CECL: Ready, Set . . . Go?
CECL is coming. Everyone knows that. But when? A “fatal flaw” or near-final draft released to selected industry experts by the Federal Accounting Standards Board (FASB) in September raised several issues that require resolution. So why begin preparing for CECL now?

CECL is the most discussed subject in banking since Dodd-Frank – and likely will have just as much impact on the bank’s bottom line. Accountants and auditors agree that CECL will have significant effect on capital and capital planning; CECL could result in a 20 to 50 percent increase in the allowance requirement at some banks. If for no other reason than capital planning is a two- to three-year process, then despite any specifics on an implementation date, the time for banks to begin preparing for CECL is now.

“This is not a tweak for anybody or any bank,” Steven Merriett, chief accountant at the Federal Reserve System, told attendees at September’s AICPA National Conference on Banks & Savings Institutions. “You are not already doing it. Your allowance is not already sufficient to qualify under CECL. This is going to take a ton of work.”

What Will Change Under CECL?

Banks will have to predict future losses

Bankers will reserve for a loss from the day a loan is issued

Straight-line reversion to the mean for non-forecast periods

Special treatment for acquired loans with "more than insignificant deterioration since origination"
The major distinction between the current incurred loss model for estimating the ALLL and CECL is that under CECL the bank will have to predict future losses. Probably the most impactful element involved in forecasting future losses is that it will require bankers to reserve for a loss from the day a loan is issued. Day-one inclusion has been an item of contention among FASB members, to the point that two FAS Board members will vote against making CECL the new standard, according to one of the naysayers, Lawrence Smith. Still, Smith told AICPA Banking Conference attendees, CECL has “unprecedented support” from the 800-plus industry professionals who have submitted comments to FASB.

Beyond day-one accounting, the fatal flaw draft contains many details that distinguish it as substantially different from the current incurred loss approach to estimating the ALLL. Among the technical issues that drew comments from AICPA Banking Conference speakers, which included representatives of all major bank governing agencies, from the Federal Reserve to the OCC and FDIC, the SEC and FASB:

- Reversion to the mean for non-forecast periods will be on a straight-line basis.
- Acquired loans with “more than insignificant deterioration since origination” will require special treatment.

New disclosures include:

- The method for reverting to the mean for non-forecastable periods
- The policy for charge-offs
- Credit quality indicators by vintage year
- For collateral-dependent loans, the extent to which the collateral secures the asset, the type of collateral and any significant changes over the allowance period

Industry experts commenting on the fatal flaw draft unearthed other complications with the new standard: how to determine the life of loan, on which expectations of future losses are based, for credit card debt or annually renewed business loans; the durations of forecasts for different factors and portfolios; the distinction between estimated and contractual life; and if prepayments can be taken into account in estimating the remaining life of loans. As well, regulators and advisors agree that the complexity of the standard will likely require banks to employ the counsel of economists and credit specialists, that subjective qualitative factors could have more weight in CECL calculations and therefore require more detailed research and support, and that for publicly held banks the balancing act between what they do to meet expectations of the SEC and other regulators will continue.

MST’s Director of Special Projects Chris Emery told bankers in a recent CECL webinar:

“In our view, the single most important of these preparations for banks to begin now is the process of capturing and storing loan-level detail and transactional information on a regular basis.”
Regardless of the nuances to be decided and final issues to be resolved, and regardless of whether the announcement comes in 2015, 2016, or later, banks’ advisors, including their external accounting and audit vendors, are telling them to begin preparing for CECL.2

“Banks are encouraged to consider their data collection needs,” Jeffrey Geer, OCC Deputy Chief Accountant, told attendees at the Federal Banking Regulators Chief Accountants Panel3 session at the September 8, 2014, AICPA National Conference on Banks & Savings Institutions, adding that “vintage,” or historical, loan data may become much more important in adhering to the new accounting standard.

“In our view, the single most important of these preparations for banks to begin now is the process of capturing and storing loan-level detail and transactional information on a regular basis,” MST’s Director of Special Projects Chris Emery told bankers in a recent CECL webinar4.

“Under the current incurred loss model, many community banks have calculated the ASC 450-20 portion of their allowance using aggregate, pool-level information,” Emery explained. “In most cases, this was an acceptable method both from a regulatory and accounting standpoint. However, every indication is that historical pool-level data will no longer be acceptable for calculation of loss rates that are applied for the calculation of the allowance. For many banks, this will mean a lack of necessary data when CECL implementation comes around. You might think all this information is currently stored in your core loan system, but often that is not the case. Many core systems only store by default, the last 13 months of loan information, and that amount of data can be difficult or expensive to access. And many experts believe the historical data requirements for CECL will be five years or more.”

