Introduction to CECL

Making the Complex Simple

By: Scott Blakeslee

Overview

An overview of nCino's solution to CECL (Current Expected Credit Loss). This document does not go into great detail on any one method or portion of CECL; rather, it offers a holistic view of the nCino CECL solution.

Executive Summary

In June of 2016, the Financial Accounting Standards Board (FASB) released Accounting Standards Update (ASU) 2016-13, Measurement of Credit Losses on Financial Instrument (Topic 326), with the intent to improve current regulations on financial institutions' treatment of credit losses.

The current incurred loss requirements, by which credit losses may only be recognized if it is probable that losses have already been incurred, have proven insufficient as history is not a true predictor of the future. The global financial crisis was aggravated by the delayed recognition of credit losses, motivating the development of new regulation and a move to an "expected loss" requirement.

CECL eliminates the incurred loss methodologies by requiring recognition of all expected credit losses, regardless of whether a probable threshold has been met. With CECL, Generally Accepted Accounting Principles (GAAP) requirements align with financial statement users' need for timely and forward-looking recording of credit losses.

"The American Bankers Association has called CECL "the most sweeping change to bank accounting ever." One of the most significant changes is that management will need to develop and document 'reasonable and supportable' forecasts to estimate expected credit losses over the life of the loan."

Key Principles

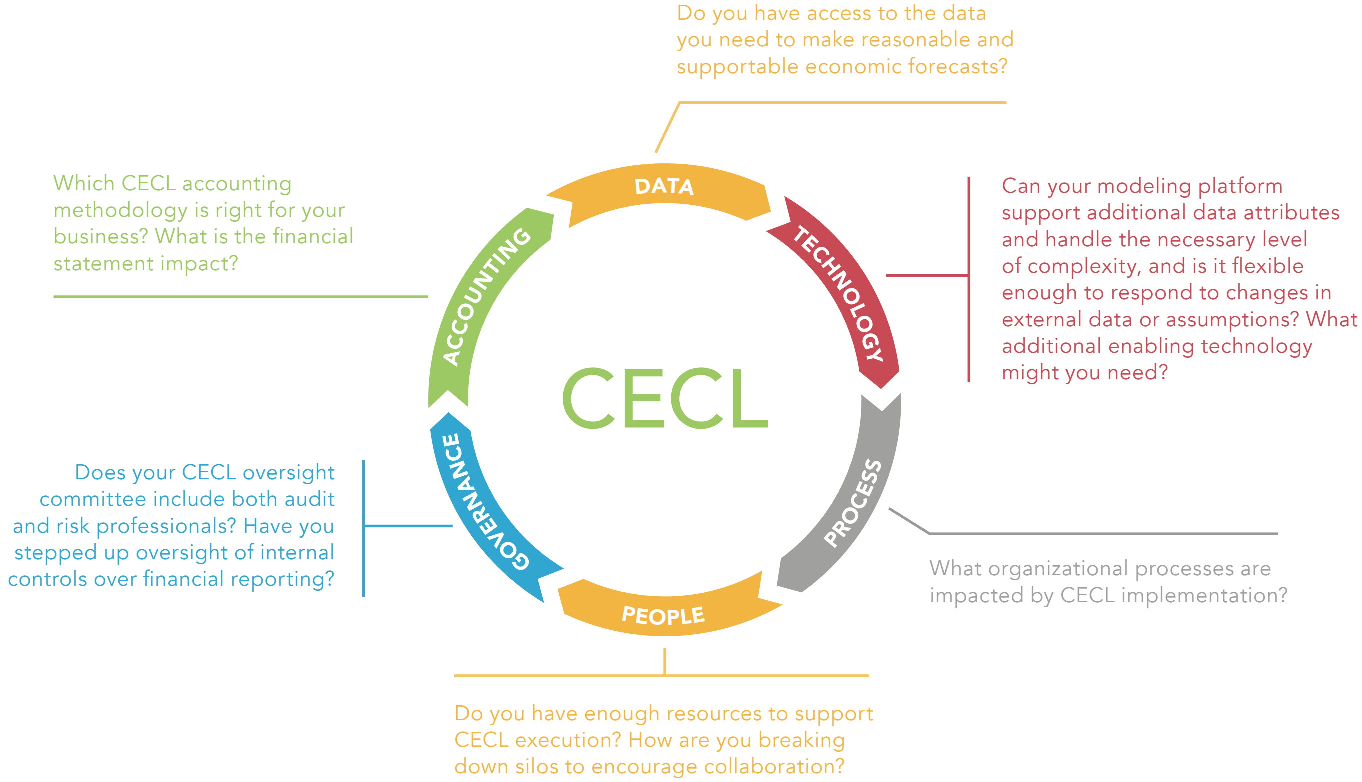
While the ASU does not specify a required methodology for calculating the allowance, it does require financial institutions to use methodologies satisfying some core principles.

