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Community bankers urged to start preparing for CECL

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Community bankers and boards have their work cut out for them as they prepare to comply with changing credit and auditing regulations, said two industry professionals to an audience at the Virginia Bankers Association CFO conference.

Two of the many topics and changes discussed at the conference, held in Richmond on Aug. 25 and Aug. 26, included the move to the proposed current expected credit loss standard and auditing guidance that will further scrutinize the internal controls designed by a bank's audit committee.

Even though the shift in how banks reserve for loan losses is years away, community bankers should begin preparing now to ensure there are minimal surprises when the new accounting procedure is adopted. The final standard for the current expected credit loss model is expected to be issued in the fourth quarter of 2015, and could go into effect in 2018 or 2019, said Randal Rabe, a director at Credit Risk Management. Despite the long interim period, he urged community bankers to model how their loan books will be impacted by the reserving change in order to have enough time to make adjustments.

"We understand the regulators are telling community banks 'Don't go out and buy a model' ... but I wouldn't want community banks to interpret that as that they shouldn't do anything. I think what they ought to be doing is going out and talking to their vendors about how they are planning to model for CECL, just to get familiar with their options," he said, later adding that conversations with vendors will let bank executives know what type of information the models will need so that they can begin collecting and archiving it.

The current expected credit loss model differs from the current incurred loss model by disregarding the matching principal of accounting. Instead, it requires bankers to reserve for all future losses on the first day of the loan. The incurred loss model is driven by the income statement and matches losses against the time period in which they occur. The allowance reflects the point-in-time estimate of a loss that has not yet been charged off, according to Rabe's conference presentation.

CECL is driven by the balance sheet and requires bankers to calculate expected losses over the entire life of the loan on day one of the origination and book them. The bank must recognize future losses when the loan is made, which "generally" smoothes out earnings, the presentation said.

"Unless you are 100% certain that you are going to collect all principal and interest on this loan, you have some sort of calculable expected loss on that loan that you have to book under CECL," he told an audience at the conference in Richmond on Aug. 25.

He told SNL later that banks should take advantage of the long interim implementation period and incorporate it into their capital planning, which tends to occur two to three years in advance. CECL is expected to have a "significant impact" on capital and capital planning, he said.

"When CECL is implemented at the beginning of 2019, you're going to calculate the expected life of loan losses for all loans in your portfolio at that date and then you're going to adjust your allowance to that new method. It's going to be an immediate hit to capital for all loans in your portfolio," he said.

Running a CECL model now will help bankers understand the potential impact the new approach will have on the bank's portfolio, allowance for loan losses and capital. It can also show bankers how different loan categories will be impacted, with the intervening years before the effective date giving management some time to reconsider their loan products and terms to minimize its impact. The CECL calculation itself is complicated, and may prove to be an additional regulatory expense for some banks. Rabe said community banks that are performing their allowance calculations in-house may outsource them because of the amount of time and information required to complete them.

Another topic the conference highlighted was auditing guidance on internal controls to prevent material misstatements. The guidance, issued by the Public Company Accounting Oversight Board in a 2013 staff audit practice alert, could mean greater analysis surrounding internal control procedures for banks and enhanced communication with external auditors. The guidance is in response to "significant auditing practice issues" that the board's staff observed relating to internal controls over financial reporting, it said in the practice alert. Dave Niles, a partner at DHG Financial Services at Dixon Hughes Goodman LLP, highlighted the update to provide bank executives with more clarity behind the change and how they may be expected to comply.

The guidance is intended to encourage auditors to do more to understand and report on the specifics as to how companies design their internal controls and operate them at a level that is precise enough to detect material misstatements, Niles said. He said the aim is for companies and their auditors to be able to articulate specific objectives and definitions as part of their internal controls: what executives are looking at, their expectations about what they would find, items that trigger a further review and the process by which they would go about that. The guidance also seeks greater disclosure and background of those employees performing the control checks, the frequency of the check and the level of data aggregation examined.

"I think the outcome of this [guidance] is really good, and people will be able to use these higher-level type controls to really benefit them and identify when something doesn't look right," he said.

The guidance is intended to help management at public companies strengthen their support for their assessments of internal con-

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trols, and assist auditors in their assessments, Niles said. It builds on analysis that management teams are already performing on income statement accounts, average balance sheets and budget reconciliation, which are all part of the normal review structure, he said. But it goes a step further by detailing what management is looking for.

"[What] they haven't really been doing until late is documenting what are they really looking for when they're doing that review," he said. For companies to be in compliance with the accounting oversight guidance, they need to "develop it a little bit more."

He gave examples of hypothetical questions employees need to ask themselves, including: "'What, to me, constitutes a variance that I think I should follow up on? How am I going to follow up on that? How am I going to look at the data? How precise am I going to get?'"

Niles said he believes auditors would be "very interested" in having access to documentation that banks create. The paper trail helps banks and other public companies prove in part that they and their auditors have done enough work to render their opinions on the effectiveness of internal controls.

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