Preparing for CECL

How Community Banks Can Prepare for Implementation

Moody's Analytics

Changes in the accounting and reporting of credit risk have been in the works since the financial crisis, but that doesn't make adopting them a simple task. The Financial Accounting Standards Board (FASB) has issued the current expected credit loss (CECL) standard, and now financial institutions must start the work of adhering to it. There is no denying that CECL is hard to navigate. In order to help with that, this eBook will explore several topics.

- Four preparation steps to take now
- How to ease pain points in adoption
- Benefits and outcomes of CECL

Let's Get Started

CECL Time Frame

Looking Back

To start, the following is a reminder of how we got here.

- In 2008 after the financial downturn, the financial industry formed an advisory group, which determined that the crisis had been exacerbated by the existing incurred loss methodology delaying recognition of credit losses.
- The FASB worked with the International Accounting Standards Board (IASB) to come up with a new, more forward-looking and cycle-sensitive way of measuring credit losses and recording them in financial statements.
- The FASB issued an Accounting Standards Update (ASU), commonly known as "CECL," which ultimately gives more transparency to the expected credit losses inherent in an institution's financial assets.

What is CECL?

In essence, the new CECL standard is about improving the measurement and reporting of credit risk. Upon initial recognition of an exposure, institutions will need to estimate credit losses expected over the life of the exposure considering the following:

- Past events, including historical experience
- Current conditions
- Reasonable and supportable forecasts

CECL applies to:

- Financial assets subject to credit losses and measured at amortized cost
- Certain off-balance sheet credit exposures, including loans, held-to-maturity debt securities, loan commitments, financial guarantees, and net investments in leases, as well as reinsurance and trade receivables

Timing

On June 16, 2016, the final CECL standard was issued, and the implementation timelines were announced.

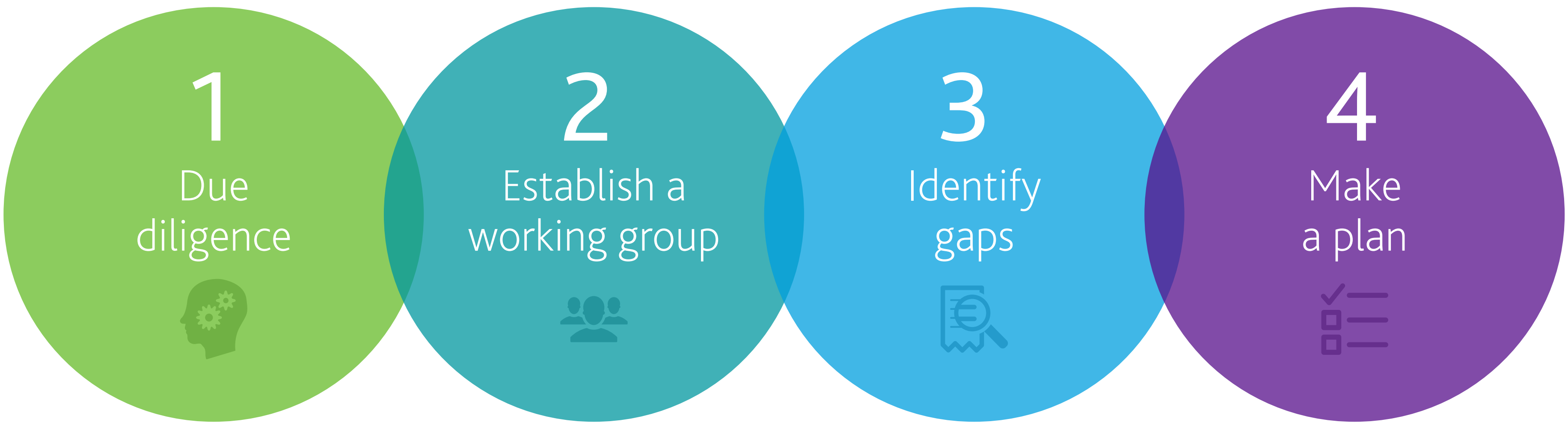
Institution	Effective Date: All Reports After
Public, SEC Filers	Dec. 15, 2019
All Other Public Institutions	Dec. 15, 2020
Private Institutions	Dec. 15, 2021

For a private community bank that has a fiscal year end of December 31, the new standard would apply in FYE 2021.

Early adoption will be permitted for all entities for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

These deadlines are several years away, but the magnitude of the change means that institutions should start preparing now. Let's explore four key steps for preparation.

How to Prepare



Step 1: Get Familiar with the New Standard

Before deciding on your road map, you need to know where you are going. The new accounting standard is available to read on the FASB website (Topic 326). But it can be tricky to understand how it applies to your institution. The standard calls for a more holistic view of expected credit losses but does not prescribe specific methodologies for creating that holistic view. Institutions will need to incorporate what is happening in the current and near-term credit environment with their historical loss experience. There are several ways to get there.

