Pulse check

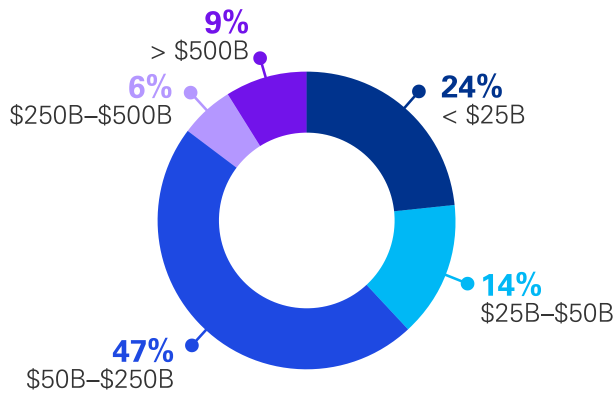
How companies are responding to economic impacts in their CECL estimates in Q4'22

We surveyed companies during the fourth quarter of 2022 to understand how current economic conditions are likely to impact their Current Expected Credit Losses (CECL) process. We asked about the continuing impacts of high inflation, rising interest rates, and a potential recession on loan portfolios—and how these forces are likely to affect CECL allowances.

Economic uncertainty continued in the fourth quarter of 2022 as market pressures persisted. KPMG surveyed commercial and consumer lenders (including banks and finance companies) to understand how companies are dealing with these issues and how economic concerns impact CECL reporting. The survey results were obtained between December 1 and December 16, 2022 and reflect information known at that time. As the economic situation continues to shift, we expect companies will continue to monitor and reassess assumptions used in their CECL estimates up to the reporting date.

Who we surveyed

We surveyed **27 banks** and **7 consumer finance** companies. They range in asset size from less than $25 billion to more than $500 billion.

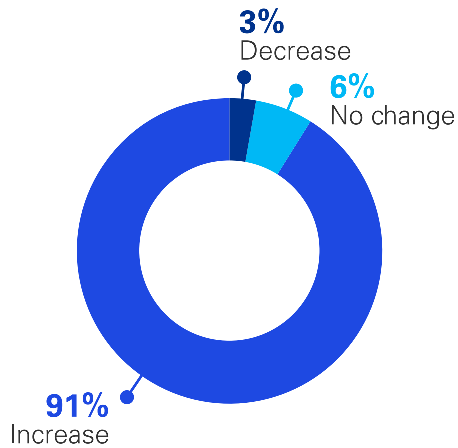


Responses were obtained between December 1 and December 16, 2022, and reflect information known at that time.

Expected impact of continued uncertainty on CECL methodology and results

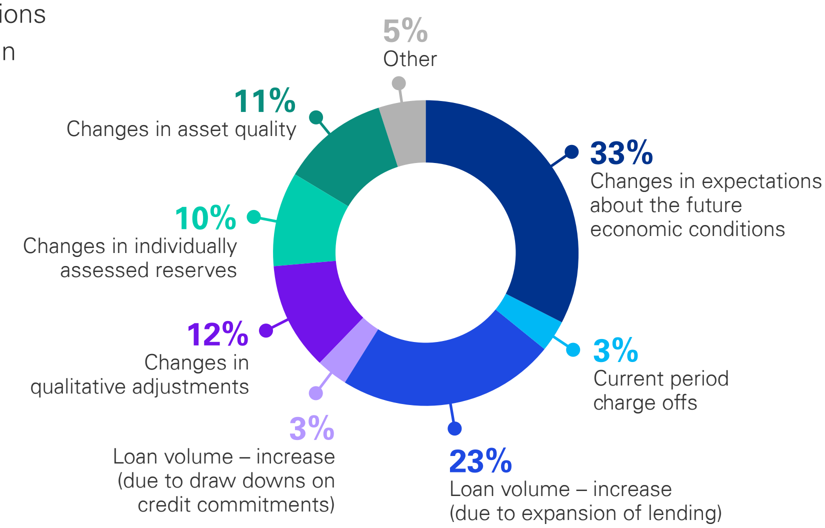
The majority of respondents (91 percent) expect the overall allowance for expected credit loss (ACL) to increase in Q4'22 compared with 74 percent in Q3'22. In contrast, only 3 percent of respondents expect a decrease in their ACL in Q4'22 compared with 9 percent in Q3'22.

1. How much do you expect the allowance for expected credit losses (ACL) to change from September 30, 2022 to December 31, 2022?



