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FUND FINANCE FRIDAY

Coming to Fund Finance: Current Expected Credit Losses

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SEC registrants, including banks, will be required to record allowances for credit losses at loan origination based on a life-of-the-loan loss forecast effective January 1, 2020, under an accounting standard that has been years in the making. FASB, earlier this month, revised the implementation schedule of its current expected credit losses ("CECL") methodology to allow "smaller reporting companies," as defined by the SEC, more time to implement the change in GAAP. The delayed implementation, however, applies to institutions sized below any participants in fund finance lending.

Having been in the works since 2016, the implementation of CECL may not be news. The new accounting standard nonetheless represents a sea change in GAAP because it replaces the existing incurred loss framework, which captures probable and estimable losses, with one based on forward-looking loss estimates. The thinking behind CECL came about after the financial crisis in response to what was perceived as a tendency towards "too little, too late" in banks' loss provisioning. The aim of the new standard is to improve transparency and extend the forecast horizon by requiring a model-based life-of-the-loan loss forecast at the time a loan is originated. (While we've focused on loans here, the application reaches to a wide range of credit assets.)

Concerns that are germane to the fund finance market have already been aired elsewhere in feedback to FASB and the SEC. There are operational considerations related to implementation, with the availability of through-the-cycle representative performance data being one. Beyond fund finance, concern has been raised over a potential increase in loss reserves at implementation and the follow-through effect on capital — banks that provided CECL impact estimates in Q1 and Q2 have generally shown increases in loss reserves. Regulators have been responsive by allowing banks to phase in implementation over three years.

Even so, the untested nature of the standard and the potential for pro-cyclical swings in reserves as the economic outlook shifts continue to be points of unease. The CECL framework breaks the lifetime loss estimate into a "reasonable and supportable" period component and a

long-term mean loss estimate, leaving banks with discretion to define the appropriate period for each. This element of discretion risks introducing volatility in loss reserves and could cloud the comparability of financial results between banks.

Net, net, we think CECL may aid the relative attractiveness of subscription lending over other bank assets. Here, we particularly have longer-lived real estate, consumer and commercial assets and longer average-life securities in mind. Short loan terms and the revolving nature of subscription loans limit the effective life of the loan over which losses are required to be forecasted. The clean performance history of the product should be an additional benefit. We can envision a scenario where CECL, while challenging to banks overall, drive greater allocations of balance sheets to fund finance and bring more lenders into the space.