

Coronavirus and CECL:

Novel Threats and New
Accounting

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Introduction

The difficulty of containing the spread of the novel coronavirus (and the resulting disease, COVID-19) is putting pressure not only on human health, but also on delicate global social and economic networks. Direct and indirect effects will continue to have a toll on human life, and this discussion does not set that aside lightly – we leave it to dedicated and trained public health professionals.

Here, we discuss what is within our scope of expertise: the potential economic impacts of the coronavirus, comparisons of accounting treatment for credit losses under legacy and current guidance, and estimation approaches for this or any other exigent circumstance. That we are entering a ‘new normal’ of uncertainty during the adoption window of new accounting presents options to explore application of that guidance ([ASU 326](#), Financial Instruments – Credit Losses, also known as the current expected credit loss standard, or CECL) before constrictive patterns and practices are established. [CECL](#), of course, took effect Jan. 1 for large SEC registrants reporting on a calendar year, based on the timeline issued by the Financial Accounting Standards Board. Private entities and public entities meeting the definition of a Small Reporting Company (SRC) may use legacy guidance until the end of 2022, unless they choose to adopt CECL earlier.

Neither accounting standard will increase or decrease the ultimate impact of the coronavirus or any other event in terms of credit losses realized. The amount of financial institution losses that will be recognized as a result is immune to the accounting treatment of the estimate. However, the nature and timing of this event present an interesting, specific case to examine the strengths and weaknesses of the legacy and new accounting standards.

ECONOMIC EFFECTS

While the domestic impacts of the coronavirus cannot be specifically predicted, we can make some inferences from overseas impacts and extend trend lines from available data at the time of this writing (March 12, 2020). Several major employers have implemented social distancing measures such as “work from home” directives, or rescinding all but the most critical business travel. State and local authorities are restricting gatherings and implementing measures of social control. Major events are canceled, sometimes mid-event. Such radical reordering of social and business practices create predictable demand shocks for several industries, notably extraction, transportation, hospitality, and events/entertainment. These demand shocks may have less immediate or less predictable follow-on effects.

For some industries, these shocks are – in the first order – liquidity shocks. Buyers (consumer or commercial) may defer or accelerate purchases and investments, but cumulative need for the good or service over a longer period of time is unchanged. For other industries, such as hospitality or travel, the first order effect is credit: the cash flows will not occur earlier, and they will not occur later. They are gone. Liquidity and minor credit issues can typically be mitigated. Fundamental credit issues in the value chain will be felt throughout that value chain between workers, operators, developers, finance partners, and consumers.

Critically, and in a departure from the financial crisis that led to the last global downturn, there is significant economic threat from supply shocks that are already being felt, both in terms of labor and materials. Labor shortages earlier in the value chain create material shortages downstream. Since the 2008 financial crisis, supply chains have faced two resiliency pressures – both through globalization (increased complexity) and by increasing efficiency (e.g., decreased inventories). These networks, however efficient, are also delicate, and certain critical networks are under additional pressure from both intrinsic coronavirus effects and extrinsic effects of human response.

We could attempt to draw inferences from the “Spanish Flu” 1919 pandemic, but it is hard to fathom a comparability claim between the global economic networks of 2020 and the world order 25 years before the Bretton Woods system and post-war order. Even if public health professionals successfully mitigate the spread of the virus, global systems will be strained until the development and deployment of a vaccine, care capacity, or sufficient immunological response.

TREATMENT AND OPTIONS UNDER LEGACY “INCURRED LOSS” GUIDANCE

Under common applications of legacy guidance (ASC 450-20¹, ASC 310-10²) , entities are specifically prohibited from incorporating forward-looking expectations into the allowance for loan and lease losses. Rather, a historical loss rate would be calculated and potentially adjusted, and borrowers who were specifically nearing default or had defaulted would be evaluated individually.

The behavior under legacy guidance, which will only be used by private entities and public entities meeting the definition of a Small Reporting Company (SRC) will, generally speaking, present a loan-loss reserve without considering future impacts of such events. At some point, that impact will be recognized by the entity in the form of loan losses, which will then and only then increase the historical loss rate. The entity will then reserve for these contingent losses **only after the losses are recognized** (by the letter of the guidance). This ‘rear-view-mirror’ constriction is one of the core issues CECL seeks to address by changing the presentation from being reflective of prior losses to one being reflective of expected future conditions.

