CECL Pulse check

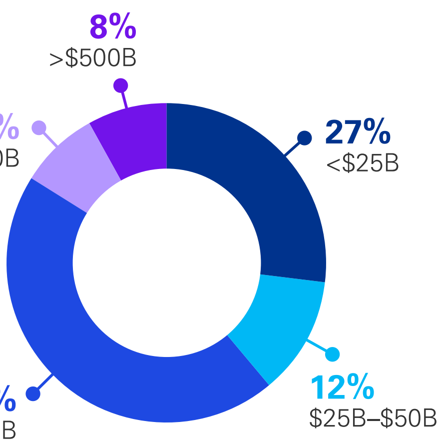
How companies are responding to economic impacts in their CECL estimates in Q1'23

We surveyed companies during the first quarter of 2023 to understand how current economic conditions are likely to impact their Current Expected Credit Losses (CECL) process. We asked about the continuing impacts of the current market uncertainty, including a potential recession, on commercial and retail loan portfolios—and how these forces are likely to affect CECL allowances.

Economic uncertainty continued in the first quarter of 2023 as market pressures persisted. KPMG surveyed commercial and consumer lenders (including banks and finance companies) to understand how companies are reacting to and dealing with these issues and their impact on CECL reporting. The survey results were obtained between March 6 and March 27, 2023 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

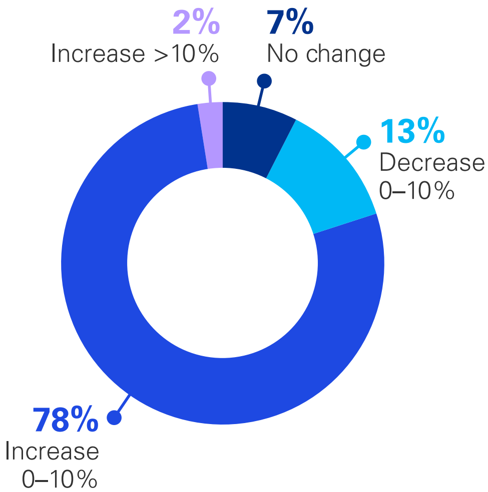
We surveyed **31 banks** and **9 consumer** companies. They range in asset size from less than $25 billion to more than $500 billion.



Responses were obtained between March 6 and March 27, 2023, and reflect information known at that time.

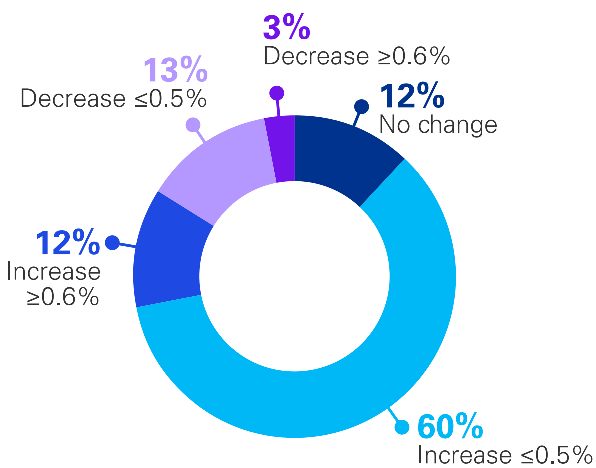
Expected impact of continued uncertainty on CECL methodology and results

1. How much do you expect the allowance for expected credit losses (ACL) to change from December 31, 2022 to March 31, 2023?