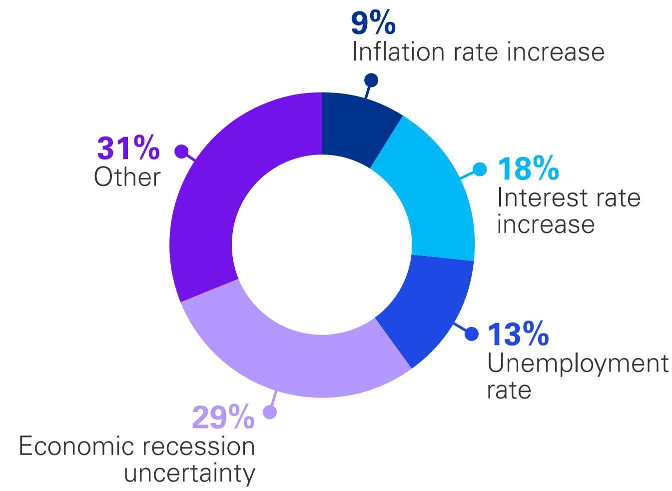
Approximately 47 percent of respondents said their outlook on future economic conditions deteriorated in Q4'22, compared to 41 percent in Q3'22. The largest drivers of ACL change cited were changes in expectations about future economic conditions (33 percent) and loan volume increases (23 percent).

2. What do you expect the largest driver of change to be in the ACL balance from September 30, 2022 to December 31, 2022?



Approximately 29 percent of respondents cited uncertainty about recession as the most significant economic concern (33 percent in Q3’22). The share of respondents citing interest rates as an economic concern was 18 percent in Q4’22 (10 percent in Q3’22). The largest percentage of respondents, 31 percent (10 percent in Q3’22), selected ‘other,’ citing such factors as increases in delinquency rates and deterioration of consumer confidence in sectors such as real estate.

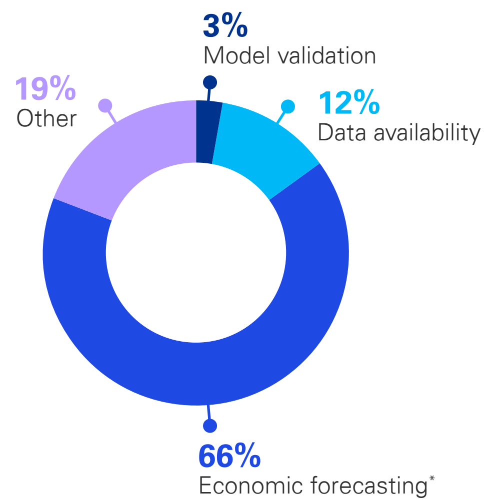
3. Which economic condition is having the greatest impact on your Company’s ACL estimate?



Responses were obtained between December 1 and December 16, 2022, and reflect information known at that time. The economic conditions selected may not reflect the impact of the Federal Reserve Bank’s most recent actions.

The majority of respondents (66 percent) stated that economic forecasting, as a result of the high inflation rate, increased interest rates, the unemployment rate and the potential of an economic recession, continues to be the greatest challenge in determining ACL estimates. This compares to 70 percent in Q3’22. Approximately 19 percent of respondents (6 percent in Q3’22) cited other factors including market instability as the greatest challenge in determining their ACL.

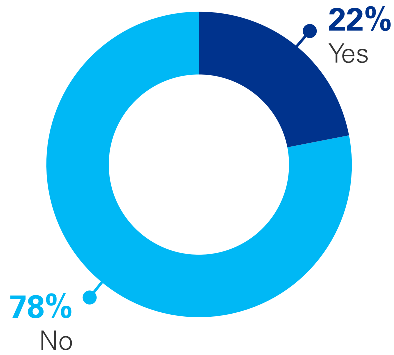
4. What challenges are you experiencing in determining your Company’s ACL estimate?



*Economic forecasting as a result of the high inflation rate, increased interest rates, unemployment rate and/ or the potential of an economic recession.

Although companies are experiencing a number of challenges in determining their ACL estimate, only 22 percent of respondents say they implemented new processes or procedures to overcome said challenges including assessing forecast accuracy based on current data trends and analyzing trends by specific portfolio type and group.

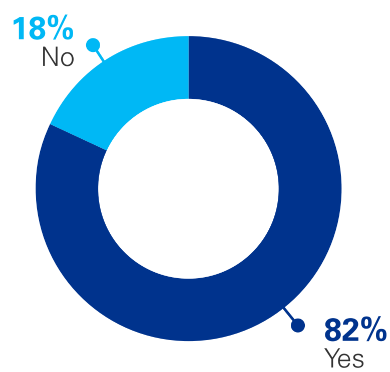
5. Have you implemented any new processes or procedures in overcoming the aforementioned challenges?



