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ARTICLE

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Is your community bank ready for CECL?

In June 2016, the Federal Accounting Standards Board (FASB) issued Accounting Standards Update 2016-13 that introduced an accounting standard for measuring credit instrument losses called Current Expected Credit Losses (CECL). The new standard will migrate loan loss methodologies from an incurred loss model to a life of loan model. All financial institutions that follow GAAP will be impacted. While the highest impact will be on the larger institutions, CECL will create challenges for smaller institutions that lack resources and systems to implement the standard. It is important to address the impact on methodology and capital, how to possibly outsource this process, and meet the implementation deadline.

HOW WILL CECL MAKE AN IMPACT?

The biggest impact will be on methodology. Historically, FASB 5 allowed institutions to group large, similar assets in into larger pools, while FASB 114 evaluated impairment on an asset-by-asset basis. Under CECL, portfolio segmentation will be more specific to smaller groups of assets. An institution can no longer simply apply a loss factor to mortgage loans. Depending on the mortgage portfolio composition, banks may need to further segment the portfolio by vintage, geographic location or risk characteristics.

The next challenge community banks will face is gathering historical data on loan segmentations. They may know how their mortgage portfolios have performed at a high-level, but the detailed information needed to evaluate the portfolio may not have been captured and stored, especially for institutions that do not have data warehouses. Banks will need to understand the risk in the portfolio in order to gather sufficient historical data to support their methodology.

Since the methodology will be an "expected" loss model as opposed to an "incurred" loss model, banks will need to evaluate the economic expectations of each market where they operate. This is done, to some extent, through interest rate risk scenario analysis. However, in the CECL model, a high amount of subjectivity will be introduced into the process. Banks will need to clearly document those assumptions and how they are supported. Understandably,

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this is a bit of a "crystal ball" approach requiring banks to evaluate their portfolio and its long-term growth ensuring they can maintain their credit risk profile.

CECL will also negatively impact capital, as it will require management to hold more reserves against financial assets. While much of the reserves added back to risk based capital, anything over 1.25 percent of assets cannot be included. Portfolio composition and growth will need to be evaluated against capital with greater scrutiny. In stress-testing models, this would be termed as dynamic testing as opposed static testing. As CECL is implemented, strategic and capital planning will need to be enhanced or more defined.

OUTSOURCING CECL

For many institutions, outsourcing the CECL process will be the best solution. While the vendor may have a technology solution that appears to meet their needs, the devil is in the details. Banks will need to evaluate several vendors to pick the best one for them. No matter which technology vendor is selected, banks will need to provide consistent oversight. The vendor will never know the portfolio as well and financial reporting implications can be very high.

HOW TO GET READY

With the following deadlines looming, there is much work to be done:

- Institutions that are public entities and SEC filers must implement in the fiscal year beginning after December 15, 2019, with regulatory reporting beginning March 31, 2020
- Institutions that are public entities and not SEC filers must implement in fiscal year beginning after December 15, 2020, with regulatory reporting beginning March 3, 2021
- Private entities must implement in fiscal year beginning after December 15, 2020, with regulatory reporting effective December 31, 2021

At this point, if institutions have not begun the process, they will need to play catch up. Here's how:

Steering Committee

Banks should develop a steering committee since the implementation of this process needs to have sufficient governance and reporting. The committee should include representatives from accounting, finance, risk, lending, operations, compliance and internal audit (non-voting member) and should meet at least quarterly initially, but with more frequency as the implementation date draws closer.

Gap Analysis

Banks should conduct a gap analysis of the methodology that is in place and what they will need to do in order to implement the pronouncement. It needs to have enough detail to ensure action plans can be developed for each area of concern and management needs to determine current resources and systems.

Detailed Implementation plan

Management will need to develop detailed action plans in order to manage the implementation effort. The action plans need to have very specific milestones and due dates. Management's progress in executing these plans need to be tracked and reported to the steering committee.

Internal Audits

Internal Audit (IA) will need to conduct progress audits and a post implementation audit. During the process, IA should be keenly aware of the controls developed to execute the methodology, as well as management's documentation to support the methodology.

CONCLUSION

The conversation to CECL will be a daunting task, but now is not the time to panic. The methodology only needs to match the size and complexity of the institution. A bank's primary task is to find the most economic method that matches the institution's risk appetite and can be fully supported. Time is of the essence. Most community banks will have no more than 24 months to implement. Is your community bank ready?

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