New CECL Disclosures

The method for reverting to the mean for non-forecastable periods

The policy for charge-offs

Credit quality indicators by vintage year

Types of collateral and significant changes over the allowance period for collateral-dependent loans
What kind of data

“CECL is built on the same foundation of information, historical loss, as the incurred loss model,” noted Graham Dyer, senior manager of Grant Thornton’s National Professional Standards Group. However for CECL these historical losses must be adjusted beyond the reporting date, looking forward according to what is ‘reasonable and supportable.’

“Key to CECL is assembling data on two primary levels,” he continued. “You’ll need data on a loan level of losses over time to build a historical loss rate by loan type, loss patterns by loan type, correlations between key economic metrics and losses, and the economic metric or loss rate lag. And CECL will require you to have data on a loan level of duration, including loss patterns and prepayments under different economic and interest rate environments.”

Advisors might differ in perspective and style but their advice is consistent in their assessments that banks will need to build an extensive cache of data.

“Data retention and analysis is increasingly critical to accounting estimates as the focus on fair value continues to increase,” noted Walter McNairy, who heads the Dixon Hughes Goodman, LLP (DHG) financial services practice. “Application of CECL will be no different.”

McNairy suggests that banks with insufficient amounts of data turn to call reports as a starting point. “Maybe that’s not loan level data, but look back at it, start gathering that information in detail right now. Have your service provider start saving that year-end data. You might decide today that certain elements are important and decide differently tomorrow, so having detail gives you flexibility.”

McNairy offered a list of the types of loan data surrounding historical losses he is advising banks to gather:

- Probability of default stats
- Loss given default stats
- Loan-level detail for net losses
- Loan rating/grade
- Was a loan TDR? Or impaired?
- Delinquency status
- Loan to value
- Linkage of key economic indicators
• Prepayment experience
• Vintage information
• Information on unique products or loan structures
• Date info, like first past due, first classified as non-accrual, etc.

“As well,” he suggested, “banks should look at similar data from previous systems and even acquired bank losses in the periods before an acquisition.”

“Most of the loan-level detail information banks should be storing is not unfamiliar to them,” MST’s Emery added. “Items like book balance, interest rate, origination date, and so on, are all fields that every banker is familiar with; however, this data might not be stored on a month-by-month or quarter-by-quarter basis. The transaction detail of charge-offs and recoveries is also probably a familiar dataset to many bankers. Again, this might not be stored at regular intervals.”

“Waiting could put you at a severe disadvantage”

Walter McNaery
Managing Partner
DHG Financial Services
Economic forecasting

Grant Thornton’s Dyer proposed three steps to developing a “reasonable and supportable” forecast:

• Identify the relevant economic metrics that drive losses for different segments of loans, which must be supported by documentation of not just the metrics selected but of other metrics considered but not selected.
• Identify economic forecasts for the selected metrics. Documentation must include reasons a specific forecast was chosen and other metrics considered but not selected.
• Translate to loss information using correlations and lags identified in historical data.

“Under the coming CECL model, institutions will have to base their allowance estimate on ‘reasonable and supportable’ forecasts,” pointed out MST CEO Dalton T. Sirmans. MST is developing an economic analysis tool to help its clients identify and gather economic data pertinent to their allowance estimation process.

“As the factors which determine the production, distribution and consumption of goods and services, economic data is critically important,” Sirmans explained. “Economics-based decisions typically consider a large amount of data for quantifiable estimates. As such, economic data provides measurable, objective information. And while regulators and FASB always include economic considerations in their guidance, few banks have an economist on staff or access to available economic expertise.”

While banks will need to vet economic data for pertinence to their businesses and communities, Sirmans shared five key measures:

• Real gross domestic product
• Nominal gross domestic product
• Unemployment rate
• Nominal disposable personal income
• Consumer price index

And four sources for aggregate measures of financial conditions:

• S&P/Case-Shiller U.S. National Home Price Index or House Price Index
• Commercial real estate prices
• CBOE Volatility Index
• Dow Jones Industrial Average, S&P 500, Russell 2000

Key Economic Metrics

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Beyond Data

In his address to the 2014 AICPA banking conference, the OCC’s Geer offered two lists of implementation considerations:

**Implementation dos:**
- Start collecting data now:
  - What type of loan suffered the loss and when?
  - In what year was the loan originated?
- Leverage existing processes and methodologies.
- Use industry available resources:
  - OCC Semiannual Risk Perspective, OCC Mortgage Metrics
- Consider capital adequacy:
  - “Appropriated” retained earnings
- Keep your regulator up to date.

**Implementation don’ts:**
- No early incorporation or “soft adoption” of expected loss concepts
- No artificial inflation of ALLL to smooth impact
- Analyze qualitative factors before releasing reserves.
- Don’t overload at adoption.
- Don’t wait to prepare.

