COMPLYING WITH CECL

The Banks' Perspective

The Road to CECL Compliance:
Preparing for Day One

Lenders are making headway with CECL accounting standards, but not without some differences of opinion. For more than 10 years, banks have been abuzz with new regulatory requirements—from the U.S. Dodd-Frank Act and the European Market Infrastructure Regulation to new capital requirements and stress testing. Now the accounting rule-makers are having their say.

The Financial Accounting Standards Board's Current Expected Credit Loss (CECL) standard introduces a new model for the recognition and measurement of credit losses for loans and debt securities. Taking effect December 15, 2019 for public business entities that file with the Securities and Exchange Commission, CECL aims to provide more timely reporting of the health of credit portfolios.

The vast sweep of the accounting change was underscored by an April 17, 2018 joint notice of proposed rulemaking from U.S. banking regulators. It described CECL as replacing "multiple impairment approaches in existing U.S. GAAP. CECL allowances will cover a broader range of financial assets than allowance for loan and lease losses under the incurred loss methodology."

In early 2018, the Global Association of Risk Professionals (GARP), in conjunction with SAS, conducted a survey to gauge lenders' progress and concerns in gearing up for the new model. In one key finding, a third of the respondents said they want to test CECL-related processes and technology in parallel with their current systems for at least four quarters before the December 2019 effective date. "This means there will be a lot of work to do in 2018," says Srini Iyer, director of industry consulting at SAS.

Iyer also noted that attentions are focused mostly on developing the expected-loss models. They are to calculate expected credit loss over the life of the loan from day one, in contrast to today's incurred-loss model, in which banks recognize losses when they reach a probable threshold, and only for the loss-emergence period. However, several other components must also be addressed in the coming months, including process readiness, governance approvals, audit reviews, and how CECL fits into Internal Controls for Financial Reporting (ICFR) processes.

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The Big Picture:
Major Strategic Impacts

A majority of survey respondents have started to see CECL's impact, especially in areas such as technology investment and capital planning.

Lenders are permitted to book a day-one increase in allowances against capital. "Banks are basically preparing prior to the adoption date, so when CECL hits it doesn't make as much of a difference," Iyer says. "As we approach CECL, we expect bank capital ratios will go up, and return to more normal levels afterward."

