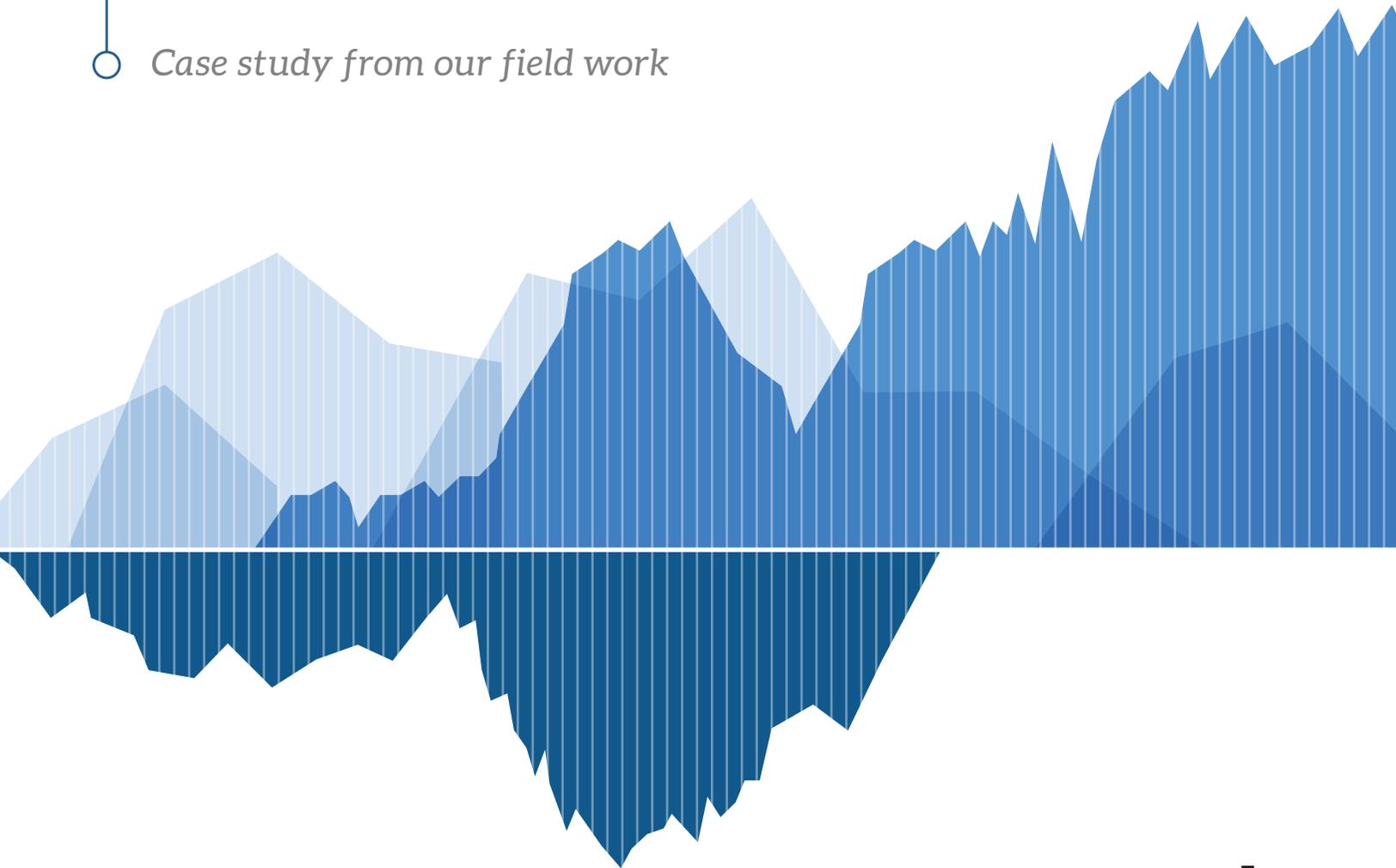


# CECL Implementation Case Studies

CECL and DFAST — Accounting vs. Simulation

- *DFAST / CECL similarities and differences*
- *Risks of programme convergence*
- *Case study from our field work*