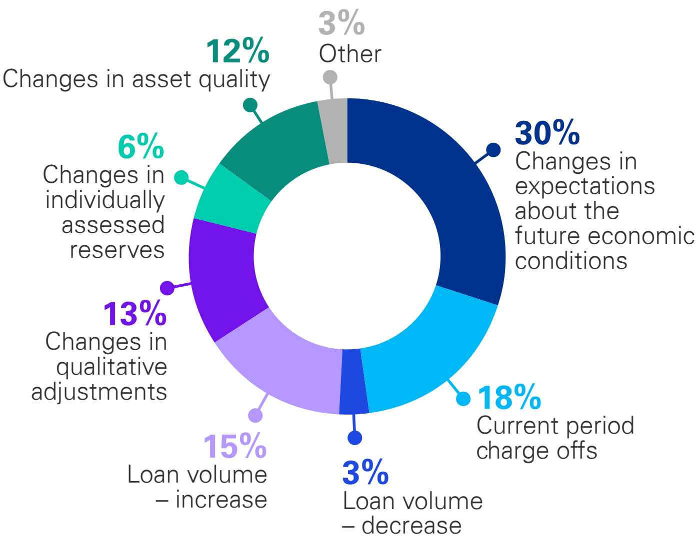
The majority of respondents (80 percent) expect the overall allowance for expected credit loss (ACL) to increase in Q1’23 compared with 91 percent in Q4’22. In contrast, 13 percent of respondents expect a decrease in their ACL in Q1’23 compared with 3 percent in Q4’22.

2. How much do you expect the total allowance for expected credit losses (ACL) to change as a percentage of end of period receivables subject to ACL from December 31, 2022 to March 31, 2023?



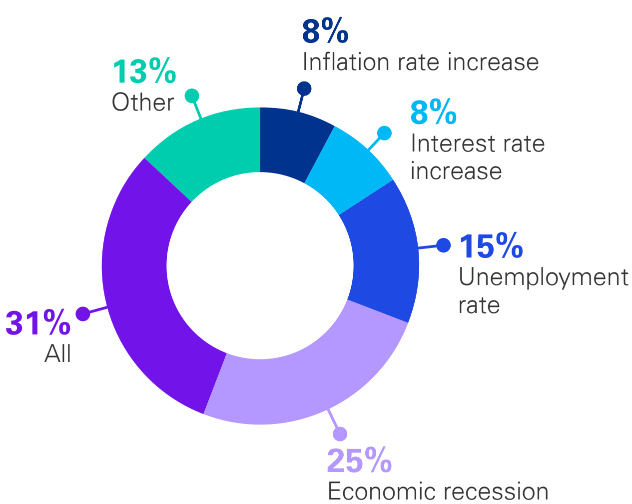
Approximately 60 percent of respondents who expect the overall ACL to increase in Q1’23 expect the increase to represent 0.5 percent or less as a percentage of total receivables assessed for ACL. In contrast, 13 percent of respondents expect the decrease in their ACL to represent 0.5 percent or less as a percentage of total receivables assessed for ACL.

3. What do you expect the largest driver of change to be in the ACL balance from December 31, 2022 to March 31, 2023?



Approximately 38 percent of respondents said their outlook on future economic conditions deteriorated in Q1’23, compared to 47 percent in Q4’22. The majority of respondents (58 percent) in Q1’23 cited no change in future economic conditions as compared to 47 percent in Q4’22. The largest drivers of ACL change cited were changes in expectations about future economic conditions (30 percent in Q1’23 as compared to 33 percent in Q4’22) and current period charge offs (18 percent in Q1’23 as compared to only 3 percent in Q4’22).

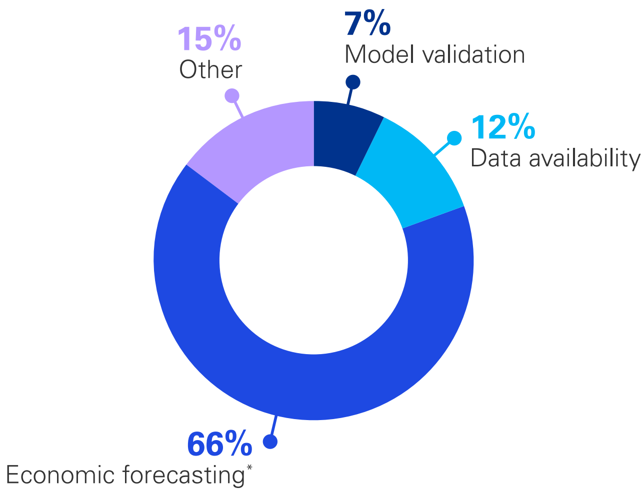
4. Which economic condition is having the greatest impact on your Company’s ACL estimate?