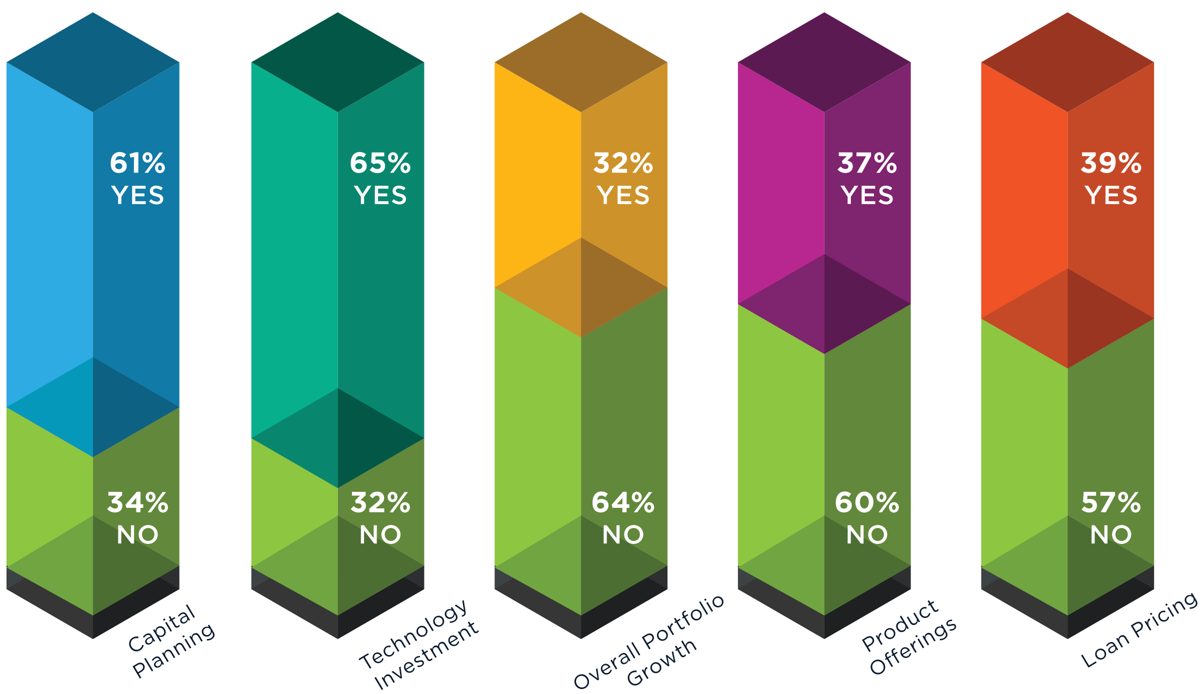
The Federal Reserve's Comprehensive Capital Analysis and Review (CCAR) process, which has evolved to assess, regulate, and supervise the largest financial institutions, requires capital projections nine quarters forward. While the CECL transition was excluded from the current CCAR process, future runs will need to consider any hit to retained earnings from CECL as part of the capital planning process before it is recognized in the financial statements. A banker at a superregional said, "They're forecasting the tail end of the horizon using models that likely are not yet fully developed. That's probably one of the reasons the Fed said don't try to apply (CECL) this early."
On the technology front, as banks conduct gap analyses and assess the requirements for CECL, many are finding their current infrastructure to be insufficient. So, it is unsurprising that most institutions have already felt a technology-investment impact.

Some are beginning to address the market-driven issues around CECL, such as product offerings/mix and loan pricing. Once effective, according to a large majority of survey respondents, CECL will significantly impact all of these strategic areas going forward.

"A truly unintended consequence of CECL is how the standard is already impacting, and will continue to impact to an increasing extent, loan product offerings and pricing as well as the overall availability of credit," says Randy Rabe, chief financial officer at Hamilton State Bank. "We think that the day-one loss treatment, the impact of term structure, and the impact of expected losses on unfunded commitments are all driving these unintended consequences."

Responding to concerns about banks' ability to adjust to changing economic conditions, regulators have proposed allowing CECL's regulatory capital impact to be phased in over a three-year transition period, as well as a delay of inclusion of CECL in supervisory stress tests.

Has CECL affected your institution's strategy?



Process Transformation:
From Spreadsheet to Swiss Army Knife

In terms of putting CECL to work at their banks, 50% of respondents agreed or strongly agreed that the new requirements will be scalable, while 30% remained neutral. Only 19% disagreed or strongly disagreed, suggesting that the outreach efforts by the FASB have been successful.

A key change driven by CECL is building models to estimate credit losses over the lifetime of loans, and the survey reveals most respondents are well underway. Under current accounting rules, 94% of survey respondents use spreadsheets (like MS Excel) in their current allowance estimation process, and 63% report using them to a great extent or entirely. That reliance on spreadsheets doesn't vary greatly by size of institution, notes John Voigt, principal business solutions manager at SAS.

It seems institutions recognize the difficulty in maintaining the additional complexity of CECL within the constricts of a spreadsheet. "It looks like we're moving from a world where, for the most part, banks are doing estimates using in-house spreadsheets, to one where only a quarter of them [26%] say they're going to develop their CECL capability in-house," Voigt said, adding that these institutions will likely need to rely on developing more programmatic approaches than they use currently.

Of the bank respondents, 30% said they have decided on a vendor or are in the process of deciding, while 41% were still exploring options.