## EXECUTIVE SUMMARY

When we work with clients on implementation of the CECL standard, we assess whether the inputs, assumptions, and results used in the modeling effort are similar to an entity's parallel activities – for example, it would not make sense for an institution's ALM modeling to make wildly different rate environment predictions than its CECL modeling. In our work we have found different results, inputs, and assumptions between the CECL accounting exercise and the DFAST exercise. This whitepaper presents a case study of such work, and demonstrates how CECL-scope results might be meaningfully compared to DFAST-scope results. While some models used in CECL loss estimation can be used to produce DFAST submission inputs, (e.g. interest income / PPNR, provision expense, etc.) they require fundamentally different assumptions, inputs, and treatments of certain events. **Management should not assume that completion of one exercise will fulfill the requirements of the other. Moreover, management should understand the significant risks in CECL/DFAST programme convergence, including audit risk to presented financials.** Nonetheless, we have found the investment in data accumulation and modeling expertise to be broadly cross-applicable.

### DFAST

Regulatory requirement to **simulate your entire institution** for a **specific period of time** with **prescribed inputs** to demonstrate **safety and soundness**.

### CECL

Accounting requirement to **estimate assets presented at amortized cost** for the **life of the asset**, including **reasonable and supportable** forecast inputs to implement a **valuation account**.

## INTRODUCTION

In June of 2016, the Financial Accounting Standards Board (FASB) introduced Topic 326 in update 2016-13, detailing the use of the current expected credit loss (CECL) notion for presentation of an Allowance for Credit Losses (ACL, or ALLL, used interchangeably). For many clients, the implementation of this standard requires a level of quantitative rigor usually beyond the scope of predominant ALLL practices. Clients who have implemented – or are beginning to implement – a stress testing capability to comport with Dodd Frank Act Stress Testing (DFAST) requirements rightly want to explore whether the modeling efforts already used for their DFAST programme can be used in the context of ACL measurement under the CECL standard. Entities that allocated significant resources to developing the capability to prepare DFAST submissions are looking to use those resources – analysts, data stores, models, etc. in other practices. When we work with financial institutions that are executing or preparing to execute DFAST submissions, we want to ensure that the modeling approaches are broadly comparable and, whenever possible, to attempt to reconcile any differences in results. Further, DFAST capabilities that are already in place can be used to serve as “benchmarks”, especially under the baseline scenario, to calibrate models for the CECL capability.

In this whitepaper, we discuss the specific similarities and differences between the two exercises and present a case study from our field work.

## DFAST - CECL SIMILARITIES

The primary conceptual change from current ALLL practices under the Incurred Loss (ILM) notion to the future standard is implementation of a forward-looking notion under CECL. An Allowance for Credit Losses prepared under the CECL standard involves some forecasting effort. The activity of preparing a stress test is also fundamentally forward-looking. To that end, models that correlate a given econometric outlook to financial performance are employed in both exercises. Development of such models can be a data-intensive exercise; in order to determine what might happen to a loan in an economic downturn it is, to put it lightly, strongly advisable to have data from an economic downturn. Further, risk identification for non-retail portfolios can require high statistical counts in order to produce a stable, meaningful measurement. To that end, data storage and validation requirements for both exercises can be similar. Our clients with data warehouse capabilities in DFAST scope have found those capabilities were sufficient for CECL scope.

Development and deployment of such models as might be used in these exercises requires similar skillsets and capabilities. Whether an entity works with a vendor platform, develops tools in-house, outsources some or all of the effort, or takes a combination of these approaches, the resulting models will require an understanding of the nuance, art, and science involved. Such models rarely produce static “answers”; rather, the language of ranges and confidence intervals is employed. It is not just management’s right, but its responsibility to interpret these results in both cases.

Finally – and this point is easy to lose sight of – the results of the DFAST and CECL modeling will not determine how an entity performs. Forecasts and scenarios under both exercises are not prophecy. Being adequately reserved or under-reserved does not change whether an entity’s borrowers can repay any more than Allowance practices control asset prices for underlying collateral.

At this point, however, the material similarities end and the important divergences begin.