» Talk with your fellow practitioners. With a change this significant, the banking community will be an important resource.

» Seek out education. Tap into your sources of financial information. Attend webinars; go to conferences; read about it. Speak with trusted advisors and trade groups.

» Consult with third-party experts. Trade group leaders, regulators, and solution providers can help you understand how the standard applies to your institution.

» Watch for updates from the FASB and banking agencies. As questions arise around the transition in the coming months and years, they'll likely issue clarifications and more information.

Myth: You need a crystal ball.

Reality: The standard states institutions must come up with a defensible, reasonable, and supportable forecast regarding future conditions.

Step 2: Establish an Internal Working Group

Changing the way you calculate credit losses will affect many departments within your organization, and it's important to involve key players. The key stakeholders will vary depending on the organization, but senior management should spearhead the efforts. Below is a list of others to consider including.

- Board members
- Finance and treasury
- Credit
- Risk
- Loan review
- IT

Each group will bring different perspectives to the discussion. Be prepared to gather insights into risk identification from credit personnel, for instance, and look to your IT leads for a discussion of how you'll automate any changes.

Get everyone on board by expressing the importance of the change, be open to their expertise, and then work with them to set timelines for addressing key milestones as you go through the remaining steps.

Step 3: Identify Gaps

When you've done the research and have formulated a road map, you're ready to start pinpointing the gaps in your current process. It is important to note that it won't be all about what's missing, though. There are likely certain aspects of your current process that you'll be able to leverage as you change to a new framework.

The FASB has not prescribed specific methodologies for developing an estimate of expected credit losses. If you're currently using discounted cash flows, loss rate, probability of default, or provision matrix models when developing estimates, for example, you may be able to leverage them in developing an expected credit loss model.

But there will also be areas you'll need to enhance. Ask yourself the following questions.

» How much data do you currently have access to? The new regulations will require a projection of credit risk over the life of the loan, including risk drivers that are relevant to your market and portfolio. Do you have the data necessary for the wider look, or do you need to explore new ways to collect and organize it?

» What resources do you need? Will additional tools or outside resources be needed to create an efficient, consistent, and repeatable process?

» Will your current infrastructure support the new process? Think about what you'll be asking your infrastructure to handle, and look for areas of weakness. What needs to be reinforced?

> "There are likely certain aspects of your current process that you'll be able to leverage as you change to a new system."

Step 4: Make a Plan to Bridge the Gap

Take a methodical approach and address each issue one by one. Try following the steps below.

- Consulting your resources again. See whether other financial institutions in your community or region are facing the same gaps and ask how they're addressing them.
- Exploring publicly available resources. Look to those guiding organizations like auditors, regulators, and trade groups. Examples of publicly available data sources may include the FFIEC, Federal Reserve, and "give-to-get" consortiums.
- Looking into third-party resources. It might be time to bring in information, data, tools, and methodologies that are commercially available from vendors and consultants.

Then, as it comes time to start implementing the changes, run your new methodologies parallel to existing ones. You'll likely need to go through several iterations to better understand the business impact of implementing the new accounting standard, as well as the financial impact on earnings and capital.

Myth: Addressing CECL is a complex undertaking.

Reality: What's expected from a community bank is not the same as what auditors and supervisors are expecting from larger institutions. Your solution must be appropriate for your institution's size and complexity.

Opportunities

A Chance for Improvement

When thinking about the steps you need to take to accommodate CECL, resistance is a very human reaction. But this also represents an opportunity to examine current practices and better your business. At its heart, CECL is a way to improve the measurement of credit risk. This can bring big benefits.

- » Better analysis. Risk trends and credit monitoring are improved when specific pools of loans with similar characteristics are readily identified.
- » More informed decisions. When you have more information, you can better assess risk, allowing you to take on loans your competitors can't accurately analyze.
- » Comparative benchmarking. Gain a better understanding of where you stand among other banks.
- » Efficiency of integrated components. Taking a close look at your process will help you identify processes across the organization that can interact more seamlessly.
- » Consistency and cooperation. In most banks, allowance calculations are done separately from credit risk functions, and that can lead to disparities. This new approach will be more consistent and comprehensive.
- » A well-rounded view. By adding things like micro- and macroeconomic data, banks will have a better understanding of the current and near-term impact credit risk has on their portfolios.

"At its heart, CECL is a way to improve the measurement of credit risk."

We Can Help

In the end, CECL will help banks develop a more disciplined information-gathering process. The outcome will be better data, which management can use for improved decision-making. Looking at your current processes under a microscope requires some work, but you'll have an improved system as a result. This is your chance to make changes and improvements in ways both large and small. If you need help with any step of the process, let us know.

Contact Moody's Analytics

To learn more about how Moody's can assist with CECL implementation, visit www.moodysanalytics.com/cecl.

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