Market implied expected credit losses

Using market prices to estimate expected credit losses under CECL

Overview

The FASB's new CECL (current expected credit loss) requirements may significantly impact how both financial and nonfinancial entities calculate credit loss reserves. However, for nonfinancial entities ("corporates"), CECL also requires a major shift in perspective, because for the first time they will need to measure potential credit losses from a forward-looking perspective, in particular their exposure to trade receivables.

With little or no experience forecasting or modeling economic conditions that drive credit losses, and potentially insufficient data available to do so, corporates are facing a complex challenge to comply with CECL.

One method that corporates are using to incorporate the forward-looking requirements of CECL is to use expected credit losses derived from market prices of comparable debt instruments.

Are market implied expected credit losses compliant with CECL?

Economic theory states that if markets are efficient, then market prices reflect all the information pertinent to the instrument's future risk and return characteristics over the life of the instrument. In this way, the expected credit losses derived from the market price of a receivable reflect all the information available at the measurement date, including past events, current conditions, and forecasts of future economic conditions. As such, expected credit losses appropriately derived from credible market prices that reflect the credit risk characteristics of the receivable are consistent with CECL reporting requirements.

It may even be argued that if a credible market price exists for a receivable (or similar debt instrument) held by a corporate, then that corporate would be remiss in not incorporating this market information into its CECL estimate. For example, if an entity holds a significant trade receivable from a customer that also has issued public debt, and the market price of the debt has experienced a rapid decline, not considering this market information (directly or indirectly) may result in an inadequate CECL estimate.

Using public debt instruments as proxies for receivables

In practice, however, market prices for identical receivables or similar debt issued by the same obligor may not be readily available. Therefore, suitable publicly traded instruments with similar credit characteristics would need to be used as proxies to estimate the market prices of receivables.

In this regard, ASC 326's requirement that an entity should estimate CECL on a pooled basis (where similar risk characteristics exist) is helpful in that only one proxy debt instrument is needed for each designated risk pool.

Since the public debt instruments used as proxies are not identical to the subject receivables, the expected credit losses derived from market prices of these instruments would likely require certain adjustments and/or need to be combined with historical losses to ensure that their CECL estimates reasonably reflect the specific characteristics of the subject receivables.

> **CECL at a glance**
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> Released as part of ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326),* CECL replaces current U.S. GAAP's incurred loss models for financial assets measured at amortized cost.
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> Under CECL, expected credit losses represents the portion of the amortized cost basis that an entity does not expect to collect over the asset's contractual life, considering:
>
> — Past events
>
> — Current conditions
>
> — Reasonable and supportable forecasts of future economic conditions.

Estimating market implied current expected credit losses (MICECL)

While MICECL can provide for practical and readily observable forward-looking expected credit losses, estimating MICECL can be challenging. Since market prices of debt reflect more than just the expected credit losses (e.g., liquidity risk), market debt yields need to be carefully decomposed to isolate the credit-only component that excludes any market-based risk adjustments, as required under ASC 326. Failure to account for liquidity and market-based risk adjustments can lead to distortions and inappropriately more volatile expected credit loss estimates. In addition, while rare, in times of market failure, entities applying this method will need to consider whether their MICECL estimates are credible.

See below for the process entities can follow to estimate MICECL from a selected market debt yield.

Decomposition of market debt yields to estimate MICECL—Illustration

1. Observed market debt yields

Market debt yield	**MDY**	Observed market debt yield from selected proxy debt instrument with comparable risk characteristics as receivable (or receivable risk pool)

2. Decomposition of the market debt yield:

Risk-free rate	**RFR**	Time-value of money
Credit risk	**CR**	**Credit risk: Market premium for expected credit losses**
Liquidity risk premium	**LR**	Liquidity risk: Risk of loss as a result of lack of liquidity

3. Decomposition of the credit risk premium:

Credit risk	=	Market expected loss given default	x	**Market risk-adjusted probability of default (aka risk-neutral probability of default)**		
	=	Market expected loss given default	x	**Market implied probability of default**	x	Risk adjustment factor

4. Estimation of market implied current expected credit loss (MICECL):

MICECL	=	Specific loss given default	x	**Market implied probability of default**	x	Exposure at default

How can KPMG help

We have developed a MICECL valuation methodology that complies with the forward-looking requirements of ASC 326. We can assist corporates calculate, support, and embed the MICECL valuation methodology as part of their compliance with CECL requirements, or it can be used to help validate the CECL estimation process.

For more information, please contact your local KPMG adviser.

Contact us

Alok Mahajan
Principal, Valuation & Business Modeling Services
T: 408-367-2841
E: amahajan@kpmg.com

Ron Elkounovitch
Principal, Valuation & Business Modeling Services
T: 404-222-7375
E: ronelkounovitch@kpmg.com