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Authors

Eric Ebel

Managing Director, product management

Eric Ebel is a managing director of product management at Moody's Analytics, where he is currently responsible for the company's CECL solutions. He has more than 15 years of experience managing and developing software for the financial services industry.

Emil Lopez

Director, Enterprise Risk Solutions

Emil Lopez is a director in the enterprise risk solutions group at Moody' Analytics, focusing on the development of software and analytic solutions for impairment accounting (IFRS 9/CECL). He previously spent five years leading risk modeling advisory engagements for Basel and DFAST institutions.

How to Unlock Benefits from CECL Compliance: 5 Principles

BY ERIC EBEL AND EMIL LOPEZ

The primary objective of FASB's CECL standard is to provide investors with more meaningful and timely information regarding credit risk, but it also presents a unique opportunity for financial institutions to advance credit risk practices, break down silos and strengthen business decisions. What steps can your organization take to extract value from CECL, beyond compliance?

When asked about the main challenges presented by the Current Expected Credit Loss (CECL) impairment accounting standard, banks consistently mention data availability and credit loss quantification. However, while early CECL preparation activities indeed focused primarily on these two areas, systems and processes should not be overlooked.

Decisions about the infrastructure supporting the CECL process arguably present the greatest opportunities to extract real business value from your CECL implementation. To unlock these benefits, institutions should focus on five core principles when designing their CECL process: (1) fostering collaboration; (2) strengthening governance and auditability; (3) improving decision making; (4) supporting organizational growth; and (5) integrating banking processes.

Typical CECL Process

Let's review a typical allowance estimation process and the associated challenges under CECL. While there are similarities with what is required today, CECL clearly adds several new wrinkles.

Under CECL, institutions will need to centralize granular data required for calculation and reporting needs, some of which resides in different systems and in varying formats.

They will also need to decide on an appropriate estimation approach for each relevant portfolio – including decisions about the type and number of economic forecasts and the expected credit loss methodology (e.g., historical loss rates or PD/LGD) to be used.

After gathering the relevant data and selecting the appropriate methodology for each segment, these inputs will be fed into the accounting engine to calculate lifetime expected credit losses and the associated allowance at the reporting date. Typically, initial estimates are based on quantitative measures of credit risk and are supplemented by qualitative adjustments. These adjustments should be informed by a variety of analyses, including trends, benchmarks and attribution of changes to key drivers.

Following the approval of the allowance estimates, the institution will need to produce the required disclosures and appropriate management reports to finalize the process and inform its financial reporting systems.

So, how can institutions incorporate these five design principles into the CECL process?

1. Foster Collaboration

Your CECL process should help foster collaboration across the organization and further break down the silos in which many banks operate. Running an effective allowance process will require collaboration from different groups in an organization – including the loan office and the risk, finance and accounting functions.

An effective CECL infrastructure should allow portfolio managers to understand the potential impact of individual deals on their allowance, and to reflect this understanding in pricing decisions. In addition, it should make it easier for model development and validation teams to access historical performance data for model development or back testing, and to evaluate the impact of new models on allowance estimates.

Smart CECL infrastructure investments should also help distinguish and enable an easy handoff between foundational risk measures (e.g., ratings and scorecard outputs) typically owned by risk teams and the enhancements (e.g., qualitative adjustments) the accounting teams might apply for compliance. Moreover, your CECL infrastructure should make it easier to audit the allowance, which leads us to our second core design objective.

2. Strengthen Governance and Auditability

The allowance is one of the largest estimates on a financial institution's balance sheet, and it is likely to face greater scrutiny under the new standard, which requires incorporating more subjective, forward-looking elements. As such, investments in your CECL infrastructure must strengthen the governance and auditability of the estimates.

The CECL infrastructure should provide traceability to the portfolio data, including access to business rules and data transformations applied to the input data. It should also document the methodology and models used for the various segments of the portfolio, including the scenarios used, if any, to incorporate forward-looking information.

Auditors will look to assess the reasonableness of the estimates by directly testing the process or by establishing independent estimates to corroborate management estimates. A process that can provide a range of estimates leveraging external benchmarks, different models or different scenarios would help quantify estimation uncertainty and support the final allowance estimate.

What's more, the individuals vetting the process should also be able to see who did what, and when it was done, and have ready access to documentation about the models, benchmarks, qualitative adjustments and approvals used as part of the allowance estimate.