**DIVERGENCE: AUDIENCE AND AUTHORITY**

DFAST is a supervisory activity, monitored by a regulatory authority and prescribed by an Act of U.S. Congress. The intended purpose of the stress test is to demonstrate institutional safety and soundness in the United States banking system; to that end, satisfactory submissions will be methodologically defensible and, ideally, demonstrate capital adequacy in specific circumstances. However, criticism of DFAST modeling efforts, assumptions, and preparation does not impact the realities of bank performance or users of financial statements.

In contrast, CECL is an accounting activity prescribed by the FASB and part of U.S. GAAP. Its application will be evaluated by audit firms who answer to their own reputational risk, the PCAOB, etc. CECL estimation will impact the institution’s balance sheet ACL and income statement PCL lines, which are presented to investors and may have tax implications. Issues with the CECL implementation can cause material weakness findings in an audit.

While this contrast is generally well-understood, the implications are subtle. Putting the modeling efforts for CECL and DFAST in lock-step creates an environment where criticism of one function imperils the other. Considering the audiences for the exercises may have interests that are not in line – safety and soundness versus defensibility – the interprogramme risk should not be taken lightly.

**DIVERGENCE: SCOPE**

The CECL standard for preparation of an Allowance for Credit Losses applies to assets reported at amortized cost. While for bank financial institutions this scope represents an entire side of the balance sheet, or nearly so, DFAST modeling must consider the entirety of both sides. In many cases, the modeling effort for DFAST may include autoregressive factors (outputs are predicted by prior period outputs), or correlations to other outputs, even on the other side of the balance sheet. Further, and perhaps most critically, loan production and retention must be correctly modeled for DFAST to produce a meaningful result, while these assumptions are *explicitly disallowed* under the accounting standard – mercifully, we do not have to allocate reserves for loans that have not been made.

**DIVERGENCE: FORECASTS VERSUS SCENARIOS**

While both exercises have a forward-looking element, the Federal Reserve provides the model input “answers” in the form of the baseline, adverse, and severely adverse scenarios. Institutions must correlate these economic indicators to their portfolio performance, but are not responsible for defining the indicators themselves. CECL requires both – that important indicators are *identified and predicted*. The scenarios under DFAST are hypothetical, projections under CECL are intended to be *likely*. For that reason, forward-looking models employed under CECL should only consider, as inputs, factors for which the institution can create or source a reasonable and supportable forecast, regardless of the strength of correlation of the factor to the bank’s credit loss experience. As an illustrative but perhaps facile example, death and divorce rates may correlate to a bank’s losses – but it is unlikely the bank will want to be in the position of defending such forecasts to their auditor... as much as it would make financial institution MD&A more entertaining reading.

**DIVERGENCE: APPLICABILITY**

The difference here is straightforward – as of the date of publication, DFAST requirements apply to financial institutions with more than \$10B of assets. CECL applies to all institutions with assets in scope, with different phase-in requirements

and required adoption dates depending on an institution’s status as an SEC filer or Public Business Entity. Congress may act to adjust which institutions must perform the stress testing activity, but has been historically reluctant to address accounting standards.

**DIVERGENCE: CONTRACT VERSUS CRISIS**

The CECL standard requires institutions to predict lifetime credit loss expectations for assets presently on the balance sheet, with the contract lifetime being adjusted either implicitly or explicitly for pre-payment behavior. In contrast, regulatory stress testing prescribes institutions compute at least a two-year outlook to determine the institution’s ability to survive a crisis of that duration. The synthesis of these differences is important, as it describes the most fundamental hurdle to program comparability – DFAST models and results assume some level of renewal and some level of asset production, while CECL implementation requires the opposite assumption. Depending on the implementation of the stress testing programme and the ACL programme, it may not be possible to “unwind” these effects.

