Briggs & Veselka Co.
CPAs and Business Advisors

CECL: Update on Current Expected Credit Loss Approach

By Dan St. Clair, Director, Audit Department

Now that a year has passed since FASB issued Accounting Standards Update (ASU) No. 2016-13: Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, it is appropriate to examine what has transpired since then, and for forward-thinking banks to plan for implementation so that can get ahead of the compliance curve, given the complexity of the standards.
As a note, for all non-SEC filers, this standard is effective for fiscal years beginning after December 15, 2020;   SEC filers are obligated to adapt these standards by December 15, 2019.

What changed in the guidance?
There are three significant changes related to CECL since its introduction:

- “Probable” threshold eliminated – the standard moves from the previous incurred-loss model, which identified impairment to be “more likely than not”.
- Lifetime expected credit losses – the standard moves to an expected-loss approach, which requires the full amount of all estimated credit losses projected over the life of the financial asset to be booked up front
- Use of “reasonable and supportable forecasts – the institution must document their projections of what will happen over the next few years.

For institutions generally under $2 billion in net assets, without a significant number of unusual or high risk credits, it is my opinion that the new guidance actually aligns closer to the current methodology utilized in establishing the allowance for loan losses (ALLL). As such, building upon existing processes and reporting likely makes the most sense.

What will change on the ALLL methodology?
The answer – it depends.

The new standard does not require a specific method for establishing the estimate. However, the methodology will likely include various components including historical charge-off rates, current

conditions and supportable forecasts. There have been several models recommended including

- •Discounted cash flows analysis
- •Average charge-off method
- •Vintage analysis
- •Migration analysis
- •Probability-of-default method
- •Regression analysis.

Since no specific model is required, it is my belief that using a complicated method, such as regression analysis or discounted cash flows analysis, could easily obfuscate the process and weaken its effectiveness. A complicated approach is likely only necessary with complicated loans that do not fit into a pool of loans with common risk characteristics. The guidance notes in Section 326-20-55-3 that "historical loss information generally provides a basis for an entity's assessment of expected credit losses." Therefore, the current models used by most banks based on historical loss information adjusted by qualitative factors such as trends in economics, risk, management and growth, is the proper starting point.

The new CECL guidance focuses on reviewing loans in pools that have common risk characteristics, which could include loan type, geography, term, age, industry or size. Any assets not sharing common risk characteristics for a pool will need to be assessed on an individual basis. That means that the traditional groupings of commercial real estate, residential real estate, commercial and industrial, and consumer loans may not satisfy the CECL requirements.

The next steps include organizing the loan types into pools with similar characteristics and verifying that the information can be pulled in a manner that easily identifies the outstanding amounts within the individual pools. Start by looking at the largest loan groupings and ask if there are natural subgroups within the category.

Assets that do not share common risk characteristics for a pool need to be assessed on an individual basis. This means high risk loans, including loans classified as impaired or substandard, and any unusual loans that cannot be pooled based on common risk characteristics, will be evaluated on a loan by loan basis. Loans that cannot be pooled will often carry a higher risk profile and have a larger allowance placed on the asset balance.

Your Action Plan

Based on our experience with more than 50 community banks and conversations with many of them on CECL, here are our recommended first steps: (graphic of three interlocking circles)

- •Form an implementation team
- •Create a plan with milestones
- •Begin reviewing and retaining data

The Team - First and foremost, this is not a one or two person project. The implementation team will require ideas and authority from multiple disciplines including finance, lending, and technology. At a minimum, the team should include the CFO or equivalent, with knowledge of accounting issues; the chief credit officer, with a deep knowledge of the loan portfolio and related risks; and a chief technology officer to assist with gathering and retention of data. We recommend documenting the members of this team, including their skills and roles on the team. This will provide some evidence for the Regulators should they request your CECL plans.

The Plan – While most people in the industry have heard countless presentations on the subject of CECL, many have a “wait and see” attitude and have done little to start down the implementation path. Key issues here are to know your implementation deadline, which varies whether you are considered a Public Business Entity (PBE) or not. You need time to test the data and make alterations. Ideally, you want a final model for validation a full year prior to implementation.

The Data – Start with what you have and build on it. The historical loss model currently in use, for example, should suffice for most community banks, if properly adjusted for new requirements and documented.

Recommendations Moving Forward

Our best recommendations are to stay calm and try not to build a model so complicated that it cannot be reasonably maintained.

1. Start planning for CECL now. Gather the right people, including financial, lending and IT, to plan your strategy for implementation. Areas to discuss include the breakdown of loans into common risk pools, which methodologies make the most sense by group, and what data is currently available as well as additional data that will be needed to properly document the information required, including risk pools, historic losses, forecasts and related allowance.

2. Be realistic in the current starting point of historical losses, including any additional losses that were incurred during disposition of other real estate.

3. Clearly document the thought process related to the qualitative adjustments for current conditions, which is likely the most important area of the model, and should include internal risks (lending strategies and underwriting practices) and both micro and macro external risks (industry issues, business environment, geographic and economic risks, and other market conditions). Gather and maintain your support as you go, so there is an audit trail for both the regulators and your auditors.

4. Lastly, don’t get trapped by the “crystal ball” notion of peering into the future. The guidance clearly states the use of “reasonable and supportable forecasts” so avoid trying to create something you are not meant to create.

This regulation, like the legions before it, could present challenges for some financial institutions, yet they are not insurmountable. Advance planning and a measured approach will help banks navigate this latest regulatory hurdle, now and into the future.

Daniel St.Clair is an Audit Director in Briggs & Veselka’s Financial Services group, where he consults with community banks, de novo banks, credit unions and other lenders on financial reporting matters. Contact him at dstclair@bvccpa.com. The opinions expressed within are strictly his own; banks should engage legal and accounting professionals to tailor the CECL approach most appropriate for their circumstances.

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The Briggs & Veselka Banking Practice

Fast Facts

- One of the largest financial services practices in Texas, offering sophisticated operations consulting in addition to audit and tax compliance
- The Briggs & Veselka team consists of former bankers, regulators, internal auditors, loan review professionals and consultants, delivering practical solutions based on actual financial services experience
- Insights into the unique aspects of banks, credit unions, mortgage companies, investment companies, and other financial services organizations
- Team professional designations include Certified Bank Auditor, Certified Internal Auditor, Certified Financial Services Auditor and CPA

Services for Community Banks

Tax Planning & Compliance
- Federal Tax Returns
- State Tax Returns
- Estimated Payments

Audit & Attestation
- Financial Statement Audit
- Director's Examination
- Supervisory Audits
- SSAE 18 Engagements
- Employee Benefit Plan (401k) Audits
- FFIEC (Federal Financial Institutions Examination Council) Information Technology (IT) Reviews
- Trust Audits

Business Advisory
- Internal Audit Outsourcing/Co-sourcing
- Regulatory Compliance Audits
- Bank Secrecy Act/Anti-Money Laundering Audits
- Outsourced Loan Reviews
- ALM/ Interest Rate Risk Audits
- ACH Audits; Penetration Testing and Network Vulnerability Scans
- Sarbanes Oxley (SOX) Compliance
- Consulting Services
- De Novo Application Process Assistance
- Development of Policies and Procedures
- Fraud Investigation
- Enterprise-Wide Risk Assessment
- Regulatory Liaison
- Loan Portfolio Stress Testing
- Risk Assessments
- System Conversion Consulting