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Current Expected Credit Loss Accounting Model - MI Impact

The Current Expected Credit Loss (CECL) accounting model was developed by the Financial Accounting Standards Board (FASB) and is a fundamental shift in how loss reserves are established. Instead of waiting until losses are probable, institutions will forecast losses and establish reserves in advance. The final rule was announced on June 16, 2016 and will impact any institution that holds loans on its balance sheet at amortized cost, such as banks, credit unions, and real estate investment trusts (REITs).

TIMING

Public companies filing with the Securities and Exchange Commission (SEC) will need to adopt CECL for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. Public companies that are not SEC filers will be required to comply with the new standard in 2021 (for FY beginning after December 15, 2020, including interim periods within those fiscal years) and all other institutions will be required to comply by 2022 (for FY beginning after December 15, 2021, including interim periods within those fiscal years).*

IMPACT

CECL will likely affect banks and credit unions in varying ways depending on how each lender models their Allowance for Loan and Lease Losses (ALLL). One constant is that upon initial adoption, there will be a one-time reduction to equity. A reserve will be recorded applying CECL with a charge to earnings for all mortgage loans originated or acquired as well as for the increases or decreases in expected credit losses that have taken place during the period. Although the regulators provide guidance on how CECL is to be implemented, they do not provide specific forecasts or models. Rather than reserving for losses on these loans on an incurred basis, as they currently do, lenders will be required to post a reserve against the ***lifetime*** expected credit loss of the loan on day one. The rule will have the most significant impact on loans that have the highest of credit risk, which will include those loans originated as part of the Community Reinvestment Act (CRA).

The net result of this change will directly impact pricing of loans, the amount of capital allocated to a portfolio lending strategy; which products are offered to consumers; and net income, since changes to the ALLL impact pre-tax operating income. The impact of CECL extends into the future because lenders will also have increased costs related to loss forecasting and reporting, especially as they continue to update estimated loss reserves over the life of their loans.

CECL will also impact every loan currently on an institution's balance sheet. While CECL will impact all public companies, it is expected to impact lenders most significantly. In congressional testimony, industry representatives suggested that the transition to CECL is estimated to increase loan loss reserve between $50 billion[1] and $100 billion for banks.

Naturally, lenders are concerned and there has and is a concerted effort to change the rule in advance of its implementation deadline. As noted by Government Accountability Office (GAO), "CECL is considered by some to be the most significant accounting change in the banking industry in 40 years." Banking regulators, including the Federal Deposit Insurance Corporation (FDIC) and the Office of the Comptroller of the Currency (OCC), have issued final rules[2] on CECL implementation and have proposed changing the ALLL as a new defined term.

* FASB has proposed a delay in the implementation date of CECL for all private companies and for small public companies (those with a market capitalization below $250 million and annual revenue of less than $100 million). If that proposal is enacted, the standard for those companies would not take effect until January 2023.

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SOLUTIONS

The CECL standard will require loss reserves on all expected losses after adjusting for offsets, including credit enhancement. In estimating the expected credit losses, institutions can reflect how credit enhancements (***other than freestanding contracts***) mitigate expected credit losses.

The estimate of expected credit losses shall reflect how credit enhancements (other than those that are freestanding contracts) mitigate expected credit losses on financial assets, including consideration of the financial condition of the guarantor, the willingness of the guarantor to pay, and/or whether any subordinated interests are expected to be capable of absorbing credit losses on any underlying financial assets. However, when estimating expected credit losses, an entity shall not combine a financial asset with a separate freestanding contract that serves to mitigate credit loss. As a result, the estimate of expected credit losses on a financial asset (or group of financial assets) shall not be offset by a freestanding contract (for example, a purchased credit-default swap) that may mitigate expected credit losses on the financial asset (or group of financial assets).[3]

A freestanding contract is one that is entered into either:[4]

1. Separate and apart from any of the entity's other financial instruments or equity transactions;
2. In conjunction with some other transaction and is legally detachable and separately exercisable[5]; or
3. Transfers expected losses[6]

While there are a variety of forms of credit enhancement out there, many will not be given credit under CECL. Pool insurance, credit default swaps, and other "freestanding" contracts are not acceptable under CECL because they can be separated from the loan and exercised independently.*

WHAT DOES THIS MEAN?

- Lenders who have utilized traditional primary loan-level mortgage insurance (either borrower or lender-paid), can use that coverage to reduce their CECL reserving requirements. By insuring loan production, a lender can mitigate the volatility that CECL introduces to the financial statements.

- As S&P[7] points out, "the lifetime allowance calculation includes the probability of default, the exposure at the time of default and any expected recoveries." Banks and Credit Unions that acquire mortgage insurance at loan origination will include these insurance policies in their CECL calculation can actually reduce their loss exposure or increase their recoveries.

	Modeled Loan: Loss Given Default		
A	Original Value	$ 300,000	
B	Original LTV	95%	
C	Original UPB	$ 285,000	C = A x B
D	UPB at time of Default	$ 279,981	
E	Claimable Expenses	$ 41,997	
F	Total Claimable Amount	$ 321,978	F = D + E
G	REO Expense	$ 30,798	
H	Sales Proceeds	$ 252,631	
I	Lender Loss Given Default	$ 100,145	I = F - (H - G)

	Modeled Loan: CECL Reserve		
J	Probability of Default	2.00%	
K	Loss of Severity (% of Orig. UPB)	35.13%	
L	CECL Reserve w/o MI	$ 2,002	L = J x C x K
M	MI Proceeds at 25% Coverage	$ 80,495	M = F x 25%
N	CECL Reserve w/ 25% coverage	$ 393	N = J x (I - M)
O	MI Proceeds at 30% Coverage	$ 96,593	O = F x 30%
P	CECL Reserve w/ 30% Coverage	$ 71	P = J x (I - O)

* If Credit Enhancement is purchased after the fact or does not travel with the mortgage if it is sold, then it cannot be considered in the CECL calculation. While not eligible for favorable reserved treatment under CECL, FASB is considering whether recoveries from pool insurance could be recognized at the time a CECL allowance is recorded, though no guidance has been released from FASB at this time.

[1]Banking: Current Expected Credit Loss (CECL), EveryCSRReport.com, October 9, 2018.

[2]Office of the Comptroller of the Currency.

[3]FASB ASU 2016-13 for more details, paying particular attention to to: 326-20-30-1.

[4]Credit Impairment Handbook, KPMG, March 2019.

[5]FASB ASU 2016-13 for more details, paying particular attention to to: 326-20-30-1.

[6]Credit Impairment Handbook, KPMG, March 2019.

[7]Mortgage insurance could reduce CECL pain, S&P Global, December 12, 2018.