**CECL IN DFAST**

We have discussed the differences between the CECL and DFAST exercises, but we have not yet broached the topic of CECL *within* DFAST. Allowance and provision projections in stress tests typically are handled in one of two ways:

First, for entities with top-down, backward-looking Allowance models, the notional Allowance is computed for each stress period based on prior period simulated results. Alternatively, some entities model the relationship between the economic factors, loss rates, etc. and historical Allowance levels, and use this to set Allowance levels (and thereby provision amounts) in their modeling. Both of these approaches are conceptually sound, but raise two important questions, one of which was mercifully answered this month:

*How should my DFAST models account for the accounting change on my adoption date?*

It is conceptually unsatisfying to have to model a cumulative-effect accounting entry in the middle of the stress period that may potentially move capital into the Allowance for Credit Losses. The presentation matters alone (ALLL? ACL?) are confounding, and since the Allowance fundamentally impacts the *timing of loss presentation in income* and not the *amount of the loss*, pointless for purposes of the safety and soundness exercise. Further, the only way to comply with the requirement would be to complete your CECL implementation effort when the adoption period appeared in DFAST scope – which has already occurred as of this publication.

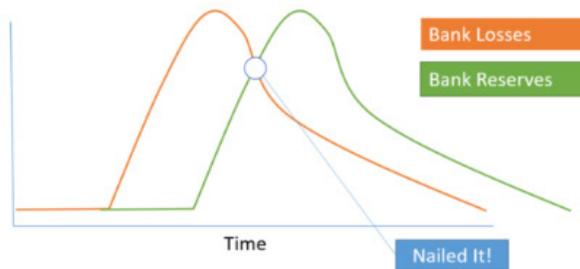
A [proposed rule](#) published April 17, 2018 codifies clear guidance for institutions on this first question – note the rulemaking process is ongoing as of the date of publication of this whitepaper – even early adopters of the CECL standard should wait until the submission year of their **required** adoption date to include CECL modeling assumptions in their ACL/PCL reporting under DFAST. In other words, submitters should not model the adoption of CECL in their projections.

Year of Adoption of ASU No. 2016-13	2019 Stress Test Cycle	2020 Stress Test Cycle	2021 Stress Test Cycle
2019	Provision for loan loan and lease losses	Provision for credit losses	Provision for credit losses
2020	Provision for loan loan and lease losses	Provision for credit losses	Provision for credit losses
2021	Provision for loan loan and lease losses	Provision for loan loan and lease losses	Provision for credit losses

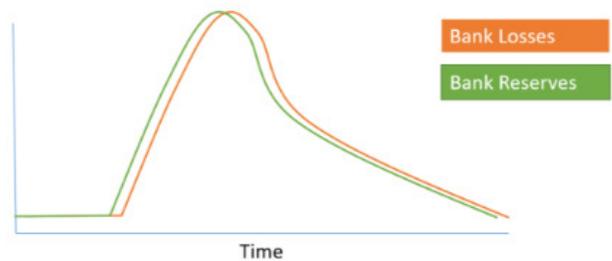
How do I model CECL when the time comes to do so in my submissions?

Unfortunately, we do not (yet) have an answer to this question. In the 2020 stress cycle, there will be no data available to regress ALLL or ACL levels under the CECL notion to \*any\* economic indicator, so that approach will not be possible. The notional-allowance approach begs some philosophically profound, ultimately pointless conceptual questions. Under the current practices around the Incurred Loss notion, ALLL levels are set *responsively* to past events, which makes them easy to calculate but practically guaranteed to be wrong in a dynamic environment. This is one of the fundamental drivers for the change in accounting standard for the Allowance for Credit Losses. In contrast, CECL attempts to project expected losses in its ACL:

### Under ASC 450-20 (Incurred Loss, “Look-Back”)



### Under CECL (In Theory)



This change is not immediately problematic until we consider how a projected institution would perform projections of loss. Do DFAST submitters need to model how their model would model the scenario? Do we assume these simulated bankers have accurate forecasts? Do we assume they’ve implemented the CECL / ACL notion correctly? Are you, the reader, just a tiny computer simulation of a banker in some megaverse preparing its own DFAST submission? Am I, the author? How did we get here? Do we truly remember yesterday, or are we only simulated/programmed to *think* we remember?

The conceptually soundest approach— and coincidentally, the easiest to implement – is to make the assumption that our DFAST model bank can accurately model its own future credit loss, and has access to correct forecasts, the effect of which would be a large provision event in the first stress period to absorb the losses of the subsequent periods, with bonus points awarded for separating loans-on-book versus new production in the stress period. A two-year stress period would be well within the weighted average loan life for most segments, so the new production component would be the primary difference between CECL ACL estimations and DFAST loss projections within the stress period.

