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Develop a Winning CECL Strategy: 3 Tips for Success

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Introduction

The 2007-2008 financial crisis, and the Great Recession that ensued, left in its wake significant economic devastation that is still impacting financial institutions today. One of the most profound impacts is the current expected credit loss methodology (CECL) for estimating allowances for credit losses that is set to take effect at the start of 2020 for public business entities that are U.S. Securities and Exchange Commission filers.

Triggered by the bursting of the $8 trillion housing bubble, the Great Recession resulted in significant reductions in consumer spending, a collapse in business investments, and the most severe employment contraction of any recession since the Great Depression.[1] It also underscored the need to revamp accounting standards on loan loss provisioning to incorporate forward-looking information.

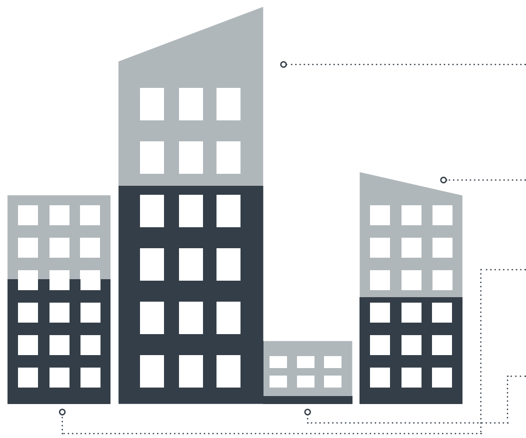
Current U.S. generally accepted accounting principles (GAAP) regulations require an incurred loss approach for recognizing credit losses, which delays recognition of credit losses on loans until it is probable a loss has incurred. Critics argue this approach results in “too little, too late” loan loss allowances.

As a result, the Financial Accounting Standards Board (FASB) introduced CECL in 2016. The Accounting Standards Update (ASU) aims to improve financial reporting by requiring timelier recording of credit losses on loans and other financial instruments held by financial institutions and other organizations.
“The new standard addresses concerns from a wide range of our stakeholders—including financial statement preparers and users—that the existing incurred loss approach provides insufficient information about an organization’s expected credit losses,” stated FASB chair Russell G. Golden in announcing the new guidance.[2]

CECL is significant and relevant to all financial institutions (banks, credit unions, mortgage and auto lenders, consumer lenders, etc.) currently impacted by U.S. GAAP regulations. And, with implementation deadlines looming, many financial institutions are still piecing together the puzzle. Whether looking to analyze data gaps, build models, ensure platform support or develop governance processes, there are many factors that financial institutions must consider in their CECL journey.

According to a 2018 survey of financial institutions, nearly all respondents have started taking steps to prepare for CECL. However, far fewer — especially smaller institutions — have made substantial progress. Fifty-five percent of respondents indicated they were “having internal discussions/meetings” on their plans to implement CECL, while 27 percent said they are testing potential CECL-compliant methods, and 31 percent have engaged a third party to assist. A mere 2 percent indicated they have completed their transition process.

This eBook provides actionable insights and tips to help you gain confidence in your CECL plan and develop a winning strategy.



55% percent respondents indicated they were “having internal discussions/meetings” on their plans to implement CECL

31% percent have engaged a third party to assist

27% percent said they are testing potential CECL-compliant methods

2% percent indicated they have completed their transition process.

[1] “The Great Recession.” State of Working America, Economic Policy Institute, stateofworkingamerica.org/great-recession/.
[2] “FASB Issues New Guidance on Accounting for Credit Losses.” FASB, 16 June 2016, www.fasb.org/cs/ContentServer?cid=1176168232900&d=&pagename=FASB/FASBContent_C/NewsPage.
[3] “CECL: Where Are We Now?” MST 2018 CECL Survey of Financial Institutions, MST, 14 June 2018, www2.bankerstoolbox.com/mst/cecl_survey_2018

Tip #1: Get to Know CECL

Let's begin by taking a closer look at CECL. What is it? What does it mean for today's financial institutions?