"The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset." So, the allowance should reflect the portion of the financial asset(s) expected to not be collected due to credit loss.

Expected losses should be measured on a pool basis when similar risk characteristics exist. Assets with unique risk characteristics should be considered on an individual basis.

The allowance should be estimated using relevant information about past events, current conditions, and reasonable and supportable forecasts. It is left to the institution to determine which information is relevant and how to incorporate that information in the loss estimate.

Expected credit losses should be estimated over the contractual term of the financial asset, with prepayments considered either implicitly or explicitly in the estimate, and without regard to extensions.



"The adoption of the CECL standard will likely affect internal controls and the need for data not previously used for financial reporting purposes. Accounting standards implementation is often a finance-only effort, but not CECL. It has many governance, modeling, credit analysis, information technology, and financial reporting interdependencies."

Portfolio Segmentation

Properly segmenting your portfolio is the first step in the CECL process. Referring to the collectively reviewed portion of CECL, the FASB says, "an entity should aggregate financial assets on the basis of similar risk characteristics." Meaning, when you segment your portfolio, the "spirit of the law" requires that the segmentation result in pools of loans that are reasonably homogeneous in risk. This must be balanced with sample size considerations. Some loss estimation techniques have certain sample size requirements that might be violated if too much disaggregation is in place. nCino recommends that each institution carefully consider how to create homogeneous pools without losing the benefits of healthy sample sizes.

Generally, segmentation is composed of three levels: segment, class, and credit quality indicator (CQI). Segments are usually broad loan categories (e.g. residential real estate), classes are usually sub-categories (e.g. first mortgages), and CQIs are metrics of loan quality (e.g. credit score), although the ASU allows for other means of segmentation such as term, rate, etc.

Methods for collectively reviewing loans are specified at the class level, and within each class, the institution may choose to have the methods carried out at a CQI level (i.e. the historical loans used in the method would be partitioned by CQI). The CQI-specific calculations are not necessary for the Probability of Default (PD) or Discounted Cash Flow (DCF-PD) methods because the Probability of Default estimates account for CQI. nCino recommends CQI-specific calculations for Vintage and Static Pool methods if the concentrations of credit quality within the class have materially changed over time and the pool formed is of sufficient size to accommodate the analysis.

The New CECL Model

Segments or pools are created based on common loan characteristics. A combination of both internal and external information, including macroeconomic variables, are used to establish a relationship between historical losses and other variables.

To reflect current asset-specific risk characteristics, adjustments to the historical data will need to be considered. These adjustments are usually done through a combination of both qualitative and quantitative factors.

The forecast period to project expected credit losses should be reasonable and supportable. Document the rationale and provide evidence supporting the reliability and accuracy of various economic scenarios and forecasts.

Entities are to revert to unadjusted historical loss information when unable to make reasonable and supportable forecasts. The approach used to determine a "mean reversion level" must be well-documented.

The result should represent the current expected credit loss over the remaining contractual term of the financial asset or group of financial assets.

Individually Reviewed Loans

The next step is to decide whether certain loans should be reviewed on an individual basis. Loans with unique risk characteristics that do not fit nicely into a class should be reviewed on an individual basis. This might include troubled debt restructurings (TDRs) or loans unique in type or circumstance.

nCino provides three methods for individually reviewing loans:

1. The first method is Related Allowance Provided. In this method, the user uploads the results of their off-system analysis to nCino so that it can be included in the CECL reporting framework.

2. The second method is Discounted Cash Flow. This method looks at future cash flows and discounts them to arrive at a present value. The allowance is the difference between present value of these future cash flows and the recorded investment (balance). Note that the Discounted Cash Flow for individually reviewed loans should not be confused with the Discounted Cash Flow method (DCF-PD) for collectively reviewed loans.