Michael L. Gullette⁸, vice president of Accounting and Financial Management for the American Bankers Association (ABA), has been the ABA’s eyes and ears on FASB’s CECL proceedings. In May, he told attendees at the MST 2015 National Conference on the ALLL that banks can prepare for the new accounting standard by:
- Assuming an expected loss accounting model
- Ensuring key data are gathered and governed
- Coordinating credit risk management metrics with CECL
- Understanding the impact of the forward-looking requirement and vintages

Nicholas Rossini⁹, a consultant with Financial Services Risk Advisors and a former banker responsible for his bank’s ALLL, suggested in a recent blog that beginning now to prepare for CECL by evaluating or running more sophisticated quantitative methodologies like Probability of Default / Loss Given Default (PD/LGD) could give the bank a competitive advantage.

“The loss given probability of default estimates can be stressed using the economic forecast by adjusting variables that would result in one or more changes in loss at default (i.e. real estate value decline, inventory obsolescence, evaporated liquidity), or likelihood of default (i.e. unemployment rate, foreign competition, declining cash flow) ... the results of the stress test in a pricing model or return on equity calculation (could) provide a picture of the most advantageous loan portfolio mix for the expected economic situation.

“That,” he offered, “can create a significant competitive advantage for you in your market.”
While FASB will not specify a methodology for estimating the allowance under CECL, advisors are telling banks to begin testing models and comparing results with their current incurred loss estimations. As a form of shadow analysis, testing could help determine what kind of model to gravitate toward for CECL as well as provide the bank an idea of the impact of estimating expected losses.

“A methodology that will give the bank better, more granular data will help it prepare for the new requirements,” Emery pointed out. “A different methodology could help the bank start building some of the underlying structure that CECL will require. And because the bank will need to be more forward-looking in its analysis, the data the bank gathers today will remain useful for several years.”

According to Emery, the most important consideration in transitioning to a different methodology is the type and amount of data required to make the change. He suggests two types of methodologies the bank might consider:

**Loss Migration:** Calculating loss rates based on the migration of losses back through the history of a loan in order to assign the losses to risk-stratified segments allows for more granular analysis of loss rates based on risk characteristics.

**Probability of Default/Loss Given Default (PD/LGD):** The method combines the calculation of the probability of loans experiencing default events with the losses ultimately associated with the loans experiencing those defaults.

Steven Lackowski, manager of Grant Thornton’s National Financial Services Advisory Practice, used the MST 2015 National Conference to offer additional approaches to expected loss modeling:

**Cohort:** Similar to loss migration, grouping loans outstanding at the beginning of a loss accumulation period by relevant risk characteristics, and measuring losses accumulated on each “cohort” over the following loss accumulation period.

**Vintage:** Tracking homogeneous loans on the basis of calendar year or quarter of origination and measuring losses accumulated on each “vintage.”
Universally, advisors are warning banks against procrastination.

“Waiting could put you at a severe disadvantage,” DHG’s McNairy warned and offered several reasons: the large volume of new banks rushing to adopt this will cause significant upticks in costs (supply & demand); the bank might not have time to perfect its data management responsibilities; it might not have time to prepare for a sizeable increase in reserves; it will be taking on two major tasks, implementation of a new methodology and a new model, putting extra strain on operations and personnel.

The regulators themselves are steeped in change related to the more complex CECL environment. The Fed’s Merriett told the AICPA banking convention gathering that regulators have devoted almost half of the staff of the Fed’s office of the chief accountant “almost exclusively” on CECL over the coming years, through outreach, education and internal training. The OCC is also readying its examiners and supervised banks with regulatory expectations, “years ahead of the shift to CECL and its implementation,” said Louis “Rusty” Thompson, acting deputy comptroller and chief accountant. Early in 2015, the agency assembled a cross-functional group of accountants, credit and capital specialists, economists and attorneys to develop the OCC’s CECL transition plan.

McNairy referenced the Chinese proverb: “The best time to plant a tree was 20 years ago. The second best time is now.”

“The best time to begin preparing for CECL was several years ago,” he paraphrased, “but if you haven’t started yet, the time to begin is now.”
References

1. Presentations from the AICPA National Conference on Banks & Savings Institutions, National Harbor, Maryland, September 16-18, 2015


9. “The #1 thing you can do with CECL to give your bank a competitive advantage,” Nicholas Rossini, Financial Services Risk Advisors, LinkedIn post, September 28, 2015

MST (MainStreet Technologies of Atlanta, Ga.) provides financial institutions throughout the United States with software solutions for estimating the ALLL and analyzing and mitigating loan portfolio risk. MST solutions are configured for each institution, integrate with core systems, deliver greater adherence to policy, consider data security and exponentially improve efficiencies. Contact MST at 877-910-9789 or visit the MST website at www.mainstreet-tech.com.

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