Responses were obtained between March 6 and March 27, 2023, and reflect information known at that time. The economic conditions selected may not reflect the impact of more recent market events.

Approximately 31 percent of respondents in Q1’23 cited inflation, interest rate increases, the unemployment rate and economic recession uncertainty, in combination, as being the most significant economic concern. A 25 percent share of respondents in Q1’23 cited uncertainty about recession specifically as the second most significant economic concern (29 percent in Q4’22).

5. What challenges are you experiencing in determining your Company's ACL estimate?

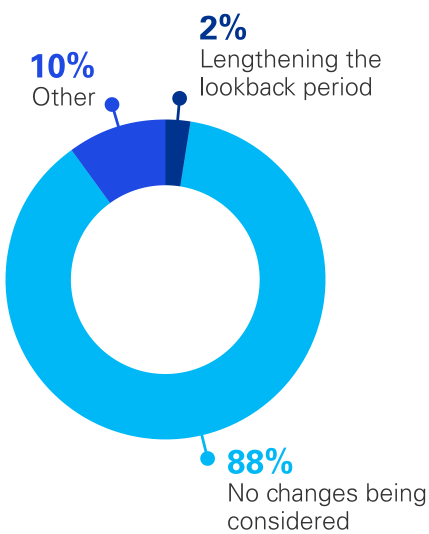


*Economic forecasting as a result of higher inflation rate, increased interest rates, the unemployment rate and/or the potential of an economic recession

The majority of respondents (66 percent), consistent with Q4'22 (66 percent), stated that economic forecasting as a result of the higher 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. Approximately 15 percent of respondents in Q1'23 (19 percent in Q4'22) cited other factors including market instability as the greatest challenge in determining their ACL.

CECL methodology components

6. Is your Company currently considering making changes to one or more of the key ACL assumptions or components either in response to the aforementioned challenges or as part of the assumption/component review?



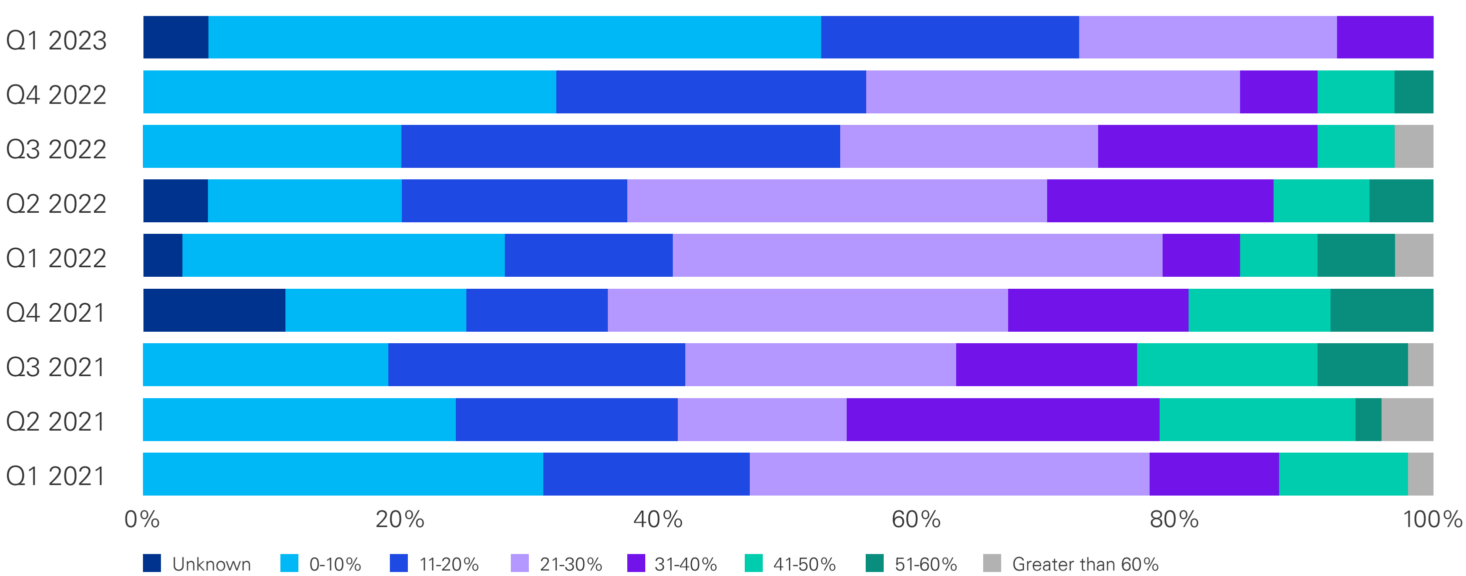
When asked whether changes to ACL assumptions are being considered in response to current challenges in determining the ACL estimate; 88 percent of respondents in Q1'23, consistent with Q4'22 (88 percent), cited they are not planning or considering making changes to the reasonable and supportable period, reversion period, or lookback period in response to current challenges in determining their ACL.