3. The third method is Fair Value Less Cost to Sell. This method is used for collateral dependent loans and takes the collateral value less costs to sell, as the name implies, and then subtracts these net proceeds from all outstanding balances, including senior liens. If the net proceeds are not sufficient to cover the outstanding balance of an allowance is recorded.

Collectively Reviewed Loans

The final step is to collectively review loans. Remember that CECL requires an expected lifetime loss estimate, so a one-year charge-off ratio will not suffice anymore. However, nCino advises that there is not one single best loss rate method for CECL. Each institution's product mix, data availability, underwriting patterns, etc., all play a role in determining which method should be applied. For this reason, nCino offers multiple methods, each with a unique set of strengths.

These methods include:

- Static Pool
- Vintage
- Advanced Vintage
- Probability of Default (PD)
- Discounted Cash Flows with Probability of Default (DCF-PD)

For more information on the individual methods, refer to the CECL Methodology Selection Guide.

Economic Forecasts

Consideration of economic forecasts is one of the key changes that comes with CECL. Compliance with this aspect of CECL can be factored into two necessary steps:

1. Producing forecasts

2. Incorporating forecasts into expected loss

Because both steps can be technical in nature, a separate white paper is provided on this topic.

Incorporating Forecasts

There are many ways forecasts can be factored into your loss allowance. The cleanest way to do so would be to use either PD or DCF-PD, both of which already account for economic and loan characteristics. The other methods require some explicit adjustment for changing economic conditions.

Producing Forecasts

nCino provides forecasts of unemployment and house prices at both state and Metropolitan Statistical Area (MSA) levels as well as commercial real estate values at a regional U.S. level. The forecast methodologies used are either in-house statistical forecasts or modified industry-provided forecasts.

The statistical forecasts utilize Gaussian Process Regression (GPR) to leverage the correlation between neighboring points in time. For example, because house prices between subsequent months are highly correlated, historical data can be used to quantify that correlation. The results are then used to project future house prices.

When a user desires industry-produced forecasts, but the forecasts are only provided at a national level; nCino provides modified, geography-specific forecasts. Specifically, for each geographical area (state or MSA), historical data is used to find the correlation with the national metric. The correlation factor for each geographical area is then applied to national forecasts to achieve specific forecasts for each area.

Reports and Disclosures

CECL reports and disclosures should align with the following three purposes as outlined in the ASU:

1. The credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio
2. Management's estimate of expected credit losses
3. Changes in the estimate of expected credit losses that have taken place during the period

Specific disclosure sections include credit quality information, the allowance for credit loss itself, information on past due status and nonaccrual loans, as well as other disclosures that relate to less common, specific lending situations.

nCino provides all required disclosures in addition to other useful reports. A set of standard reports are automatically populated when the required steps are completed for your portfolio. In addition to the standard reports, users have access to report builders for any desired custom reports.

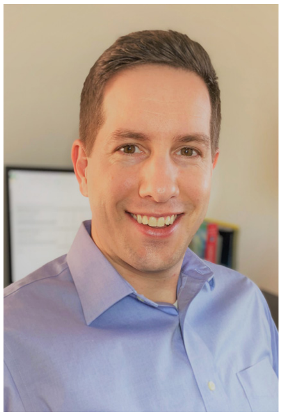
The standard reports include the following:

- Executive Summary
- Individually Reviewed Summary
- Collectively Reviewed Summary
- Q&E Summary
- Credit Quality
- Delinquency Aging
- Vintage Analysis
- Charge-off Analysis
- Non-accruals
- TDR / Modifications
- Stress Test Results
- Data Quality

Conclusion

nCino will provide a complete, turn-key, user-friendly CECL solution that allows a user to easily segment their portfolio, analyze individual loans for impairment and expected loss, collectively review loans using CECL-compliant loss rate methods, incorporate qualitative and environmental factors and reasonable and supportable forecasts, and access a comprehensive suite of standard and custom disclosure reports. ■

About the Author



Scott Blakeslee is the Product Director for the nCino ALLL/CECL Feature. His background is in accounting and audit, having worked previously at Deloitte and the Public Company Accounting Oversight Board (PCAOB) in Washington, DC. Scott earned a Bachelor of Science in Accountancy from Boise State University.

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About nCino

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