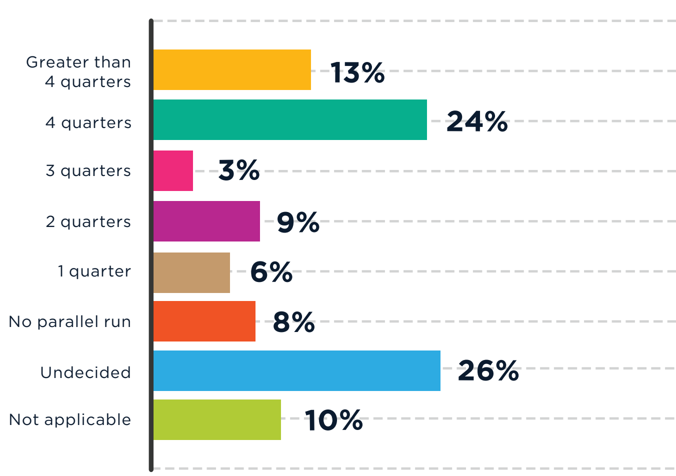
One survey respondent said his bank is developing its loss and economic models in-house, using a vendor platform that will be installed on-site. He added that the allowance-for-loan-loss calculation alone represents a sea change in computational complexity and requires significant investment.

Treating the CECL modeling platform as a generic credit-loss modeling platform should bolster other areas, such as in scenario-based forecasts for stress tests, and for capital planning. "Rather than just a single-purpose tool, we're aiming to develop a Swiss army knife," the banker said.

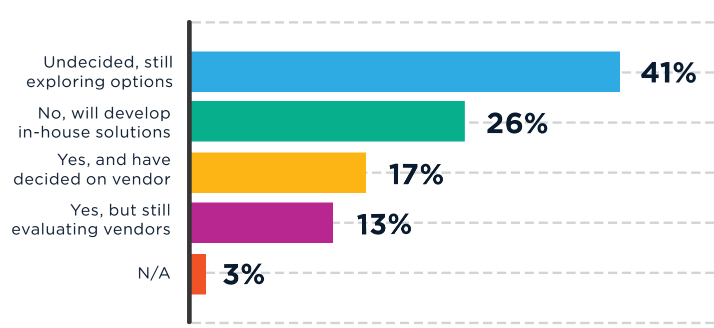
To implement the significant technology changes, many banks are planning to test their new processes in parallel with existing systems. However, for those planning to pursue the test for four quarters or more, they have less than a year to put the technology in place to be ready for first-quarter 2020 financial reporting.

"As the clock ticks away, if the pattern we observed with IFRS 9 implementation repeats", Voigt says, "there will be an increased shift toward vendor models as banks realize the complexity of what they are trying to build."

What is your institution's plan for a parallel run?



Do you plan to use a vendor solution for CECL?



Comfort Levels and Concerns

Interestingly, the aspect of CECL that the largest slice of survey respondents said they are most comfortable with is modeling lifetime losses (29%), despite the complexity of such models. However, another 28% cited that aspect as the one they are least comfortable with.

While difficult to determine, this dichotomy may simply be attributed to the roles of the respondents or their progress in developing the models to date. Another factor bolstering the comfort level with modeling may be previous experience gained in meeting Basel III and CCAR requirements. “It’s complicated, but also mature,” the superregional banker said.

Aspects of CECL implementation

	Most Comfortable	Least Comfortable
Controls and auditability	21%	9%
Data availability and quality	14%	43%
Modeling lifetime losses	29%	28%
Production workflow	11%	12%
Reporting and disclosure	22%	7%
N/A	2%	1%

The aspect bringing the most discomfort to the respondents is the availability and quality of data. Those less comfortable with data availability and quality skewed toward smaller institutions, which have not had to collect this type of data before and, by definition, have less data to work with. “Small banks, particularly those with low historical losses, are going to struggle calibrating their models,” says Hamilton State Bank’s Rabe. “Extrapolating a zero loss rate over a lifetime will still be zero.”

However, as the superregional banker noted, large banks that segment their portfolios “nine ways to Sunday” can also end up with a paucity of data in each segment.

