From Incurred Loss to Current Expected Credit Loss (CECL): A Forensic Analysis of the Allowance for Loan Losses in Unconditionally Cancelable Credit Card Portfolios

FRB of Philadelphia Working Paper No. 20-09

49 Pages
Posted: 29 Apr 2020

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Date Written: March, 2020

Abstract

The Current Expected Credit Loss (CECL) framework represents a new approach for calculating the allowance for credit losses. Credit cards are the most common form of revolving consumer credit and are likely to present conceptual and modeling challenges during CECL implementation. We look back at nine years of account-level credit card data, starting with 2008, over a time period encompassing the bulk of the Great Recession as well as several years of economic recovery. We analyze the performance of the CECL framework under plausible assumptions about allocations of future payments to existing credit card loans, a key implementation element. Our analysis focuses on three major themes: defaults, balances, and credit loss. Our analysis indicates that allowances are significantly impacted by specific payment allocation assumptions as well as downturn economic conditions. We also compare projected allowances with realized credit losses and observe a significant divergence resulting from the revolving nature of credit card portfolios. We extend our analysis across segments of the portfolio with different risk profiles. Interestingly, less risky segments of the portfolio are proportionally more impacted by specific payment assumptions and downturn economic conditions. We also analyze the impact of macroeconomic forecast error and find that it can be substantial and can be impacted by CECL implementation design features. Overall, our findings suggest that the effect of the new allowance framework on a specific credit card portfolio will depend critically on its risk profile. Thus, our findings should be interpreted qualitatively, rather than quantitatively. Finally, the goal is to gain a better understanding of the sensitivity of allowances to plausible variations in assumptions about the allocation of future payments to present credit card loans. Thus, we do not offer specific best practice guidance.

Keywords: allowances, unconditionally cancellable, expected credit losses, credit loss, revolving credit

JEL Classification: G21, G28, M41

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