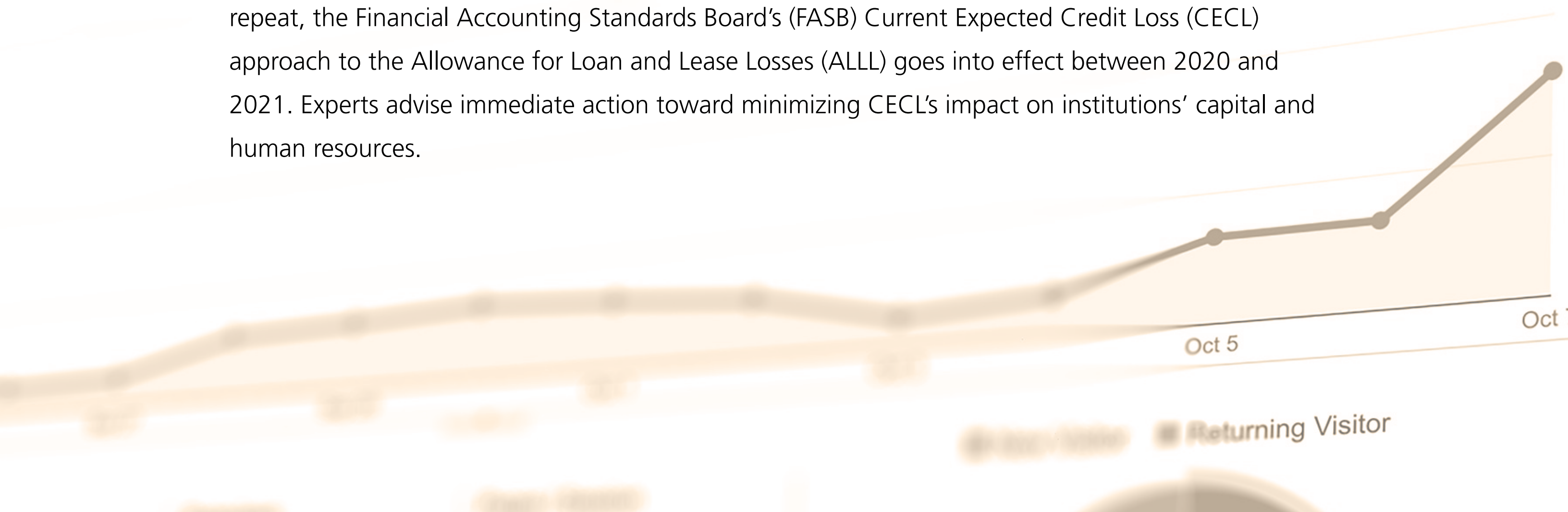
21CFS
INNOVATIVE BANKING

Banker's Guide Book to CECL Compliance By 2020

The FASB's Current Expected Credit Loss (CECL) standard is inching toward reality. The new rules are intended to address concerns raised by a wide range of stakeholders following the 2008 financial crisis. The CECL regulation will go into effect December 15, 2020. Fortunately, this gives you some time to prepare. CECL will not only affect how banks calculate credit loss reserves, but also how organizations fundamentally manage their ALLL and organizational processes for both finance and risk management. The scope of these changes can be substantial depending on the complexity of the balance sheet. The changes required by CECL require a much deeper level of modeling, analysis and reporting than what has previously been required. And these changes are significant in terms of how banks will need to manage risk and financial data, build their analytic platforms and share information between departments.

Originally published in Bank News magazine, this checklist is a simple tool for assessing your bank's readiness for CECL. It doesn't cover everything, but serves as a quick and easy method for ensuring you've taken care of the big hurdles you might face. If your bank has any questions or uncertain of your process to be fully ready by 2020, please contact 21CFS, we are here to help!

Very soon, CECL will fundamentally change how the financial industry accounts for loan loss reserves. Currently, institutions can't record expected losses until deemed "probable." Because of this limitation, they were inadequately reserved before the 2008 financial crisis. To avoid a disastrous repeat, the Financial Accounting Standards Board's (FASB) Current Expected Credit Loss (CECL) approach to the Allowance for Loan and Lease Losses (ALLL) goes into effect between 2020 and 2021. Experts advise immediate action toward minimizing CECL's impact on institutions' capital and human resources.



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THE FOLLOWING GUIDE TAKES YOUR INSTITUTION THROUGH IMPLEMENTATION, ONE STEP AT A TIME.