As noted earlier, FASB issued in 2016 the ASU Financial Instruments — Credit Losses (Topic 326), which is more commonly known as current expected credit losses, or CECL. The goal: To improve financial reporting and provide regulators, auditors and investors with better information about expected losses on a more timely basis.

For public business entities that are SEC filers, the ASU is effective for fiscal years, and interim periods within those fiscal years, beginning after Dec. 15, 2019. Thus, for a calendar-year company, it would be effective Jan. 1, 2020.

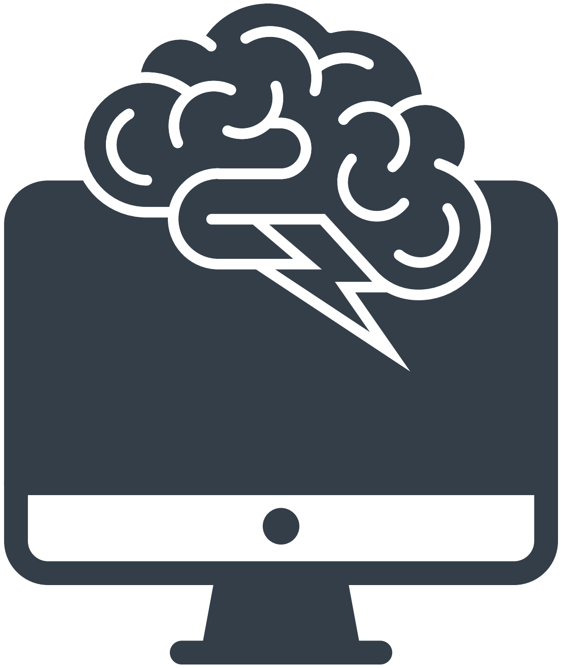
For public business entities that are not SEC filers, it is effective for fiscal years, and interim periods within those fiscal years, beginning after Dec. 15, 2020.

Under an FASB update issued in November, non-public business entities — which includes credit unions — are required to implement CECL for fiscal years beginning after Dec. 15, 2021, including interim periods within those fiscal years. According to FASB, the change better aligns the implementation date for their annual financial statements with the implementation date for their interim financial statements.[4]

Rather than waiting for a borrower to display signs of distress and cross a probable threshold of loss, lenders will, under CECL, need to immediately make a projection of credit losses that may occur in their loan portfolios. These estimates must take into account historical experience, current conditions, and reasonable and supportable forecasts.

It's clearly a remarkable shift from the long-standing practices that lenders are accustomed to and its impact is far reaching. Therefore, it comes as no surprise that CECL has sparked a great deal of apprehension among many financial institutions.

"It is one of the most significant pieces of accounting pronouncements or accounting pieces that was published or issued by FASB over the last probably 20 years. I don't want to overstate it, but really the key here is that it's not something that is specific to one entity or type of industry. This will have impact throughout the financial services industry footprint and any other entity that has these, what I would call long-time financing receivables, on their books," said Ivan Cilik, partner in Baker Tilly's depository and lending practice.[5]



[4] "FASB Issues Narrow-Scope Improvements to Credit Losses Standard." FASB, 15 Nov. 2018, www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176171644872&d=&pagename=FASB/FASBContent_C/NewsPage
[5] Cilik, Ivan. "Personal Interview." 7 Nov. 2018.

In addition to eliminating GAAP's incurred loss approach and increasing the usefulness of financial statements by incorporating forward-looking information, FASB[6] noted that the ASU also:

- Increases comparability of purchased financial assets with credit deterioration (PCD assets) with originated and non-PCD assets;
- Increases users' understanding of underwriting standards by requiring additional information about credit quality indicators by year of origination (vintage); and
- For available-for-sale debt securities, aligns the income statement recognition of credit losses with the reporting period in which changes occur by recording credit losses (and subsequent reversals) through an allowance rather than a write-down.