Multiple Stakeholders

The credit loss provision expense is a critical component of banks’ reported financials, often determining their profitability and resulting capital position. The solutions banks reach to provide CECL’s credit loss estimates will thus be subject to intense scrutiny from stakeholders, including:

- The board of directors, which approves the institution’s credit risk strategy, along with the policies and procedures to support that strategy
- Senior management, responsible for implementing the board’s approved strategy
- Internal and external auditors
- Regulators
- Investors, who rely on the soundness of reported financials to assess performance
- Analysts in risk and finance groups, who must deliver defensible allowance estimates under strict timelines and a robust, repeatable and sustainable process

Principles vs. Prescription

When the CECL standard was being drafted, before its 2016 adoption, there was industry concern about the magnitude of the changes and difficulty of implementation. Rules that are highly prescriptive can be too inflexible to be applied by all, given lenders' wide range of size and complexity. Conversely, institutions can struggle to interpret and comply with requirements that are too inexact.

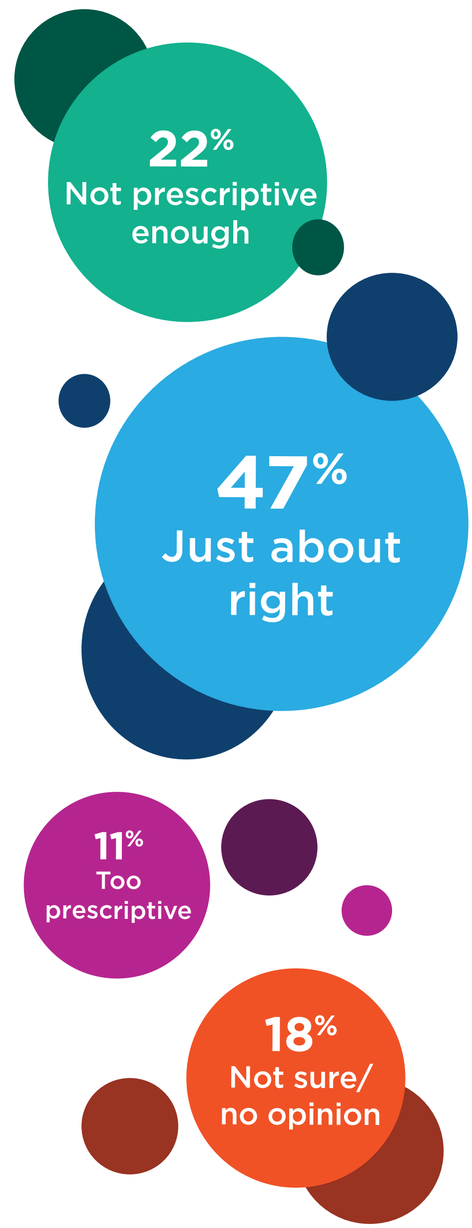
Voigt notes that the FASB actively engaged with institutions of all sizes and complexity throughout the standardization process, and it seems to have struck the right balance. Among lender respondents, 47% said the level of prescriptiveness was just about right. On the other hand, 22% of all respondents said it was not prescriptive enough.

> Interpretations of principles-based accounting could result in "vastly different assumptions"

The Federal Reserve's CCAR and stress-test regulations are not fully prescriptive, and this has led the industry to sort out best practices over time. The same is likely to happen with regard to CECL. The FASB's Transition Resource Group for Credit Losses, and trade associations such as the Risk Management Association and American Bankers Association, have actively sought to address the credit-loss model's open questions through industry dialogue. This approach could potentially result in less friction than would highly prescriptive requirements that run against the grain of industry practice. Yet principles can have unintended consequences.

An executive vice president of a superregional bank said that interpretations of principles-based accounting could result in "vastly different assumptions from one bank to the next." That seems contrary to FASB's mission of providing more useful information to financial-statement users. Unlike CCAR, CECL directly affects financial statements and reported income.