STEP 1: Initiate Education and Planning

According to the American Bankers Association (ABA), regulators consider CECL "the biggest change ever to bank accounting. You can help control the pain, if you haven't already done so, by educating staff and planning now:

1. **ASSIGN A TEAM LEADER AND ASSEMBLE A TEAM**
   Identify a strong candidate with experience in such areas as credit risk or accounting. Familiarity with project management also is ideal. The CECL leader should build a team representing key affected areas, including senior management, loans, credit underwriting, risk management, accounting and internal audit.

2. **EDUCATE THE TEAM AND BOARD**
   Review CECL and explain its possible implications to your board and key stakeholders. Start by reviewing these interagency documents about CECL: Joint Agencies Statement and Frequently Asked Questions.

3. **CREATE A PROJECT PLAN**
   Your detailed project plan should manage system and policy changes, provide training and communication, and account for contingencies.

4. **COMMUNICATE WITH YOUR CORE PROVIDER**
   CECL relies on historical data on life of loan or life of portfolio loss rates, key portions of which reside within your core system. So, contact your provider to make adjustments to the current closed-file destruction schedule. This ensures your access to CECL information. CSI Presents CECL by 2020-21: One Step at a Time

STEP 2: Address Key Decision Points

The CECL project team must consider these points to determine your institution's best course of action.

1. **DATA IDENTIFICATION**
   Institutions must anticipate collecting the following data—at a minimum—for individual loans, and assess the need for more granular detail: risk rating, loan duration, origination date, maturity date, loan balance, key charge-off or recovery information, and loan segmentation.

2. **DATA GATHERING**
   Gather individual loan data for existing loans to build the historical picture and vintage disclosures CECL requires, including data from:

   - Core system: determine the data available, and plan for retaining and accessing it.
   - Loan accounting and servicing systems: determine how to retrieve additional data points captured within these systems.

- Loan files and credit memos: certain data points may only be available within the loan file or credit memo. • Other databases: search other resources, like customer relationship management systems, to complete customer profiles.

3. PROCESS ADJUSTMENT

The project team must adjust existing loan processes and systems to capture the CECL data more cost effectively. This includes creating consistent codes for data fields, eliminating duplicate fields, ensuring data can be accessed and transitioning to digital-collection methods.

4. DATA ANALYSIS

Decide where to store the data, be it in an Excel spreadsheet or a complex, secure database. Your institution also must determine a cost-effective way to analyze that data.

5. PORTFOLIO SEGMENTATION

The Federal Reserve advises to "identify the portfolio segmentation needed to implement the proposed CECL model, such as grouping assets with similar risk characteristics." These segments should consist of the same product or collateral type, interest rate, or other shared risk characteristic. The agency adds that loan portfolios should be accounted for at the most granular level, since granular segmentation equals better loss estimates.

6. ECONOMIC VARIABLES

Institutions also must include national and local economic data when calculating CECL. Those that are readily available, including unemployment rates, housing prices and commercial real estate prices, will prove the most helpful.

7. CECL METHODOLOGY

FASB doesn't require that a specific methodology be used to calculate the ALLL under CECL. The interagency joint statement explains "allowances for credit losses may be determined using various CSI Presents CECL by 2020-21: One Step at a Time Page 3 methods. Additionally, institutions may apply different estimation methods to different methods. Additionally, institutions may apply different estimation methods to different groups of financial assets." Methodologies include:

- Average charge-off method
- Vintage analysis
- Static pool analysis
- Roll-rate method or migration analysis
- Probability of default
- Regression analysis
- Discounted cash-flow analysis

Validate and Test Your Decisions

STEP 3:

Follow the change management best practice of Plan, Do, Check, Act.

1. VALIDATE CHOSEN METHODOLOGY

Ensure your methodology meets all CECL requirements and provides the most accurate reserve estimates. The former will indicate your institution's compliance readiness; the latter helps minimize the financial impact from CECL. If issues arise, adjust and retest.

2. RUN PARALLEL ALLLS

Calculate both the current ALLL model and the newly devised CECL version through the transition period, to help with budget decisions in preparation for CECL's effective date.

3. ESTIMATE CAPITAL IMPACT

The Federal Reserve suggests institutions "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."

Transition to CECL by 2020-21

STEP 4:

Institutions that follow this multi-step plan, making use of the extended time frame and system-driven resources, will reap many benefits, including balancing CECL-related tasks with other responsibilities, streamlining data analysis and ensuring their CECL rollout meets regulatory expectations. Using this background information and our four-step plan, you have the tools to determine how to implement CECL based on your institution's size, loan complexity and budget.

Source: Bank News: https://www.banknews.com/blog/cecl-your-step-by-step-guide-to-compliance-by-2020-21/