While CECL has the potential to arm stakeholders with better information and strengthen overall financial reporting, its ripple effect could impact lending decisions and have consequences on the cost and availability of credit.

Wrote Moody's Analytics senior director Cristian deRitis in a recent Equifax blog post, "Switching to a measure of potential lifetime loss will not only increase banks' allowances for loan and lease losses (ALLL), it will dramatically change the timing of those provisions. Whereas today a lender can use the interest and principal payments collected early on in the life of new loans to build capital in anticipation of defaults, under CECL they'll need to add to their reserves before having collected even $1 in loan payments. This could change the economics of the transaction and lead to higher fees or interest rates."[7]

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[6] FASB, 2016, FASB in Focus: Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326), www.fasb.org/cs/ContentServer?c=Document_C&cid=1176168232790&d=&pagename=FASB/Document_C/DocumentPage

[7] deRitis, Cristian. "Getting to Know CECL." Equifax Insights Blog, 29 Aug. 2018, insight.equifax.com/getting-to-know-cecl/?intcmp=search/DocumentPage

Tip #2: Data is King

One of the most significant concerns in complying with CECL is the availability and quality of data. Estimating CECL will require more historical data than required by an incurred loss method and transitioning to an expected losses approach is uncharted territory for many financial organizations. This is especially the case for smaller banks and credit unions that may lack the data and internal expertise to forecast losses that way.

According to a 2018 survey, more than 70 percent of respondents are still compiling data. Fifteen percent have already determined they will need more data than they can assemble internally, and another 15 percent indicated they are unsure if they have sufficient quantity and quality of data to estimate under CECL.[8]

The top five types of data being collected:[9]

1. Loan type (98 percent)
2. Origination data (95 percent)
3. Loan number (94 percent)
4. Maturity data (93 percent)
5. Current interest rate (91 percent)

"The data needs and the data requirements are significantly enhanced from what we're currently seeing. That's one of the biggest challenges for institutions," said Mike Lundberg, partner, national director of Financial Institutions Services at audit, tax, and consulting firm RSM US LLP.[10]

According to Lundberg, there are two groups of financial institutions that may be particularly challenged:

- Smaller lenders that, perhaps, haven't been keeping as much data compared with global institutions due to resource limitations; and
- Entities that have grown through a series of acquisitions versus organic growth. Firms that have completed a series of acquisitions may not have converted, or perhaps even lost, historical data when conducting systems conversions.

Additional factors that must be considered include portfolio segmentation, economic scenarios and modeling methodologies.

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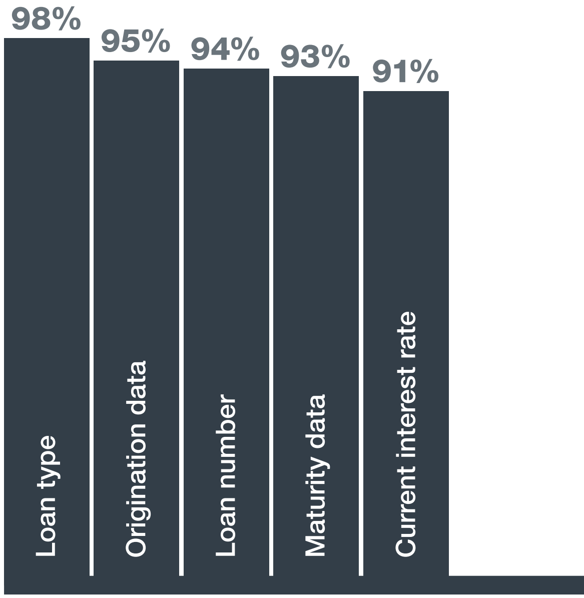


[8] "CECL: Where Are We Now?" MST 2018 CECL Survey of Financial Institutions, MST, 14 June 2018, www2.bankerstoolbox.com/mst/cecl_survey_2018
[9] "CECL: Where Are We Now?" MST 2018 CECL Survey of Financial Institutions, MST, 14 June 2018, www2.bankerstoolbox.com/mst/cecl_survey_2018
[10] Lundberg, Mike. "Personal Interview." 9 Nov. 2018.