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## CASE STUDY INTRODUCTION

We now ascend from the pit of madness, confident that we are not simulated entities ourselves, to consider a case study. Specific numbers, brands, and marks have been anonymized, but the insights are still applicable; we will consider Rocket Bank, an institution preparing submissions under DFAST that has been working with Sageworks Advisory Services on implementation of the CECL standard. In this case study, we evaluate Rocket Bank’s CRE modeling efforts, and attempt to compare DFAST results to CECL estimations. Key points:

- DFAST models included econometric and performance inputs, using autoregressive techniques
- CECL forecasting models included two primary economic factors with a 1-year outlook and 2-year reversion length for CRE pools
- Scope of CECL estimation is commercial real estate assets held to maturity
- Rocket Bank’s internally observed default and loss-given-default rates were measured with meaningful statistical power and used as inputs to the credit layer of the DCF model for baseline/current conditions results.
- CRE pool weighted-average-life of 4 years, representing a 25% annual attrition rate.
- Comparisons are to 2017 Severely Adverse regulatory scenario

- DCF projection elected for measurement for reasons beyond the scope of this whitepaper
- Observed 0.35% default rate for CRE under recent, performing conditions.
- Qualitative factors were **not applied** in this exercise.

#### CECL Estimation- Baseline

CECL modeling under a “baseline” condition, representing a forecast of continued current conditions over the forecast period, modeled a NPV difference of \$9.4MM, representing a 31bp allocation.

Scenario	CRE NPV Difference (\$1,000s)	Expressed as Ratio
Baseline	\$ 9,423.88	0.31%

Setting the DFAST comparison aside, this is an important result – data quality exercises had been completed by Rocket Bank, and this projection used credible, first-party inputs for the timing and credit loss expectation layer. This result is *significantly less* than Rocket Bank’s stated allocation under the incurred loss notion including qualitative factors. This result is *slightly more* than Rocket Bank’s stated allocation under the incurred loss notion, net of qualitative factors. In terms of credit practices, exposures, risk appetite, and pricing we believe Rocket Bank’s CRE portfolio to be broadly representative of CRE exposures at institutions of similar size and complexity.

#### CECL & DFAST Estimation - Severe

We fed inputs analogous to the DFAST Severely Adverse scenario into our cashflow model, and observe an attendant increase in NPV difference, nearly doubling indicated allocation:

Scenario	CRE NPV Difference (\$1,000s)	Expressed as Ratio
Baseline	\$ 9,423	0.31%
Severe	\$ 17,769	0.59%

In this scenario, we model a 1-year climb to “severe” conditions, at which point reversion effects are implemented at the input level. By way of contrast, the two-year stress scenario under Rocket Bank’s preparatory DFAST submission results are as follows:

Segment	Q1	Q2	Q3	Q4	Year 1
CRE NOO	\$ 1,983	\$ 1,707	\$ 2,029	\$ 2,525	\$ 8,244
CRE OO	\$ 2,753	\$ 2,315	\$ 2,616	\$ 3,571	\$ 11,256
					<b>\$ 19,500</b>

Segment	Q1	Q2	Q3	Q4	Year 2
CRE NOO	\$ 3,763	\$ 4,146	\$ 4,517	\$ 3,912	\$ 16,339
CRE OO	\$ 4,174	\$ 4,836	\$ 5,243	\$ 5,465	\$ 19,719
					<b>\$ 36,058</b>

Note the combined 2-year stress period loss anticipation of \$55.6MM **grossly** exceeds our attributable NPV difference of \$17.7MM. The reconciliation of this excess is the topic of this whitepaper.

### Modeling Interpretation

As previously mentioned, a good model produces a quantification of its own uncertainty and model risk. Thoughtful institutions of any size will pay close attention to this uncertainty when implementing the CECL standard under any methodology. An average default rate measurement of, for example, 1.1% is certainly a useful metric, but a meaningful metric would include some form of confidence interval or distribution of the results, e.g. “95% of the observations of the default rate are between 0.7% and 1.5%.” The functional equivalent in a regression model is the 95% confidence interval result; the model may produce a midrange point estimate of 1.1%, but truly be indicating the result is 1.1% +/- 0.4% at the 95% confidence level.