CECL methodology components

To estimate losses over the reasonable and supportable forecast period, entities are permitted to incorporate one or more economic scenarios into their ACL estimate. Accordingly, many institutions have incorporated multiple economic scenarios into their ACL framework, particularly in response to economic recession uncertainty, inflation rate increases, interest rate increases, and possible change in the unemployment rate.

6. For your models that utilize macroeconomic inputs, do you leverage multiple economic scenarios to inform your ACL estimates?



We also surveyed companies about their percentage probability weights used in their macroeconomic scenarios for both Q4’22 and Q3’22. For those companies that do use a probability weight; we have summarized the average percentage probability, where a percentage probability is applied, by scenario below. For example, for those respondents that applied a percentage other than zero percent to the base case scenario, the average was 60 percent in Q4’22.

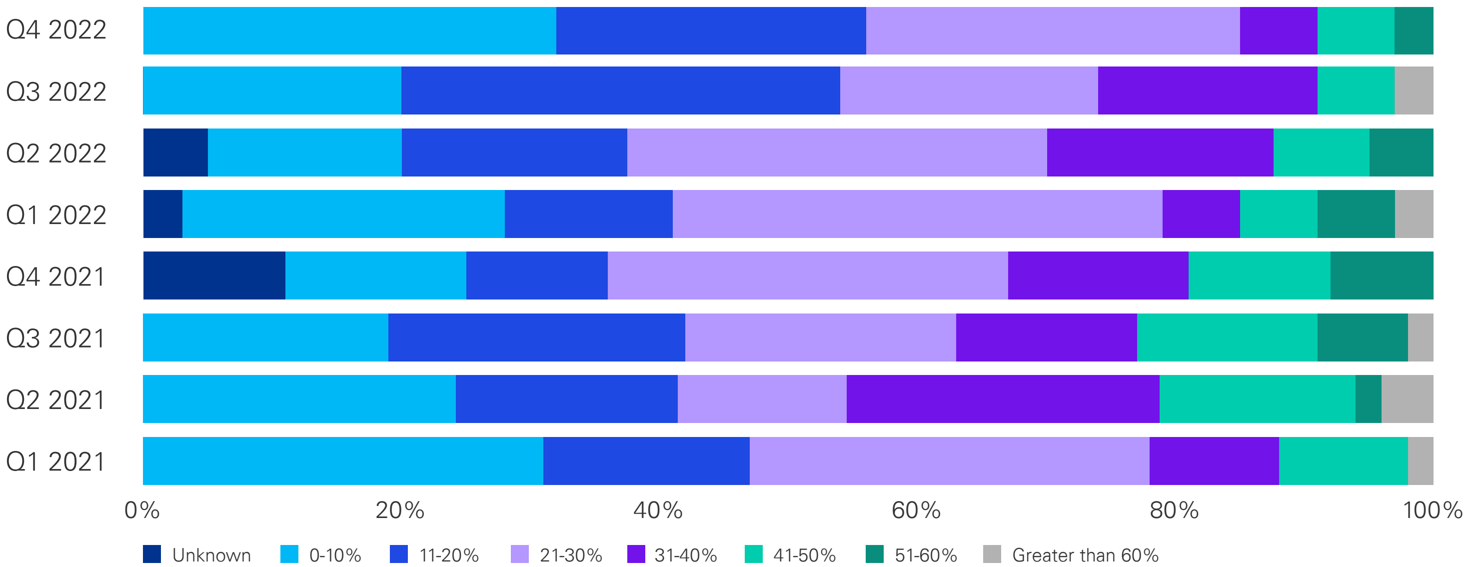
	Base case	Upside	Downside	Severe downside
Q4’22[1]	60%	20%	32%	17%
Q3’22[1,2]	59%	19%	34%	17%

[1]The probability weights do not add to 100 percent given the table represents an average percentage probability by scenario where a percentage probability is applied other than zero percent.

[2]The average percentage probability by scenario for Q3’22 is based on actuals for Q3’22 as provided by companies surveyed in Q4’22.

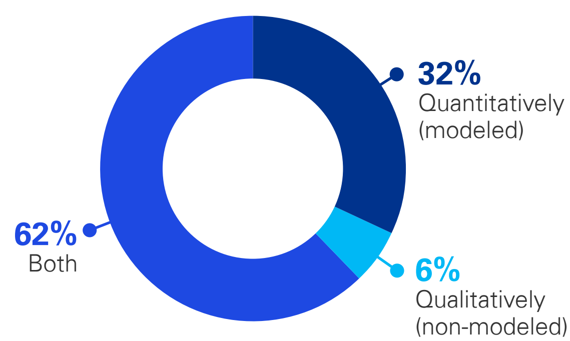
Many companies incorporate qualitative adjustments into their ACL estimate to capture changes in expectations, and we understand they will continue to do so. Approximately 44 percent of respondents indicated they expect qualitative factors to comprise more than 20 percent of the total ACL estimate in Q4'22 as compared to 46 percent in Q3'22.