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.

For those companies that utilize percentage probability weights in their macroeconomic scenarios as part of their methodology; we 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 56 percent in Q1'23.

	Base case	Upside	Downside	Severe downside	Other
Q1'23[1]	56%	20%	29%	48%	58%

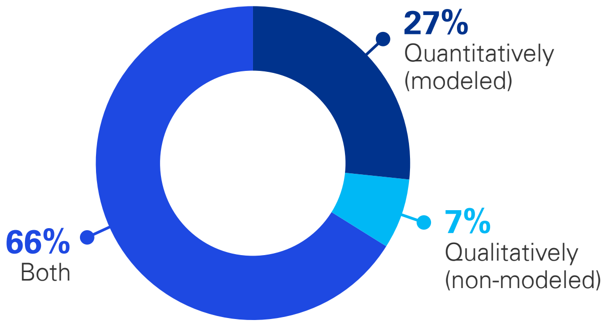
7. What percentage of your Company's ACL as of March 31, 2023 would you estimate to be based on qualitative factors?



Many companies incorporate qualitative adjustments into their ACL estimate to capture changes in expectations, and we understand they will continue to do so. Approximately 28 percent of respondents indicated they expect qualitative factors to comprise more than 20 percent of the total ACL estimate in Q1'23 as compared to 44 percent in Q4'22.

[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.

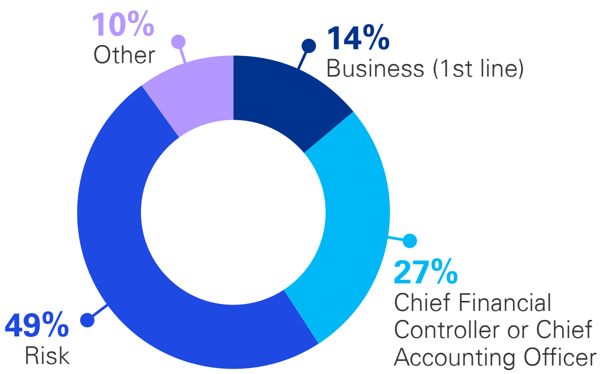
8. How are economic conditions such as the higher inflation rate, increased interest rates, the unemployment rate and/or the potential of an economic recession being factored into your Company's ACL estimate?



In Q1'23, approximately 27 percent (32 percent in Q4'22) of respondents are factoring in impacts from the high inflation rate, increased interest rates, the unemployment rate and a potential economic recession within their ACL estimate quantitative (modeled) approach whilst 66 percent (62 percent in Q4'22) of respondents are factoring in these conditions both quantitatively (modeled) and qualitatively (non-modeled).

CECL process

9. Who within your Company owns the quantitative modelling process and associated models?



We surveyed companies about their CECL process namely who within their company owns the ACL process. Approximately 49 percent of respondents say that the group/individual within the Company who owns the quantitative modelling process and associated models is the Risk Department.

Approximately 75 percent of respondents also cited that the group/individual within the Company who owns the quantitative modelling process is the same as the group/individual who owns the qualitative adjustment process.

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 first quarter of 2023.

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