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CECL Deferred for Banks Due to the Impact of the COVID-19 Pandemic

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As public filers are preparing to file their first quarter financial statements for the period ending March 31, the unfolding COVID-19 pandemic and the related economic fallout have thrown mounting uncertainty as to what losses to report – and how to estimate them. Before the pandemic hit the market and caused stocks to lose 35% of their value, banks were well on their way preparing to estimate their credit losses under the new Current Expected Credit Losses (CECL) accounting rules, otherwise known as the Allowance for Credit Losses (ACL) or loss reserve on loan portfolios. Now, things don't look so clear.

The Economic Impact of COVID-19 Is Spurring Regulatory/Legislative Intervention

Last Thursday, March 19, 2020, the Federal Deposit Insurance Corporation (FDIC) Chair, Jelena McWilliams, released a letter to the FASB urging postponement of CECL for large public filers that have to comply with the CECL standard starting this year. The letter signaled that bank regulators think it might be better for banks to use the existing Incurred Loss framework for the foreseeable future. Specifically, the letter expressed a concern that the planned introduction of the new accounting rule "may strain the ability of financial institutions to serve their depositors and prudently meet the credit needs of their communities."

If this weren't enough, last night the Senate passed its $2.2 trillion stimulus package to rescue the U.S. economy which is in the throes of the COVID-19 pandemic. The text in the final Senate bill indicates that *no insured depository institution, bank holding company, or any affiliate thereof shall be required to comply* with the CECL standard during the period beginning on the date of enactment of the legislation and ending on the earlier of (a) the date on which the national coronavirus emergency declared by the President on March 13, 2020 under the National Emergencies Act terminates, or (b) December 31, 2020.

The situation is moving so quickly that, at this time, it is difficult to know what to plan for, but here are a few things we know or can reasonably assume will come to pass:

- Consumer and small business portfolios are likely to feel the economic impact of COVID-19 the soonest, as these borrowers typically have less capital and savings on average to tide them over for any extended period of unemployment or business disruption. Personal loans secured by stocks are also likely to be under stress, as stock values securing those loans have deteriorated.

- Larger businesses, and entire industry sectors such as airlines, hotels, restaurants, commercial real estate (CRE) and retailers, are going to see dramatic stress. Consumer goods and retail companies are facing higher-than-normal financial risk. Accordingly, credit risk downgrades across portfolios are likely already taking place at most banks, similar to what happened at the beginning of the 2008 financial crisis.

- Consumer confidence in the current political environment and uncertainty surrounding the ability of the global healthcare industry to accommodate COVID-19-related needs could mean that the downturn is deeper than anticipated and recovery prospects more uncertain for the near future.

Admittedly, this historic pandemic presents a tough economic climate in which to implement an overhaul of credit loss estimation methodologies, which may be the very point the FDIC Chair was getting at in her letter.

With respect to the Senate legislation, we expect it will be enacted quickly. As such, it is reasonable to expect that with deferral of the CECL implementation, banks will have the challenge of determining whether to revert quickly to the previous Incurred Loss framework or to continue forward with CECL to estimate loss reserves as of March 31, 2020. This means that external auditors may need more time to review loss reserves calculated under the Incurred Loss framework, as well as the control environment around the process. Needless to say, this could be an unprecedented set of circumstances for preparers and auditors alike.

In anticipation of this and other COVID-19-related challenges, on Wednesday March 25, the SEC issued an order extending the time period covered by its COVID-19-related filing relief. The order states that public companies that are unable to meet filing deadlines due to COVID-19-related circumstances will have an additional 45 days to submit 10-Qs and other required disclosure reports that would otherwise have been due between March 1 and July 1,

2020. This move virtually assures that the enactment date of the legislation precedes the required, and delayed, 10-Q filing date.

What if the President terminates the national emergency around the COVID-19 pandemic before the end of the year? Everyone is hopeful we encounter such good fortune. Assume it happens in the third quarter of 2020, what then? Are calendar-year reporting financial institutions required to begin implementing CECL in that quarter or in the last quarter? The literal application of the Senate bill suggests they are required in that quarter. We cannot recall such a scenario; it would mean that the accounting during a portion of the year would be under one model and the remaining portion would be under another model. This result would confuse rather than serve the interests of investors. We doubt that the SEC would allow this to happen. Nonetheless, this remains an unanswered question.

Be Ready to Pivot

Regardless of the loss reserve approach ultimately to be used, banks need to carefully assess the economic impact of the COVID-19 pandemic on various portfolios prior to the Q1 filing date as they estimate the loss reserve for loans. An abundance of evidence to issuers and their auditors will be available between the quarter end and the filing date.

In addition, trying to incorporate yet-to-come COVID-19 economic impacts as well as the potential offsetting impact of government-led stimulus/recovery efforts make it very challenging to estimate the loss reserve under either approach.

Banks can expect urgent discussions with their regulators, regardless of whether CECL or the Incurred Loss Framework is used, if they think the loss reserve estimates are not indicative of the risk of loss in various portfolios.

Banks should carefully consider the decision to use CECL or to revert to the Incurred Loss approach under previous accounting guidance for their upcoming public filings. This guidance includes ASC 450-20[1] (FAS 5) Loss Contingencies to reserve for performing loans, and ASC 310-10[2] (FAS 114) to reserve for impaired loans, with the allowance calculated using information available as of the financial statement date, inclusive of historical information and known events as of the filing date.

[1] Codification Topic 450-20, Loss Contingencies

[2] Codification Topic 310-10, Impairment of a Loan Accounting by Creditors for Impairment of a Loan

Reverting to the Incurred Loss approach will likely require updates to methodology, models, process and documentation to account for recent changes in credit quality and market events.

Pay Attention to Model Risk and Use of Qualitative Adjustments

Similar to the situation during the 2008 financial crisis, financial forecast models may "break" because they are not always designed to perform well in volatile economic times where conditions are changing rapidly. This is particularly true with allowance models that use historical relationships between commonly modeled variables that have been historically correlated, such as unemployment and loan defaults, where the expected correlation may not hold in the current environment.

The use of qualitative adjustments by management outside a formal model under either approach may increase in the near term for loss reserve estimation purposes to account for model limitations. When using qualitative adjustments, it is important to ensure that a structured and replicable process is in place, where the adjustments are well supported with sound rationale and a quantification of the metrics employed.

Concluding Comments

With the uncertainty surrounding the COVID-19 pandemic and its effect on the economy, the banking industry finds itself in a quandary, similar to most industries. But the expected Congressional legislation that, in effect, makes CECL implementation optional creates an added layer of complexity that is unique. If some banks opt to defer implementation and others don't, this will likely create challenges for investors and regulators in comparing loss reserve estimates across the industry. Additionally, many industry analysts expect that CECL may be deferred indefinitely, making the decision to opt for CECL during the national emergency period less attractive. Taking the right action in this situation requires two things — be alert and be ready to move. Banks must quickly evaluate the two approaches and decide which one allows them to create management's best estimate of the loss reserve and clearly explain to investors and regulators the drivers and rationale behind it.

For our part, we will continue to keep you informed with the latest developments, on our blog and on our website.

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