Lenders' viewpoint on CECL standard level of prescriptivness



More Decisions to Make

Less prescriptiveness means banks have more autonomy in deciding how best to comply. For example, CECL does not require performing discounted cash flow (DCF) analysis, which takes into consideration incoming payment streams and should result in a reduction of reserve requirements. But it is complicated, especially for those still relying on spreadsheets. Nevertheless, 44% of survey respondents said they were planning to use DCF analysis.

"A lender benefits greatly from using the discounted cash flow method when its loans or exposures have very high effective interest rates and longer duration, because the guidance says it must discount cash flows at the effective interest rate," Iyer explains. "So, the higher the rate, the lower the present value of the future cash flows."

Perhaps surprisingly, smaller institutions also appear enthusiastic about DCF: 29% of lenders with less than $5 billion in assets said they would use DCF analysis, as did 50% of those between $5 billion and $10 billion in assets. Voigt says that even these banks appear to recognize there is a potential economic benefit in the DCF approach, though they may need to turn to vendor technology to automate that analysis.

Rabe agrees, noting that along "with the potential for lowering reserves, I think banks recognize the usefulness of leveraging more advanced approaches, like DCF, for their overall credit risk management activities."

Yet there are potentially significant hitches in DCF, stemming from the differences in how bankers and accountants view loss forecasts and when to recognize losses. A banker who has been tracking the issue says that most banks model losses based on accounting charge-offs, which is what comes through as the actual loss. Using DCF analysis in the context of cash flows is fine, he says, but applying it to charge-off loss forecasting accelerates the implicit recognition of cash collection, even though in practice that cash may take one, two, or three years to collect.

That is especially true for assets such as residential real estate loans, home equity loans, and commercial real estate loans, which can have workout periods of up to three years or more. By estimating the full loss and taking the accounting charge up-front, instead of incurring it until the final disposition when the cash is collected, banks may artificially understate their CECL reserves.

"The acceleration of that event would incorrectly lead to a lower CECL reserve," the banker points out. Incorrect application of CECL "is where regulators will become very concerned, once they understand the issue."

Another issue in the accounting-standard update that is related to credit losses is the new requirement to recognize the lifetime expected credit loss of an asset when the asset is originated or purchased. Financial-statement users tend to support the measure for the transparency it provides. However, two FASB board members disagreed, contending that the requirement does not accurately represent the economics of lending (see page 8, "When to Recognize Credit Losses: A FASB Debate").

Another decision point is the measurement of purchase credit deteriorated (PCD) financial assets. CECL introduces the PCD concept, replacing purchase credit impaired (PCI) accounting. Under current accounting, an asset is PCI when the borrower becomes delinquent on the loan—a narrower and more straightforward approach than PCD treatment. CECL prescribes PCD for any asset a lender purchases that experiences some type of credit deterioration, based on the price it paid less the amortized cost.

Will you be using a Discounted Cash Flow method?

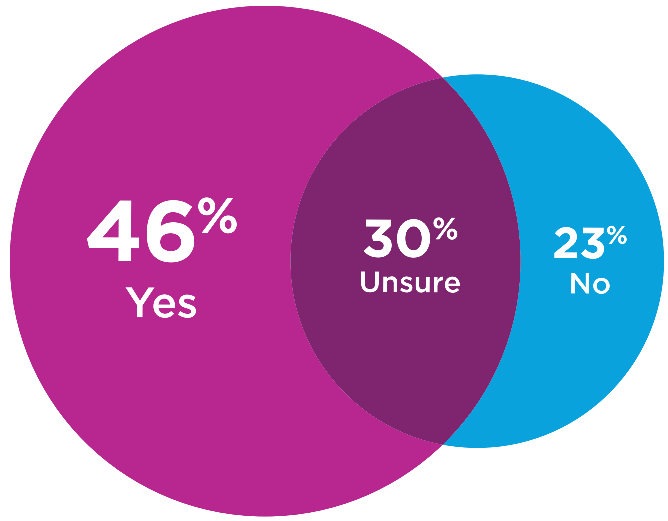
A much larger universe of loans is expected to qualify for PCD treatment, but the CECL language doesn't prescribe how to evaluate whether credit deterioration is insignificant or not. "It just says the bank needs to define how to do it and provide documentation and assumptions around the process, to make sure it's applied consistently and has a sound evaluation," Iyer says.

