

## CECL – Seeing is Believing

By Randal Rabe, Director at Credit Risk Management Analytics, LLC

The Financial Accounting Standards Board (FASB) is expected to release its final standard on accounting for credit losses by the end of June 2016. The new approach is called “CECL” (Current Expected Credit Loss) and will fundamentally change the Allowance for Loan and Lease Losses (ALLL) concept as well as the methodology of calculating the ALLL. The effective dates for CECL will be 2020 for SEC-filers and 2021 for other entities.

The proposed standard has been debated for over three years, and while we have seen the various “tentative decisions” that FASB has made on this proposal, there had not been a new exposure draft released except for the draft document made public prior to the initial Transition Resource Group (“TRG CECL draft”) meeting in early April.

This article is designed to help financial institutions begin to identify the critical issues that need to be clarified prior to implementation, and hopefully the final standard will be proof of the old adage “Seeing is Believing”.

### 1. Can existing simple methodologies be used for CECL?

The primary methodology used by community banks and credit unions to calculate today’s ALLL is based upon an annualized historical net charge-off approach. Many of these institutions perform these calculations utilizing spreadsheet software. FASB has indicated that financial institutions can use existing spreadsheet methodologies to calculate life of loan losses.

However, this seems to be contradicted by section 825-15-55-24 of the original 2012 proposed standard: “It typically would be **inappropriate** to estimate the expected credit losses for a long-term asset by **multiplying** an **annual loss rate** “...” **by the remaining years** of the asset’s contractual term because loss experience is often **not linear**.”

It is unclear how existing spreadsheet methodologies can be utilized for CECL calculations without converting to vintage analysis or some other model approach and it will be important that the final guidance provide examples. Examples #1 & #2 in the TRG CECL draft were referred to as using a Loss-Rate Approach but contained the phrase “cumulative historical lifetime credit loss rate”; however, there was no discussion of how to convert “annualized loss rates” to “lifetime loss rates”.

### 2. How will Qualitative and Environmental Factors apply to CECL?

Qualitative & Environmental (Q&E) factors will remain under CECL and may become more complicated. Under today’s regulatory guidance, the purpose of Q&E factors is to provide for an adjustment to historical loss rates to account for changes from the historical conditions to the conditions that exist as of the balance sheet date.

The 2006 Interagency Guidance recognized the **qualitative** nature of these adjustments and stated “Management must exercise significant judgment when evaluating the effect of qualitative factors on the amount of the ALLL because data may not be reasonably available or directly applicable for management to determine the precise impact of a factor on the collectability of the institution’s loan portfolio as of the evaluation date.” Current audit requirements for documentation of calculations and controls have created challenges in this area of ALLL.

In a CECL world, these Q&E factors will not only be used to adjust historical loss rates for current conditions, but they will also be used to adjust for conditions expected during the reasonable and supportable forecast period. The key questions:

- How will these adjustments be determined?
- How will these adjustments be documented to satisfy audit requirements?

### 3. What's the truth regarding acquired loans under CECL?

Upon a first reading of the proposed standard, we were pleased to see that the credit marks on Purchased Credit Deteriorated ("PCD", formerly PCI) loans would become a component of ALLL rather than be netted into the fair value loan balance.

However, later analysis has become more concerning as it now appears that non-PCD loans would be subject to CECL accounting as well as fair value measurement at the merger date. We are all hopeful that the final standard will clarify that this "double-counting" of the credit mark will not be required.

In addition, while PCD loans will be accounted for using a gross-up method with the credit mark being included in ALLL, the definition of PCD assets has been expanded to include assets with **more than insignificant credit deterioration** since origination (previously required **significant deterioration**). The TRG CECL draft provides extensive flexibility to define PCD assets and we wonder if financial institutions will be forced to utilize the PCD definition flexibility to avoid the "double-counting" of the credit mark for non-PCD loans.

### 4. What will CECL's treatment of unfunded commitments uncover?

A liability for estimated losses on unfunded commitments is not included in ALLL under today's methodology, but, if required, is recorded as a liability on the balance sheet. Today's treatment and calculation methodology of this liability is fairly wide-ranging. Under CECL, the estimated losses on unfunded commitments should be calculated using the contractual period for unfunded lines unless unconditionally cancellable by the bank.

This more prescriptive language will likely lead to more consistency in the calculation methodology

but could have a negative financial impact on the financial institution depending upon current practice and the extent of unfunded lines.

### 5. What will be the most significant unintended consequences?

Significant new regulation and even new accounting standards seem to invariably result in some level of unintended consequences. CECL will likely generate a few, including:

- How will "Day 1" lifetime loan loss provisioning impact lending activity?
- How will CECL-driven changes in contractual terms impact borrowers' choices and lending activity?

These questions are in addition to the big question regarding the **intended** consequences – Will CECL solve the issue of "Too Little Too Late"? Unfortunately, not even a well-crafted final CECL standard will be able to provide that answer.

*Disclaimer: The views and opinions expressed in this article are those of the author and do not necessarily reflect the official policy or position of the Financial Managers Society.*

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