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ONE-ON-ONE INTERVIEW

CECL – BEST PRACTICE TO HELP ACCELERATE IMPLEMENTATION

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John Voigt, CFA is a principal business solutions manager at SAS. He has over 15 years of experience in risk management, including model development, risk strategy and consulting. Through this work, he has developed practical domain knowledge across a number of areas, including regulatory and economic capital, stress testing, credit loss forecasting and CECL/IFRS 9.

R&C: Could you provide an overview of how extensive a challenge the new current expected credit loss (CECL) model is for the US banking industry?

Voigt: CECL is really a revolutionary change, because it impacts so many areas, both analytically and strategically. On the estimation side, you have the data and modelling demands of lifetime loss forecasting and the increased expectations around disclosure. While all of this adds complexity to the production workflow, you will need to maintain your regular production schedules while ensuring all the controls required for financial reporting remain in place. Then there are the business challenges around how to manage the balance sheet under the new rules as they will likely lead to both higher levels, and greater volatility, of reserves. This requires an informed analysis, which is dependent on having a process in place that can produce estimates in short order. Though 2020 seems a long way off, it really is quite a challenge to have all of this in place and tested.

R&C: What specific compliance activities should banks proactively address at this stage? How does CECL compare to IFRS 9, for example?

Voigt: While a lot of effort is required to address the data and modelling challenges of CECL, banks should be equally focused on the production process they are creating and how it will support the level of control needed for financial reporting. For example, as an expedient, many banks are looking to leverage their stress test processes as a starting point for CECL. But, however similar these processes are analytically, they have not been subject to the type of rigorous examinations required by Sarbanes-Oxley. And while issues with stress test production have been largely addressed through expanded headcount, this type of approach cannot be sustained and tends to weaken the overall control structure. CECL will need to rely on a much higher degree of automation, and banks should start planning for that today.

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R&C: What items should be on every US bank's checklist for CECL readiness?

Voigt: By now, banks should have completed a gap analysis and have hopefully assembled a cross-functional team to develop a project plan for implementation. They should also be starting an education process within the organisation to get everyone up to speed on the impacts of the new standard. This is necessary because CECL's secondary effects – whether on loan pricing, product offerings or collections – could be very significant but are yet to be fully understood and the people most able to assess those impacts may not be directly involved in the initial implementation. It is important for them to understand what is coming, so they can start thinking about the more strategic ramifications.

R&C: To what extent can more thorough planning help US banks avoid some of the pitfalls encountered by their counterparts in Europe? How can banks adapt lessons learned into an effective path toward implementing CECL?

Voigt: For IFRS 9, collectively, the industry underestimated the amount of work involved, and we have seen their plans for parallel testing ratchet down over time as a result – from four or more quarters initially down to one today. There was a tendency to focus too much energy on the modelling aspect – not that this is not incredibly important – but many banks ignored the bigger picture and found that they had led themselves down a road where they have created processes that are horribly inefficient and full of control gaps. US banks should learn from this and design their CECL processes with an eye on the long term.

R&C: How important is parallel testing in helping to accelerate CECL implementation? How can banks ensure they have adequate time to do this accurately?

Voigt: The parallel run will be a critical time to assess the overall impact of CECL on the financials and build an understanding of the materiality of the various decision points and assumptions that went into its implementation, not only in terms of their contributions to the CECL level but also in terms of their impacts on the future volatility of those estimates. These are things you do not want to learn after it is baked into your financial statements. To do this, banks should really strive to have a production-like process in place prior to the parallel run, so they can really make use of the time available. If they are only prepared with a piecemeal process, and it takes days or weeks to generate numbers, their ability to test different approaches and understand the results will be severely limited.

R&C: With the deadline for CECL implementation not scheduled until 15 December 2019, when should banks begin evaluating the ramifications of the choices they make in addressing CECL requirements on their business strategies and financial reporting?

Voigt: Again, this is why an effective parallel testing period will be critical, but it does not need to wait until then. Banks can perform a sensitivity analysis or champion-challenger tests on individual model components to better understand the materiality of the various modelling options. They can also begin performing a high-level, top-down analysis on their income statement and balance sheet to gain an appreciation of its potential financial impacts. This will inform the education process and foster a dialogue across the organisation.

R&C: What final piece of advice would you give to banks in terms of streamlining their CECL development processes so that they meet compliance deadlines?

Voigt: Banks should avoid introducing too much modelling complexity at the beginning. This is something that tripped up many institutions while implementing IFRS 9. Start with something relatively simple and easily understood and build from there. Furthermore, do not wait for all the models to be completed before addressing the process and control issues. This work should run concurrently to ensure it can be fully tested and is operational prior to the cut off date. While the compliance deadline is the big hurdle, it is by no means the end of the race. Think proactively about the production process that is being created and whether it will remain tenable quarter after quarter. R&C