This nuance is **critical** and notably absent from most implementations of the incurred loss notion for measurement employed today. It is not simply management’s right to interpret these ranges, it is management’s **responsibility** to understand the level of precision in modeling efforts and apply judgment **at the policy level** in interpretation of that precision. To that end, we repeat the analysis in the baseline and severe CECL projections, only this time interpreting our 95% confidence interval at the upper, conservative bound; we implement pessimism as a matter of policy.

For a detailed discussion of a straightforward approach to modeling under the forecast requirement, please see the [relevant chapter](#) of our *Practical CECL™ Transition... Readers who worry about producing meaningful estimates under any methodology should consult our discussion of the use of [Peer and Industry Data](#).*

Scenario	CRE NPV Difference (\$1,000s)	Expressed as Ratio
Baseline	\$ 9,424	0.31%
Severe	\$ 17,770	0.59%
Baseline Conservative	\$ 14,301	0.48%
Severe Conservative	\$ 25,330	0.84%

DFAST CRE Component	Losses (\$1,000s)	As Ratio Against Initial Basis
DFAST Year 1 CRE Losses	\$ 19,500	0.65%
DFAST Year 2 CRE Losses	\$ 36,058	1.20%
DFAST Total Stress Period CRE Losses	\$ 55,558	1.85%

Even applying a conservative interpretation to our modeling efforts, we produce a change in NPV just under half of our stress period loss rates.

### Payment Activity

In our example, we are considering the attributable difference to NPV from timing and credit assumptions – we have not “washed out” the timing inputs in the effective yield calculation. However, we have held the prepayment and curtailment assumptions constant in all scenarios. Wishing to examine the effect on Rocket Bank’s estimations should prepayment and curtailment activity be reduced in a deteriorating environment -- effectively, implementing longer durations – we depress both inputs by 75%.

For more information, please see the [Practical Transition Content](#) on the use of projective DCF modeling.

CECL Scenario	CRE NPV Difference (\$1,000s)	Expressed as Ratio
Baseline	\$ 9,424	0.31%
Severe	\$ 17,770	0.59%
Baseline Conservative	\$ 14,301	0.48%
Severe Conservative	\$ 25,330	0.84%
Severe Conservative	\$ 29,553	0.99%

DFAST CRE Component	Losses (\$1,000s)	As Ratio Against Initial Basis
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We can see the effect of depressed payment tendency is material, as we would expect. After all, a dollar repaid is a dollar that cannot be lost. By depressing our prepayment assumptions, extended balances are left to “marinate” longer in the high-loss environment.

#### Loss Environment Onset

In our CECL model, our 1-year outlook reflects a straightline quarterly “climb” into recessionary conditions, at which point the reversion effects exert countercyclical pressure and begin to reduce loss estimations on a straightline basis. In contrast, the Severely Adverse supervisory scenarios tend to predict an immediate shock, with unemployment given as a lagging indicator. To that end, we project an immediate onset of recessionary conditions in Rocket Bank’s portfolio, while maintaining a 1-year outlook.

In a cashflow model, conditions in earlier periods strongly influence the outcome, as balances are exposed in these periods before wind-down effects such as maturity, contract payment, prepayment, and voluntary curtailment come into play. The impacts of projecting degraded conditions *immediately* are as follows:

CECL Scenario	CRE NPV Difference (\$1,000s)	Expressed as Ratio
Baseline	\$ 9,424	0.3141%
Severe	\$ 17,770	0.5923%
Baseline Conservative	\$ 14,301	0.4767%
Severe Conservative	\$ 25,330	0.8443%
Severe Conservative	\$ 29,553	0.9851%
Severe Conservative Immediate Depressed	\$ 34,447	1.1482%

DFAST CRE Component	Losses (\$1,000s)	As Ratio Against Initial Basis
DFAST Year 1 CRE Losses	\$ 19,500	0.65%
DFAST Year 2 CRE Losses	\$ 36,058	1.20%
DFAST Total Stress Period CRE Losses	\$ 55,558	1.85%

