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CECL is Released – Now What?

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

On June 16, 2016, the Financial Accounting Standards Board (FASB) released its final standard on accounting for credit losses. 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.

Because of the very long deliberation process (over three years) and extensions to the effective dates, CECL has not been a resource priority for most community banks and credit unions. While it has now been finalized, the effective dates are still three to four years out and there remains an urge to continue to procrastinate on dedicating valuable time and resources to preparation.

This article is designed to help financial institutions begin to identify the critical issues that need to be addressed soon in order to have an optimal benefit, while balancing it with the other organizational priorities.

1. **Can existing ALLL 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 "many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses." Examples #1 & #2 in the final standard were referred to as using a Loss-Rate Approach but contained the phrase "historical lifetime credit loss rate"; however, there was no discussion of how to convert "annualized loss rates" to "lifetime loss rates".

In the June 17, 2016 "Joint Statement on the New Accounting Standard on Financial Instruments – Credit Losses", the regulators explained it more clearly by stating "For example, the input to a loss rate method would need to represent remaining lifetime losses, rather than the annual loss rates commonly used under today's incurred loss methodology". While both FASB and the regulatory bodies appear to be sensitive to the potential cost burden for smaller institutions, it is quite clear that "annualized net-charge off rates" cannot be utilized to calculate lifetime credit losses and that some input modifications will be necessary.

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

Qualitative & Environmental (Q&E) factors will remain under CECL and will likely 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. Current audit requirements for documentation of calculations and controls have created challenges in this area of ALLL.

According to the CECL final standard, "when an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated."

The key questions:

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

The examples in the final standard were deficient in providing practical guidance to these adjustments. This issue will need to be kept at the forefront during the model development and/or selection process as the regulators have stated "institutions are encouraged to build strong processes and controls over their allowance methodology".

3. Why should I perform a CECL estimate today when the standard is not effective for three to four years?

This is a fair question. The Federal Reserve Bank recently encouraged depository institutions to be proactive in estimating the potential impact to their regulatory capital ratios to assess whether they will have sufficient capital at the time that the CECL model goes into effect. Remember, in the quarter that the standard becomes effective, institutions will be required to book a cumulative-effect adjustment directly to retained earnings (capital).

However, we believe a more compelling near-term reason for performing a CECL estimate is to better understand the projected impact at a loan category level and provide more time to adjust portfolio strategies to mitigate the CECL risk. Many of the loans that you originate today will still be in your portfolio at the CECL effective date. CECL calculations as well as the calculations for liabilities on unfunded commitments are heavily influenced by the term structure of the loans. You have a valuable opportunity to positively impact the final adjustment by the characteristics of the loans that you originate between now and the effective date.

4. Are there any other critical path issues?

Certainly data collection efforts can begin even if final-model choices have not been selected. You should obtain as many month-end or quarter-end loan files (flat files or regulatory alert files) as you can access going back as far as you can to attempt to capture an economic cycle. Loan field information should include:

- Loan information (loan number, amount, exposure, origination date, product type)
- Term information (interest rate, maturity date, etc.)
- Payment information (amortization term, payment type, payment frequency, payment amount)
- Asset quality information (risk grade, LTV, credit score, days past due, accrual status, DSCR, etc.)

Also, obtain loan level charge-off and recovery information over the same look-back period. Put all files in a secure folder and continue to update them going forward. Why? In order to calculate life-of-loan loss estimates, you need a long look-back history.

Conclusion: Financial Institutions should begin a "selective preparation" for CECL

Many community banks and credit unions have not begun preparation for CECL. While we understand competing priorities and resource scarcity, we have attempted to highlight a few areas that we believe can and should be addressed soon by financial institution management teams in order to effectively prepare their organizations for the new world of CECL.

About Randal J. Rabe

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CRMª has formed an interest group on Linked-In named CECL. The purpose is to share thoughts, ideas and new information with each other so that we can all effectively prepare for CECL from both a cost and impact perspective. We invite you to join and participate in the group: *www.linkd.in/18yYLk4*.

For more information, visit *www.creditriskmgt.com*.