7. What percentage of your Company's ACL as of December 31, 2022 would you estimate to be based on qualitative factors?



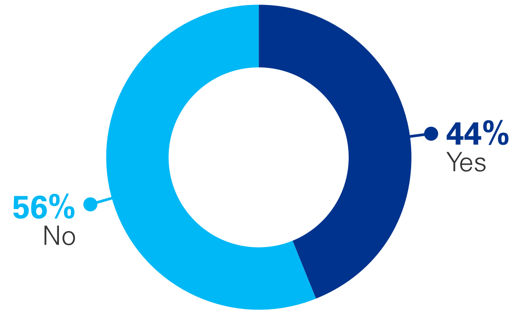
Approximately 32 percent (50 percent in Q3'22) of respondents are factoring in impacts from the high inflation rate, increased interest rates, unemployment rate and a potential economic recession within their ACL estimate quantitative (modeled) whilst 62 percent (42 percent in Q3'22) of respondents are factoring in these conditions both quantitatively (modeled) and qualitatively (non-modeled).

8. How are economic conditions such as the high inflation rate, increased interest rates, unemployment rate and/or the potential of an economic recession being factored into your Company's ACL estimate?



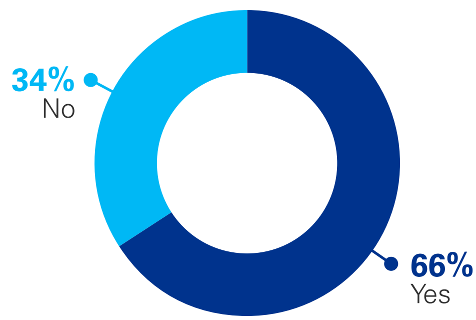
A number of respondents (44 percent) cited that recent data trends utilized in the quantitative (modeled) component have resulted in fewer manual overlays/ adjustments in the quantitative (modeled) estimate.

9. Have recent trends in data utilized by the quantitative (modeled) component resulted in less manual overlays/ adjustments in the quantitative (modeled) estimate?



Approximately 66 percent of respondents cited the percentage of their overall ACL based on qualitative factors for Q4'22 has decreased as compared to Q3'22.

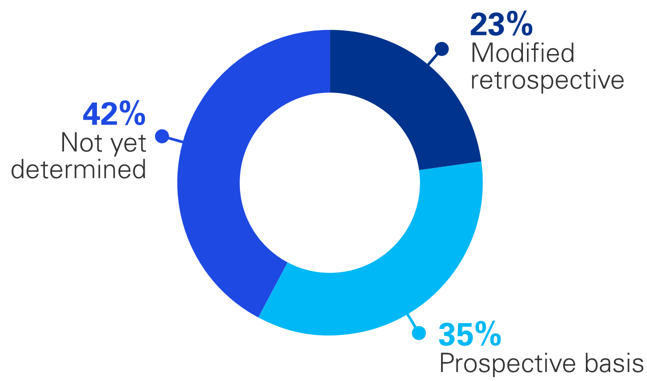
10. Has the percentage of your Company's ACL based on qualitative factors as of December 31, 2022 decreased as compared to September 30, 2022?



FASB amendments

For those respondents who have elected to adopt ASU 2022-02, which eliminates the accounting guidance for troubled debt restructurings (TDRs) by creditors in ASC 310-40, Receivables—Troubled Debt Restructurings by Creditors; approximately 35 percent of respondents will apply this amended guidance on a prospective basis whilst 23 percent plan to apply the modified retrospective approach. The remaining 42 percent of respondents have yet to determine the application method in which to apply the amended guidance.

11. For those Companies who have elected to adopt ASU 2022-02, which eliminates the accounting guidance for troubled debt restructurings (TDRs) by creditors in ASC 310-40, Receivables – Troubled Debt Restructurings by Creditors, how will this amended guidance be applied?



Conclusion

Uncertainty surrounding the economy, including concerns about the impact of inflation, high interest rates, and a potential economic recession, continues to be a challenge in determining CECL estimates. Analysts and investors will want to understand the key drivers behind the CECL estimates, which include a significant level of estimation and judgment. Companies will need to explain and support their assumptions and estimates of the CECL methodology components, including quantitative models and qualitative factors. We encourage companies to work closely with their boards of directors, auditors, and advisors as they prepare for reporting in the fourth quarter of 2022.

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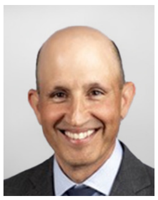

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