Impairment standard), present both complexities and challenges. This point of view discusses the complexities associated with operationalizing the accounting and regulatory requirements related to a financial institution's ALL, and the steps a financial institution should consider taking prior to implementing the FASB's new credit impairment model (i.e., the Current Expected Credit Losses (CECL) model).

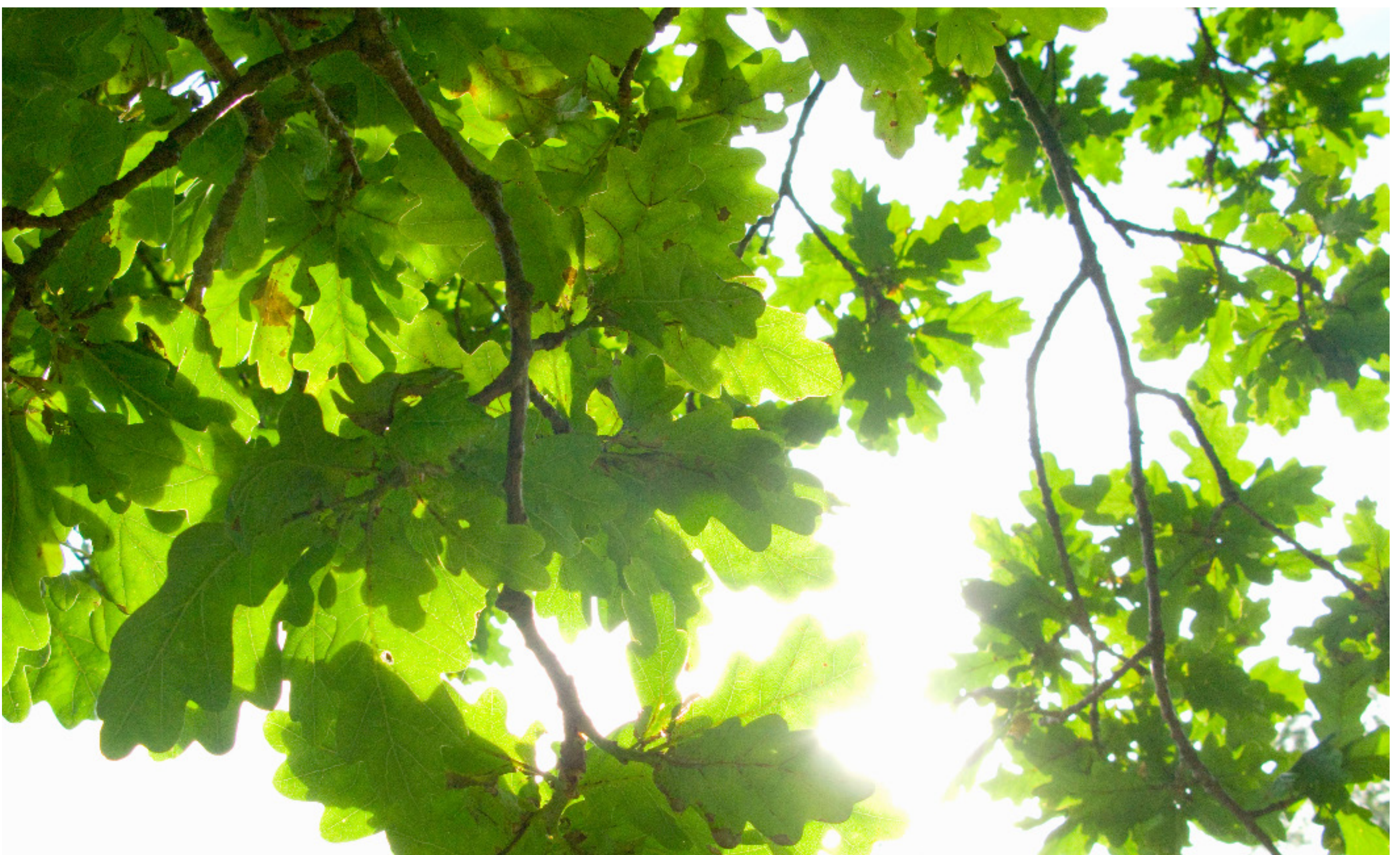
The complexities and challenges

It is often complex for a global institution to gain visibility into its exposure to credit risk, particularly if its operations are decentralized or managed using multiple financial reporting systems and dissimilar processes. Operationalizing accounting and regulatory requirements, as well as changing methodologies underlying existing credit models, continue to be challenging. In addition, banks must elevate their standards for governance and risk management to meet increased regulatory scrutiny and formal expectations set by the Federal Reserve Board, Office of the Comptroller of Currency, and Federal Deposit Insurance Corporation.