## Maturity Assumptions

Our elections so far have all represented valid scenarios for measurement of the Allowance for Credit Losses under the CECL notion, though they may not represent likely scenarios as of this publication date. By far the largest divergence between the stress testing activity and ACL measurement is the *contract life* notion, adjusted for prepayment. In other words, stress testing activities should model draw behavior (recorded under CECL as a liability), renewal behavior, and new production behavior. CECL projections fundamentally assume the extended balances can only *decrease*, and assume balloon/collection at maturity.

An important exception to this balloon/collection concept is when management can defensibly expect such behavior to be unlikely. For example, in modeling cashflows for a troubled debt restructure, it would not be sensible to assume collection of unpaid principal even when a balloon structure is in place. For deteriorated credits, it may be advisable to make a policy election of extension-through-paydown, rather than assuming collection-at-maturity; the finer points of this concern are an active area of Transition Resource Group (TRG) discussion.

In this sensitivity test, we break entirely from CECL compliance, and over-ride our model to assume renewal at maturity until paydown of *extended* balances by pushing out maturity to the extended amortization-through date:

CECL Scenario	CRE NPV Difference (\$1,000s)	Expressed as Ratio
Baseline	\$ 9,424	0.31%
Severe	\$ 17,770	0.59%
Baseline Conservative	\$ 14,301	0.48%
Severe Conservative	\$ 25,330	0.84%
Severe Conservative	\$ 29,553	0.99%
Severe Conservative Immediate Depressed	\$ 34,447	1.15%
Severe Conservative Immediate Depressed Extended	\$ 40,071	1.34%

DFAST CRE Component	Losses (\$1,000s)	As Ratio Against Initial Basis
DFAST Year 1 CRE Losses	\$ 19,500	0.65%
DFAST Year 2 CRE Losses	\$ 36,058	1.20%
DFAST Total Stress Period CRE Losses	\$ 55,558	1.85%

## Length of Recession

We begin to straightline inputs to long-run mean conditions after the 1-year “reasonable and supportable” forecast period. The DFAST Severely Adverse scenario constitutes a 2-year stress period, though does begin to “bottom out” after a year. We examine the impacts of *lengthening* our adverse conditions to a 2-year recession before entering a reversion regime.

CECL Scenario	CRE NPV Difference (\$1,000s)	Expressed as Ratio
Baseline	\$ 9,424	0.31%
Severe	\$ 17,770	0.59%
Baseline Conservative	\$ 14,301	0.48%
Severe Conservative	\$ 25,330	0.84%
Severe Conservative	\$ 29,553	0.99%
Severe Conservative Immediate Depressed	\$ 34,447	1.15%
Severe Conservative Immediate Depressed Extended	\$ 40,071	1.34%
Severe Conservative Immediate Depressed Extended Longer	\$ 52,263	1.74%