However, nearly half of respondents (46%) said they have already defined how they will evaluate a more-than-insignificant deterioration in credit upon purchase.

With FASB unlikely to provide additional guidance, the industry will seek to converge over time on a common methodology. "There will be some outliers," Iyer says, "because they have strong beliefs one way or the other, but they will have to have strong documentation to support their thinking."

Also, though a key component of the CECL result, institutions remain split on the method to determine the length of a "reasonable and supportable" forecast horizon. While larger banks are leaning toward quantitative methods, smaller banks appear to favor more qualitative and judgmental approaches.

Has your institution defined how it will evaluate a more-than-insignificant deterioration in credit upon purchase?



When to Recognize Credit Losses: A FASB Debate

Two FASB board members dissented from the CECL accounting-standard update, arguing that recognizing an asset's lifetime expected credit loss up-front inaccurately represents lending activities and ultimately results in a balance sheet presentation that reflects the credit risk twice.

One of the dissenters was FASB Vice Chairman James Kroeker, who prior to joining the accounting standard board was the deputy managing director for professional practice at Deloitte, and previously the chief accountant at the Securities and Exchange Commission. Laurence Smith, the second dissenter, managed the FASB's activities related to application and implementation issues for five of his 10 years as a board member; he left the organization in 2017.

Kroeker and Smith contended that recognizing the credit loss at the origination or purchase of the financial asset would result in financial reporting that "does not faithfully reflect the economics of lending activities." They acknowledged that financial statement users "overwhelmingly" support the anticipated transparency and information about lifetime expected losses, and they stated that ultimately the model is "operable." From a bank perspective, however, the lender is paying for the asset based on its terms, including the stated interest rate, while also reflecting the asset in its allowance for loan losses—double counting the credit risk.

Kroeker and Smith said several other models could have been developed to provide similar transparency while more accurately reflecting banks' credit risk, so that interest income and expected credit losses are both recognized over time. Recognizing full lifetime losses on a loan at initiation, they argued, is inconsistent with the underlying economics and "could have unintended implications to lending institutions' willingness to lend under certain circumstances and to certain types of borrowers."

The dissent noted that whether a bank extends credit to a homebuyer or an investor purchases a debt security, neither would be expected to incur an economic loss on the day the loan is made or the security purchased. "This [update] contradicts that economic reality by requiring the recognition of a loss for taking on risk," it said. "This is one reason why Messrs. Kroeker and Smith disagree with the board's conceptual justification of the Day 1 loss model."

Summary

The SAS/GARP survey indicates that lenders are making significant progress toward the implementation of the Current Expected Credit Loss model. It also highlights a number of challenges that must be addressed in a relatively short time frame.

The survey shines a light on several areas that will require interpretation of CECL's principles-based language, such as determining the expected life of lenders' credit card portfolios (20% said they had yet to complete that step).

The first CECL compliance deadline is December 2019, but for the many organizations intending to run CECL accounting in parallel with existing systems for multiple quarters ahead of that date, their technology development and implementation timelines are much shorter.

Smaller institutions may still manage with spreadsheets, but larger lenders will have to develop the technology in-house or rely on vendors. The standard's non-prescriptive language means banks must pay close attention to industry initiatives to coalesce around accepted methods to provide information the new accounting requires.

SURVEY METHODOLOGY

The survey was conducted online from mid-January through February 2, 2018, with 130 representatives from 98 lending organizations participating. The respondents consisted primarily of senior and mid-level executives; 89% work at banks, and 46% at institutions with more than $50 billion in assets.

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