CECL: A Deeper Dive

CrossCountry Consulting

1 WHAT IS CECL?

In the wake of the financial crisis of 2008-2009, the FASB reassessed its current impairment model to address stakeholder concerns regarding the delayed recognition of credit losses attributable to the incurred loss model. The long-awaited revised standard was issued on June 16, 2016 as Topic 326 Financial Instruments—Credit Losses, or more affectionately known as CECL (the Current Expected Credit Loss) model.

2 CORE CHANGES

The application of CECL may be the biggest fundamental change ever made to financial institution accounting. For the last four decades, U.S. GAAP has applied the incurred loss model for recognizing credit losses on loans, receivables and debt securities. Under the incurred loss model, a loss is not recognized until it is probable that the loss-causing event has already occurred. **CECL replaces the current incurred loss model with a forward-looking expected credit loss model** that requires an estimate of the expected credit losses over the life of the instrument.

3 MEASUREMENT

The new standard increases the volume of information to be considered when establishing the Allowance for Loan & Lease Losses and recognizing credit losses. Below is what the new estimate of expected credit losses should and should not include:

INCLUDE

- Past loss experience
- Current conditions
- Supportable forecasts of future events
- Estimates of prepayments
- Allowance for expected credit losses at each reporting date

DON'T INCLUDE

- Forecast losses beyond the reasonable/supportable forecast periods

Favorable and unfavorable changes in expected credit losses are recognized in current period income. The allowance is presented separately on the balance sheet as a reduction to the amortized cost basis of the related assets. Credit losses are measured on a pool basis when similar risk characteristics exist.

SIMPLIFYING THE ACCOUNTING

OLD GAAP

ASC 320-10 Investments-Debt/Equity Securities
ASC 310-10 Receivables-Individually Impaired
ASC 325-40 Investments-Beneficial Interests
ASC 310-30 Receivables-PCI Assets
ASC 450-20 Contingencies-Losses

NEW GAAP

ASC 326 Financial Instruments - Credit Losses

AFS DEBT SECURITIES

(Impairment Approach Revised)

- No change to credit loss measurement
- Under CECL, impairment recognized through an allowance (consistent with the application of CECL to other assets)
- New standard permits immediate reversals of credit losses through income upon improvement*
- Credit loss limited to the difference between the amortized cost basis and fair value and cannot be written down below its fair value
- No longer consider the length of time that FV below AC
- Continue to calculate impairment at the security level

**There may be potential differences between recoveries of pre-existing impairments and post-adoption incremental improvements of forecasted expected cash flows.*

SCOPE OF CECL CHANGES

IN

- Loans
- Trade receivables
- Debt securities classified as HTM
- Loan commitments
- Financial guarantee contracts that are not accounted for as insurance
- Net investment in leases recognized by a lessor
- Reinsurance receivables
- Purchased credit-deteriorated assets*
- Receivables related to repurchase and securities lending agreements

OUT

- Equity investments
- Debt securities classified as AFS
- Financial instruments measured at FV through net income
- Loans and receivables between entities under common control
- Financial guarantee contracts that are accounted for as insurance
- Operating lease receivables

**Record allowance at purchase and gross up asset basis to reflect the expected credit loss estimate. No income statement impact on day one.*

5 STEPS TO A SUCCESSFUL CECL IMPLEMENTATION

1 Corporate Governance & Project Management
- Establish a cross functional project team
- Coordinate early with Risk Management and Internal Audit
- Develop an understanding of Topic 326 CECL
- Perform high level assessment of accounting changes/impact
- Establish a plan for impact assessment, implementation and disclosure

2 Accounting Impact Assessment
- Identify necessary changes to the reserving process and calculations
- Review, update and document key accounting policies and policy decisions
- Ensure that methodologies produce results consistent with the standard
- Identify in-scope assets
- Determine appropriate level of portfolio segmentation

3 Model Evaluation
- Document drivers of credit loss and change
- Inventory data availability and define data requirements
- Assist with model software selection, as necessary
- Perform validation of model calculations
- Prepare and verify data used
- Perform sensitivity and what-if analyses
- Adequate analysis and recalibration of parallel runs

4 Re-Examine Processes & Controls
- Assess and update existing processes, systems and internal controls
- Consider controls over external data used
- Apply greater scrutiny over credit data and processes not previously audited

5 Optimize Efficient Implementation
- Produce a client-focused CECL playbook by portfolio
- Document basis for management judgments and assumptions
- Plan for expanded financial reporting and disclosure
- Strengthen documentation of credit loss drivers
- Benchmark against emerging industry practices

CONTACT US

Keith Linhart, Partner
703.989.1285
klinhart@crosscountry-consulting.com

CECL DATA CONSIDERATIONS

An organization's data needs will be impacted by their selected approach to implementing CECL, the complexity of the portfolio, the size of the entity, access to information and management of the portfolio. In addition, IT systems may need to be upgraded or modified to capture additional data to support the accounting and disclosure requirements.

Reasonable & Supportable Forecasts
- Will you use external data? Consider the source.
- Are your CECL forecasts consistent with other forecasts and assumptions used internally?

This will increase the complexity of forecasting for multi-regional banks, or banks that have a multi-regional lending strategy.

Data Needs
- Do you need to capture additional data?
- Do you need to retain data longer than in the past?
- What is the quality of the data?
- Where is the data stored?
- How will you get the external data?

The amount and quality of information will impact your ability to come up with a stronger, more supportable and manageable reserve figure

Data Culture
- Can you rely on the data you have today?
- Do you have access to data you'll need for compliance?
- Will your data controls pass an accounting and regulatory audit?
- Do you have the data governance, quality control, analytics, security and systems functionality you need to deal with CECL?

CECL Modeling
- Model selection: Create in-house or buy third party solution?
- Do you have the data management processes and the data availability to use an in-house solution?
- Do you have the modelling expertise necessary to build and analyze an in-house solution?
- Where do you want to be on the model cost vs sophistication spectrum?

THESE CONSIDERATIONS SHOULD BE EVALUATED NOW

Sample Data Needs
- Loan pooling data
- Data supporting life of loan assumptions
- Data needed to adjust historical loss rates when making future loan loss projections
- External forecast data applied in assumptions
- Data supporting est. losses on unamtzd discounts or premiums on HTM securities

STANDARDS IMPLEMENTATION TIMELINE

	2019	2020	2021	2022	2023	2024	2025
CECL	Early Adoption (1/1/19)	SEC Filers *Excluding SRCs* (1/1/20)			Non-SEC Filers *Including SRCs* (1/1/23)		
Revenue Recognition	Non PBEs (1/1/19)						
Leases	PBEs *Including SRCs* (1/1/19)		All Others *Annual Periods* (1/1/21)	All Others *Interim Periods* (1/1/22)			
Insurance				SEC Filers *Excluding SRCs* (1/1/22)		All Others *Annual Periods* (1/1/24)	All Others *Interim Periods* (1/1/25)

Major accounting changes headed your way. Make time for CECL now!

SRC = Smaller Reporting Company as defined by the SEC