To navigate these complexities and the ever-changing regulatory and financial reporting landscapes related to ALL, banks should ask themselves:

- Do we have the appropriate level of governance and oversight over the allowance estimation process?
- Does our governance framework and control environment result in the operation of effective internal controls and foster the right level of interaction between departments and functions?
- Do we have adequate processes in place to (1) identify data gaps, (2) define ALL parameters, and (3) ensure data integrity, before such data is used as inputs into the allowance estimation process?
- Do we have a robust framework and process in place to evaluate and identify the need for potential qualitative adjustments?
- Have we developed portfolio analytics, metrics, and back-testing techniques that allow us to validate our allowance estimation models?
- Do we provide sufficient disclosure in our regulatory reports, financial statements, and investor communications to share relevant information with our stakeholders about our allowance estimation process?

Utilizing a consistent and comprehensive approach that factors in regulatory and financial reporting considerations can be challenging and complex.



Change is on the horizon

The FASB is expected to issue its new credit impairment standard describing the CECL model during the first quarter of 2016. The CECL model will likely affect most financial institutions and applicable asset portfolios (e.g., loans, leases, debt securities) by requiring those affected institutions to estimate their ALL based on expected losses rather than incurred losses. Although the effective date is currently undecided, it will likely be no earlier than 2019. Because the amendments will affect an institution's current processes for estimating ALL and recognizing impairments on applicable debt securities, financial institutions should consider taking the following steps (see Figure 1):

- Enhance the entity's current governance framework and control environment.
- Ensure availability of appropriate data and resources to estimate the allowance under CECL.
- Streamline and eliminate redundancies in processes, applications, and financial and regulatory reporting systems.
- Incorporate leading practices related to credit risk modeling and forecasting expected losses.
- Integrate financial and regulatory reporting systems.

Measuring expected credit losses will most likely be a significant challenge for many banks and other financial institutions. While the level of effort related to implementing the CECL model will vary by entity, nearly all entities will be affected by the requirement to use forward-looking information to estimate expected credit losses over the contractual life of an asset. As a result of moving to an expected loss model, an entity's data collection processes, allowance estimation models, systems and regulatory and reporting processes will be impacted.

Figure 1: Transforming current capabilities related to ALL

In addition, a consistent and permeating theme throughout the 2015 AICPA National Conference on Banks & Savings Institutions (AICPA banking conference) was the focus on a financial institution's ALL and its preparation for implementingthe CECL model. During the three-day conference, speakers emphasized the challenges that an entity will likely face as a result of implementing CECL, and discussed the following:

- The FASB has established a Transition Resource Group (TRG) to address implementation issues as they are identified by practitioners, industry, and regulators.
- An implementation panel discussed implementation issues in applying CECL (e.g., TDRs, credit card receivables) and challenges associated with obtaining forward-looking data.
- Community banks will likely have to rely on external data owing to constraints in the abilty to hire in-house economists.
- The large banks expert panel observed the broad-reaching nature of the upcoming new standard and noted its impact on in-house resources and allowance estimation capabilities.

The discussions held at the AICPA banking conference highlighted that a financial institution's transition from an incurred loss model to an expected loss model, as required under CECL, will benefit significantly from maintaining an effective governance strategy over data aggregation, allowance estimation, performance monitoring, and regulatory and financial reporting.

Staying Ahead Allowance for Loan Losses 4 As a result, there is no better time than the present to reevaluate current capabilities related to the estimation of ALL, particularly in light of the fact that change is right around the corner.

Driving performance through enhanced capabilities

Banks need a comprehensive framework and methodology for estimating ALL. A holistic approach (see Figure 2) provides an opportunity to assess current capabilities related to allowance methodology, internal processes, credit modeling, and regulatory and financial reporting to leading practices. In addition to developing a baseline for future transformation activities, taking a fresh look at current capabilities can result in recognizing synergies from using a holistic and integrated approach for estimating ALL.

To stay ahead of this evolving landscape, institutions need an integrated framework for estimating ALL (see Figure 3) encompassing current accounting standards and regulatory views while simultaneously laying the foundation for the future. In this vein, financial institutions should:

- Benchmark themselves against leading practices in estimating allowance for loan losses.
- Evaluate existing impairment methodology, accounting, and regulatory policy decisions and operationalization based on US generally accepted accounting principles (US GAAP) and existing regulatory requirements.
- Identify gaps in existing data and additional data required for new disclosures and leverage data competencies from regulatory processes.
- Review existing ALL estimation models and identiy appropriate changes to methodologies to enhance functionality.
- Evaluate the framework to estimate the current allowance for loan loss and the corresponding regulatory and reporting processes to identify areas for efficiencies and leading practices.
- Assess current capabilities of internally-developed and third-party technology to identify necessary system changes or upgrades.