Tip #3: Have a Game Plan

The goal of CECL may seem quite logical, but actually putting it into practice and achieving a smooth implementation may prove to be something completely different for some lenders.

While financial institutions may have a good deal of leeway in determining how best to estimate losses, there are some critical factors in a lender's recipe for success.

Data Availability

As noted earlier, a critical first step in CECL implementation, and a challenge for some lenders, is ensuring the quality and quantity of historical data. Performing a data gap analysis can help identify incomplete, unreliable or inadequate data.

"No matter what method or what approach you take, the quality of that model or that implementation process is only going to be as good as the data that you have. If you identify the gaps and the holes in that process that's where you probably need to go back to the drawing board," said Cilik of Baker Tilly.[10]

If a lender finds they have insufficient historical data, leveraging external data sets like SmartReserve™ from Equifax can prove greatly beneficial.

Powered by Equifax Credit Trends, trade level data can be delivered either aggregated or at the loan level based on the unique needs of each financial institution. Specifically, the data set includes the following historical information to support your forecasts of losses:

- Pre-recession, recession and post-recession vintages, from 2005 forward;
- Monthly updates and trades linked over time to enable accurate vintage curves, updates and forecasting based on loan and consumer profiles for the life of the loan;
- Monthly updates to entire data files including balances, delinquency and current score; and the
- Ability to track book of businesses across multiple segmentation items including risk score, estimated income (score based), geography, and more.

"This is new territory for many lenders as they may not have the infrastructure to support these large amounts of data, and mid-tier and smaller banks and credit unions and lenders may not have the capacity to perform the modeling in-house," stated Amy Graybill, vice president, Enterprise Insights & Core Data Products, Equifax, in announcing the new offering.[12] "SmartReserve provides the assistance lenders need to help protect their business against non-compliance with new CECL standards, along with historical pre and post-recession data that is needed to help accurately forecast future credit losses and calculate required reserves."

[11] Cilik, Ivan. "Personal Interview." 7 Nov. 2018.

[12] "Equifax Helps Banks Become CECL Compliant with SmartReserve." Equifax, 5 Sept. 2018, www.prnewswire.com/news-releases/equifax-helps-banks-become-cecl-compliant-with-smartreserve-300706616.html

Model Methodologies

Under CECL, lenders have the ability to determine the most appropriate model to use. They may appreciate the flexibility but, regardless of the selected model, it is imperative that lenders pick a model that can be adequately supported with the available data.

"It's a catch 22. You can't really do modeling until you have the right data, and to have the right data you have to really understand what is available and what's not available," Cilik said.[13]

Added Lundberg, "My advice to clients is you want the best model that will work with the data that you have. You can have the best model in the world, but if you don't have the data to feed into it it's not going to work real well."[14]

As noted by Moody's deRitis in a recent Equifax blog post,[15] potential modeling methods include:

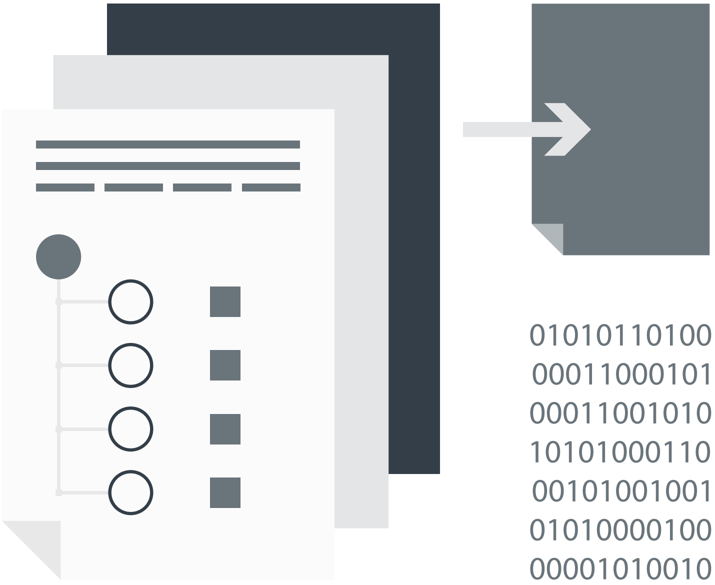
- Discounted cash flow approaches
- Vintage loss rate approaches
- Expected credit loss component models (otherwise known as PD/LGD models)
- Transition matrix approaches
- Survival or discrete-time hazard models

"A lot of institutions are going to outsource that modeling part to a software provider if they are capable and have the proper controls around that process. That's going to become more of an automated process as long as the data that's being fed [into] the model is accurate," Cilik said.[16]

Economic Scenarios

One key differentiator is that the ASU requires an organization to measure all expected credit losses based on, among other items, reasonable and supportable forecasts. So, what makes a forecast "reasonable and supportable"?

Again, FASB makes no specific recommendations but, as noted by deRitis, "Institutions may prefer to use forecasts that are generated using structural macroeconomic models similar to those used by central banks like the Federal Reserve or by private forecasters such as Moody's Analytics. These models have the benefit of being able to incorporate hundreds of economic indicators into a consistent framework. A shock to



[13] Cilik, Ivan. "Personal Interview." 7 Nov. 2018.
[14] Lundberg, Mike. "Personal Interview." 9 Nov. 2018.
[15] deRitis, Cristian. "How to Implement CECL." Equifax Insights Blog, 18 Sept. 2018, insight.equifax.com/how-to-implement-cecl/?intcmp=search
[16] Cilik, Ivan. "Personal Interview." 7 Nov. 2018.
[17] deRitis, Cristian. "How to Implement CECL." Equifax Insights Blog, 18 Sept. 2018, insight.equifax.com/how-to-implement-cecl/?intcmp=search

oil prices, for example, is propagated to all sectors to the economy so users can understand how the shock could impact employment, wages or house prices."[17]

In determining economic scenarios, institutions will also want to ensure consistency with their own geographic footprint and consider the benefits of running multiple scenarios versus a single path, noted deRitis. Additional factors that lenders need to consider when implementing CECL include:

- Reporting/disclosure requirements: CECL's reporting and disclosure requirement is a critical factor that should not be overlooked as it requires institutions to significantly increase the amount of information that is disclosed on their financial statements.

- Test, test and retest: Implementation deadlines are looming so begin your CECL journey sooner rather than later. Begin trying different loss estimation techniques and models to see what works best for your organization given the available data.

- Eliminate silos: Establish a broad multidisciplinary team to be involved in the process. Institutions will benefit from having broader perspectives at the table and should include members of the accounting, credit, IT and finance teams, to name a few.

"My advice to clients is you want the best model that will work with the data that you have. You can have the best model in the world, but if you don't have the data to feed into it it's not going to work real well."
—Mike Lundberg, Partner RSM US LLP

Conclusion

There's no denying that CECL marks a significant shift for financial institutions and it's easy to see why it's being described as the biggest change ever to bank accounting. The good news is we've got you covered. We'll help you devise a plan of action that empowers you to answer the question, "Do you have a winning CECL strategy?" with a decisive "YES."

CECL INSIGHTS

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CECL Readiness: Putting the Puzzle Together

Blogs:
Getting to Know CECL

Survey: Most Companies Aren't Ready for CECL

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How to Implement CECL

CECL Preparedness: Overcoming Data Gaps and Inaccuracies

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