3. Improve Decision Making

The third core design principle for a strong CECL process is that it should enable making better risk management decisions. Credit loss allowances are one of the key costs of lending, and management is therefore constantly deciding how to optimize their risk–return profile.

Investments in allowance process infrastructure should help diagnose trends and drivers of the allowance: i.e., what, why and how. Insights from the allowance process, if well structured, can also connect back to key portfolio management processes, including portfolio allocation, risk-based pricing, limits setting and risk appetite profiles. Furthermore, the CECL process should empower users to access critical information on demand, when needed for key management decisions, and not just at the time of period-end financial reporting.

A process that cascades loss rates and allowance estimates at the contract level, even when using pool-level estimation approaches, enables users to slice and dice the results and drill down in real time. The process should also support user-friendly tools for exploring results.

For example, suppose a user identifies that the commercial real estate (CRE) segment is contributing a disproportionate amount to the allowance. Your CECL infrastructure should allow the user to drill down to sub-segments of the CRE portfolio to understand what types of properties and locations are driving the results.

Deeper analyses should lead users to contracts with the largest allowance estimates and help identify what factors (e.g., loan terms, economic scenarios or risk rating) are driving those estimates.

4. Support Growth

The fourth core design principle for a CECL process is that it should support your organizational growth strategy. As financial institutions grow, so do regulatory expectations; the way you operated as a community bank will not be acceptable, for example, when you are a DFAST bank. We see significant differences in what growing banks are expected to do from a loss estimation perspective.

Your CECL process should have the flexibility to accommodate evolving loss estimation methodologies, allowing you to use different methods for different segments of your portfolio, when appropriate. You might decide to start with a simple CECL methodology that uses historical loss rates with qualitative adjustments.

After some growth, you will likely want to put in place the flexibility to use more advanced approaches — such as dual-risk ratings and discounted cash flows. This flexibility can also be helpful for preliminary assessments of the impact of the transition to more advanced approaches.

Growth through mergers and acquisitions (M&A) also introduces significant pressure to integrate systems and operations. Firms take different approaches to post-M&A integration: some centralize the allowance process, while others continue to delegate those responsibilities to each legal entity.

CECL infrastructure investments should support both approaches. Firms should look to build in the flexibility to structure the allowance analysis at either the holding company or subsidiary level. Whether banking operations are centralized or not, using a single platform for the allowance analysis can help achieve some of the cost synergies that management envisioned as part of the M&A.

5. Integrate Banking Processes

CECL should be at the heart of your risk and finance infrastructure, and, as such, it needs to connect with various upstream and downstream systems and processes.

Necessary inputs will include data from loan accounting systems and other sources, including macroeconomic data and risk measures. Outputs will feed accounting and financial reporting systems. Your infrastructure should provide data lineage between these different systems and reconciliation capabilities to ensure the integrity of the data throughout the CECL implementation process.

Critical insights can be derived from your CECL analysis. For example, by combining historical performance, current conditions and forward-looking estimates at a granular level, the allowance process will become a solid foundation supporting stress testing and strategic planning analysis. This foundation will provide a window into portfolio performance that will inform pricing decisions and capital allocation.

Technology as an Enabler

By following the five key principles that we have outlined, your CECL program can become much more than a pure compliance exercise and expenditure. But how can financial institutions achieve these objectives given the tight timelines to implement the new standard?

New big data and cloud technologies are reshaping the way the industry approaches this type of challenge. Applying the appropriate technology can streamline access to data and computing power, at a fraction of the cost of traditional on-premise solutions, allowing institutions to dissect and analyze more data, more rapidly. Consequently, business users will be able to navigate large volumes of data to extract insights that are tailored to their needs.

Another key benefit of new technologies is that organizations can adapt much better to frequent changes. Where traditional data warehouses required lengthy efforts to add new data fields and reports, big data infrastructures allow the addition of new data sources to derive new insights much more easily, enabling financial institutions to react faster to regulatory changes and changing market conditions.

Parting Thoughts

Addressing the CECL impairment accounting standards will require material changes to existing practices. Firms should look not only to address the data and modeling challenges that the new standard presents, but also to develop an infrastructure around the allowance process to achieve meaningful business value.

Specifically, firms should design a process that fosters collaboration, strengthens governance and auditability, supports organizational growth and integrates banking processes. Institutions that follow this plan will gain critical insights that will allow them to strengthen decision making, support strategic development and remain competitive into the future.

CECL should indeed be much more than just a costly compliance exercise.

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