Under legacy guidance, also known as the [incurred loss model](#), a qualitative adjustment may be applicable; the size and nature of this adjustment (by the letter) should not be reflective of future conditions. Entities may struggle to support the size or nature of such a post hoc adjustment. At minimum, close attention to reported default or loss data from peer institutions can serve as a North Star.

¹ General allocation, formerly FAS 5 “[Accounting for Contingencies](#).”

² Specific/Impaired notion, Formerly FAS 114 “Accounting by Creditors for Impairment of a Loan.”

If for whatever reason – public health, economic headwinds, or idiosyncratic credit strain – a borrower becomes unlikely to meet the contract obligations of their instrument, that instrument will be evaluated for impairment; the amount of that impairment may be allocated as a specific loan loss reserve or recognized as a credit loss. Charge-off through specific evaluation will then raise the historical loss rate of the pool.

Options to reflect future conditions are limited under the letter of the guidance, but entities employing a long “look back,” or period of relevancy for evaluating historical loss, should consider the conditions under which they might shorten the look-back period. As losses matriculate into the historical record, they can be considered in establishing a loss expectation, and it would strain credulity to average those loss rates with, for example, experience in 2016.

Entities that do not carefully evaluate their incurred practices could face an expensive shock when migrating to a forward-looking estimate in the event of a large economic impact from the virus or other systemic event (forward-looking) when backward-looking estimates are still low.

TREATMENT AND OPTIONS UNDER CECL

Under the FASB’s CECL Update, forward-looking information must be considered in constructing the allowance for credit losses (ACL)³. Additionally, the test of ‘impairment’ for individual evaluation of instruments is broadened, allowing individual examination of an instrument when it does not share ‘similar risk characteristics’ to the broader class of receivable.

Incorporating the forecast adjustment for future expectations can be accomplished in several ways. For entities that can rigorously substantiate the impact at a direct-input level (e.g., defaults will rise by 1% and losses on those defaults by an additional 5%), we would certainly recommend doing so. We have not had the pleasure of working with any clients with that level of public health and economics expertise in-house. However, public literature and research may provide an arms-length, credible framework for adjusting estimates in this manner at some point in the future.

Treatment at an input factor level may be more achievable. None of our clients has public health data quantitatively integrated to their models, as the standard does not require incorporation of these tail risks and contingencies at that level of rigor. However, mainstream economic headline numbers, such as unemployment, interest rate, GDP growth, etc., are commonly used to drive the quantitative portion of CECL models. Mainstream public literature and researchers will likely attempt to quantify the impact of systematic events in those terms. Entities can approach this conceptually by using these predictions as inputs to the appropriate model factors. For example, if a single-factor model is keyed to unemployment, and mainstream analyses of system shock lead to a 6% unemployment rate, an entity might use that 6% as a model input.

³ ACL (allowance for credit losses) is a nomenclature / presentation change from the deprecated ALLL (allowance for loan and lease losses) entry. We will use ACL to discuss the allowance under CECL, and ALLL when discussing the allowance under an incurred loss notion.

We cannot stress enough the importance of understanding the limitations of a quantitative model constructed in this manner. In such a model, the rate of unemployment (or GDP growth/contraction) is being used **descriptively** to put a numerical severity to a systematic headwind; the model is not making a cause-and-effect-claim. Such models, if trained on the last economic cycle, describe that relationship as borne out during a credit shock, and a supply / labor shock (or demand shock) should be considered separately. If a 6% unemployment rate is forecasted due to the virus and ancillary effects, it would not be inappropriate to use a different input if management's assessment of that level of economic severity is greater. Practitioners should also be very careful about model input ranges. If severity of impact is expected to transcend historical downturns, those economic inputs and model outputs should be viewed with deep suspicion.

When using forecast calibrations, timing should be considered thoughtfully. Credit shocks work through the system in different ways than a disease moves through populations. Just because there was a two-year lag from Underlying Event to Loss Recognition in 2008 doesn't mean any coronavirus impact will be felt the same way. Indeed, the specific and direct nature of the current circumstances may accelerate workout and recognition.