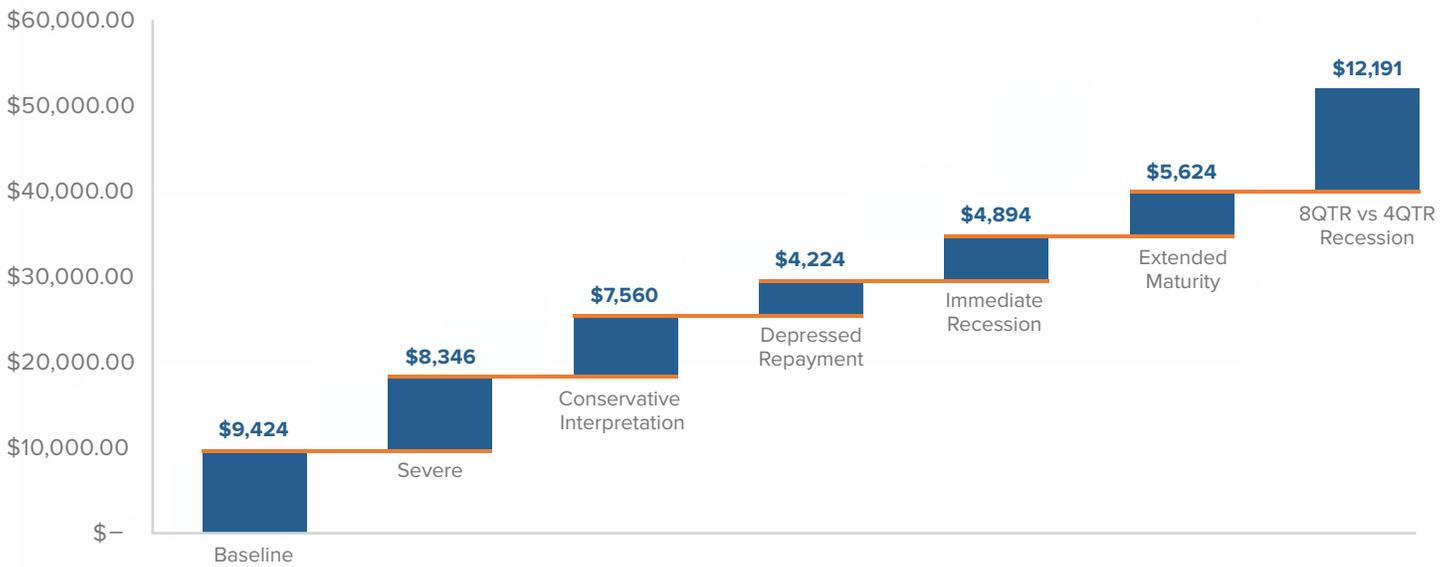
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DFAST Total Stress Period CRE Losses	\$ 55,558	1.85%

#### Synthesis & Summary

We observe a buildup for deterioration in net present value attributable to several modeling layers and assumptions. As the assumptions and layers converge on the practices for DFAST modeling in the Rocket Bank case study, the results begin to converge in a meaningful manner; in other words, as our efforts become less about *establishing a valuation account for contract assets* and more about *simulating our entity*. Note that in this exercise we have not examined the impact of new production assumptions; our final buildup scenario under a CECL notion assumes no net loan growth or replacement for declining balances.

Layer	Attributable to Layer	Indicated Allowance	Attributed to Layer	Indicated %
Baseline	\$ 9,424	\$ 9,424	0.3141%	0.3141%
Severe	\$ 8,346	\$ 17,770	0.1626%	0.4767%
Conservative Interpretation	\$ 7,560	\$ 25,330	0.3676%	0.8443%
Depressed Repayment	\$ 4,224	\$ 29,553	0.1408%	0.9851%
Immediate Recession	\$ 4,894	\$ 34,447	0.1631%	1.1482%
Extended Maturity	\$ 5,624	\$ 40,071	0.1875%	1.3357%
8 QTR vs 4QTR Recession	\$ 12,191	\$ 52,263	0.4064%	1.7421%

## Scenario Assumption Sensitivity



The particulars of Rocket Bank’s DFAST and CECL preparation are less important than the existence of substantive differences in the modeling inputs, outputs, and assumptions used for each exercise. It is our hope that this case study illustrates these differences in a manner that provides readers with justifications and strategies for separating the two programs if the risks of convergence between the two programmes are deemed unpalatable. Further, we have not evaluated the effects of individually analyzed loans or qualitative adjustment in this exercise.

At the input level, timing and credit parameters may be different between the two efforts, if for no other reason than the prescriptive nature of the DFAST supervisory scenarios and the internally generated or externally sourced nature of reasonable and supportable forecasts for likely future conditions. Even if the modeling approach and sophistication is symmetrical between the exercises, an institution has plenty of reason to use different forecast factors for each.

Differences in the assumption level derive from differences in the output level; we should not generally be modeling renewal tendencies excepting specific circumstances, and we should not be assuming new production. Autocorrelative effects that may be meaningful in a 2-year outlook can create runaway feedback loops in a general projection.

At the output level, CECL is meant to produce a valuation account for credit losses against assets reported at amortized cost. It is intended to signal to users of financial statements, using management’s best judgment, an allowance for lifetime credit losses for the specific assets already on the books – not notional future assets.