Figure 2: Five components that form the foundation of a comprehensive ALL framework

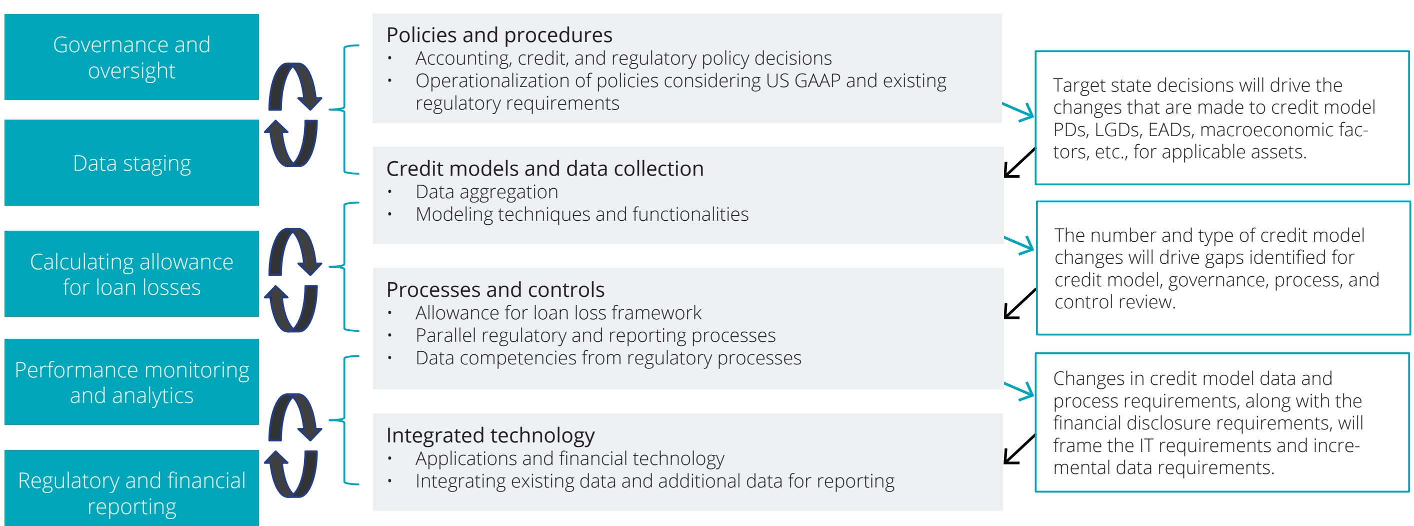
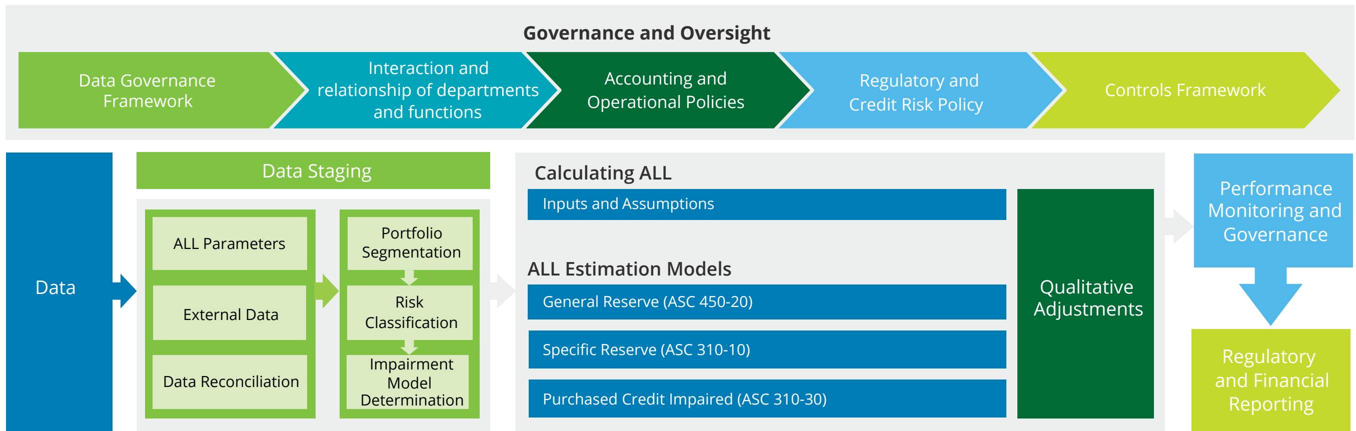


Figure 3 provides an overview of a comprehensive approach that a financial institution can take in an effort to meet prevailing and imminent financial and regulatory reporting expectations.

Figure 3: Comprehensive ALL framework



Next steps

There is no better time than the present to reevaluate current capabilities related to the estimation of ALL, particularly in light of the FASB's soon-to-be-issued Credit Impairment standard. With a holistic approach and an integrated framework described above — financial institutions can enhance their current capabilities related to estimating ALL, while fulfilling US GAAP and regulatory requirements and simultaneously laying the foundation for implementation of the CECL model.

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