Entities using a forecast provider vendor to drive their CECL estimates should seek to understand which forecast scenario, if any, incorporates best estimates of the virus's impact, as well as understand the error bars and production date of that forecast. A coronavirus scenario constructed on March 12 (the time of this writing) will be stale to the point of uselessness on March 31. When the situation is less dynamic, scenario prediction may be more stable and credible.

If no scenario specifically incorporates this impact in a timely manner, entities should question the use of the forecast vendor for financial statement scope. Entities should be aware of, and sensitive to, potential political pressures on public forecast providers as well. For example, the Federal Reserve System provides mainstream economic outlooks quarterly, but also works under a recession-fighting mandate and thus, will be unlikely to take the leading edge on public, severe predictions, or provide updates to outlooks as frequently as required during the dynamic period.

At the time of this writing, the coronavirus domestic impact is an emergent circumstance. There is no consensus on the steepness of the curve of transmission, nor is there consensus on the effectiveness of a given public health strategy to keep that curve as flat as possible for as long as possible. Testing and surveillance is inadequate to understand the risks.

It would be clearly inappropriate to **not** take such events into account for domestic economic performance (e.g., by using the Q4 2019 FOMC outlook), but there is also not a clearly **correct** adjustment to make. We consider "immediate reversion" a conceptually coherent approach as of this writing. If the entity cannot substantiate a short-term claim (a reasonable and supportable forecast cannot exist), reversion to long-run experience is an interim step toward later application of a specific expectation, whether that be a return to economic normalcy or a specific expectation of further deterioration.

Regardless of chosen factor(s), practitioners should check whether the reversion application makes directional sense. For example, present-day GDP growth (prior to coronavirus) may be lower than the 'long run average' of GDP growth and contraction over the period used in model development; reversion (on this factor alone) would then **increase** GDP projections, producing a **decreasing** pressure on credit loss estimates. If this is the case, re-evaluation of the factors' inclusion may be appropriate, or a specific forecast applied, rather than reversion acceleration.

As we recommended to incurred loss practitioners, entities using CECL should keep a very close eye on peer credit and loss performance data. Peer experience in West Coast regions may provide a slightly leading indicator to impacts elsewhere in the country, though we must caution that regional/industrial impacts may not translate.⁴

The broader individual analysis guidelines in 30-2 allow evaluation of instruments that do not exhibit similar risk characteristics to the pool of receivables. Where a borrower is experiencing specific impacts from an economic event, it may be appropriate to evaluate that instrument individually and establish a policy for doing so. Entities performing pool-level cash flow analysis, for example, might examine an affected borrower with a lower or zero probability of prepayment and higher default expectations than the pool cohort.

As the impacts continue to work their way through the system, entities might consider a risk quarantine in establishing the ACL; instruments associated with specific industries may need to be disaggregated from their broader pools for modeling purposes. As of this writing, we recommend collecting this industry classification data so that such a segmentation can be effected once impacts are detectable. For example, industry headwinds to hotel projects will likely be different from those to multifamily projects; disruption may lead to cancellation of business trips and vacations, but may not be sufficient to incent tenants to move their residence.

Entities should proactively define their criteria for 'anticipatory troubled debt restructure (TDR)'. As of this writing, it would be credible to include financial performance data as well as broad industry classification. This will allow quantitative models to project the credit losses on instruments with short-dated maturities. Modeling collection-at-maturity for clearly stressed industries will produce unrealistic estimates of credit loss, as it is unlikely that (for example) a restaurant borrower will pay off a balloon at maturity or secure alternate financing under these conditions.

Entities should also prepare for a significant increase in formally TDR-designated credits. Gathering and placing controls on sufficient industry classification data will allow pooling of TDR credits, as "2020 workouts" will defensibly share 'similar risk characteristics'.

⁴ For example, an early case cluster has been detected in Washington State, near Seattle, where Boeing is an economic titan. Even if coronavirus transmission is largely mitigated, persistent virus headwinds to the travel industry may put pressure on an already stressed entity, creating disruptions that may not be relevant in other markets.

Liquidity inputs should be carefully examined, and input-level assumptions may need to be made without historical data substantiation. For example, in the near term, it would be rational to assume that all uncancelable commitments are drawn fully to establish the off-balance-sheet component. Prepayment for certain classes of receivables may need to be adjusted down significantly in early forecast periods. Both these effects put increased pressure on reserves.

Finally, qualitative adjustment is not inappropriate. It is our position that a qualitative adjustment to quantitative inputs is more rigorous than a post hoc specific adjustment, such as “adding fifty basis points” to the calculated result. The use of a qualitative adjustment post hoc should be accompanied with management’s criteria by which the adjustment would be increased, decreased, or removed in order for external entities to gain comfort with the appropriateness and auditability of the adjustment. At the very least, any qualitative adjustment for anticipated impacts should specify a time criterion by which those impacts would be detectable and therefore flow through the quantitative model.

IMPACTS TO THE TRANSITION

The timing of this system event and the adoption of the standard by SEC registrants presents several considerations.

First, SAB-74 disclosures related to the impact of the accounting change are present on many public 10-K forms as of this date, with many more releases coming in the immediate future. These disclosure impacts are based on information available as of the statement date (usually 12/31/2019) and so subsequent events (arrival of coronavirus) should not be incorporated. However, if direct or indirect virus impacts are part of management’s estimate for the ACL as of 3/31/2020 then the ACL stated as of 3/31/2020 will likely be outside the disclosed range as of 12/31/2019, and far from the 1/1/2020 effective date adjustment. This is not a problem per se; it is the fundamental purpose of the new guidance that new information be assimilated quickly into management’s estimate. It is, however, important that entities and investors be aware that presentations as of 3/31/2020 may diverge from expectations set just a few weeks before.

When deciding whether and to what degree systemic impacts should factor into the estimate as of 3/31/2020, management should consider the risks during this unique period where the allowance for credit losses is being funded as a cumulative-effect (one-time) change to capital, with future increases and decreases in the ACL flowing through the provision for credit losses (PCL) on the income statement.

If management overestimates system or other risks at adoption (as of 1/1/2020), the capital impact at adoption will be larger. If those risks fail to materialize in the form of credit losses, the amount overestimated will release as provision income once the data becomes available to substantiate the overestimation of risks.

If management underestimates systemic or other risks at adoption (as of 1/1/2020), there will be a smaller (in some cases, positive) impact to capital. Should those risks materialize in excess of management's estimate, the amount underestimated will become provision expense events once the data becomes available to substantiate the underestimation of risks.

It is our belief that the likely major impacts today were not credibly knowable as of 1/1/2020, but that sufficient known or knowable systemic risk existed as of 1/1/2020 to substantiate very short forecast periods, even absent coronavirus or oil system shocks. The initial cluster reporting from China occurred on Dec. 31, 2019.⁵

Again, the fundamental purpose of CECL is that new information on credit losses be assimilated quickly into financial presentations, so differences from earlier estimates should not strain credulity in times of uncertainty. Communicating possible divergences is vital.

ADDITIONAL CONSIDERATIONS

The treatment of this emerging situation as an industry straddles accounting guidance is the least important impact of the coronavirus one can imagine, yet the nature and timing of the situation are an opportunity to review some of the impacts of the incurred loss and CECL accounting standards.

It is important to remember that neither the legacy nor new accounting standard will increase or decrease the ultimate impact of the coronavirus in terms of credit losses realized. The amount of financial institution losses that will be recognized as a result of this or any other event is immune to the accounting treatment of the estimate. Indeed, even a 'perfect' forward looking credit loss model under CECL will understate the dollar amount of future charge-offs, to say nothing of timing, as these models **must not** account for future originations or renewals of existing obligations. Forward-looking models developed in support of a rigorous CECL estimate, however, can be adapted to perform stress tests that account for these components and produce useful information for planners.

Finally, the present crisis has a discrete cause. Under the new standard, when an entity reasonably and supportably believes that discrete cause is in the rear-view, a sound implementation of the forward-looking estimate will release reserves in surplus through PCL in a timely manner. When sufficient medical monitoring and surveillance is in place in the community, and when social practices become predictable rather than dynamic, excess loss reserves can be put back to work in the community immediately.

⁵ <https://www.who.int/csr/don/12-january-2020-novel-coronavirus-china/en/>, Dated 12 January 2020.

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