CECL: Dos and Don’ts

Presented by Bill Lee

Learning Objectives

- Review and understand guidance surrounding CECL
- Review common methodologies used by banks
- Discuss implementation challenges and practical tips

Who Am I?

Bill Lee, Chief Credit Officer & Chief Lending Officer

- Over 28 years in banking
- Holds a degree in American History & Pure Mathematics from John Brown University as well as a bachelors in accounting from NSU
- Previously taught at the Graduate School of Banking at the University of Colorado for three years
- Regularly teaches courses with the OK Bankers Association
- CPA Aspirant

Historical Context: ASC 310 (Pre-CECL)

- Before ASC 326 and CECL, financial institutions recorded their reserve for loan losses using the Incurred Loss Model.
- This method required that reserves only be recorded once a loss became "probable".
- The wiggle room afforded by this method and lack of forward-thinking often resulted in a "too little, too late" outcome.
- Separate from ASC 310 and ASC 326, there should also be a separate allowance for specifically identified problem loans.

Overview: What is CECL?

- Stands for Current Expected Credit Loss and applies to loans, HTM securities, trade receivables, and off-balance sheet exposures.
- Loans are still reported at their amortized cost less any allowance for anticipated losses.
- Requires financial institutions to apply a forward-looking approach, recognizing the anticipated lifetime losses rather than as they become probable.
- Per ASC 326-20-30-3, the allowance for credit losses may be determined using various methods. Currently there are no preferred methods outlined in the FASB’s guidance.

Comparison: CECL Versus Incurred Loss Model

CECL:

- Recognize lifetime expected credit losses on day one of asset recognition.
- Explicitly requires reasonable and supportable forecasts of future economic conditions.
- Much broader data requirements.
- More volatile from one quarter to the next, but more reflective of economic conditions.
- Higher baseline allowance, but recognition of losses is smoother from one period to the next.

Incurred Loss Model:

- Recognize credit losses only when probable that a loss has been incurred.
- Based primarily off historical experience and management's judgement.
- Only data requirement is historical charge offs.
- Tends to lag actual credit losses with greater spikes during downturns.
- Lower allowances during good times with greater spikes during downturns.

Presentation & Disclosure Requirements

- Financial assets measured at amortized cost (loans) are presented net of any allowance for credit losses.
- Estimates of an off-balance sheet credit loss should be recorded as a liability on the balance sheet. This allowance is calculated separately from the traditional loan pool.
- If a discounted cash flow method is used to calculate the allowance, an entity is allowed to report the entire change in the present value as credit loss expense (or reversal of credit loss expense).

Presentation & Disclosure Requirements Cont.

- In general, the notes to the financial statements should include information that allows the user to understand the following:
  - The credit risk inherent in a portfolio and how management monitors the credit quality of the portfolio. This includes both the related qualitative and quantitative risks.
  - Management’s estimate of expected credit losses
  - Changes in the estimate of expected credit losses that have taken place during the period.

Common CECL Methodologies - Historical Loss Rate

- This method uses the average historical loss rates on similar loan pools to estimate expected credit losses.
- While simple, this method could make the most sense for smaller portfolios where charge offs have historically been linear and/or consistent.
- Adjustments are also made based on current conditions and forecasts.

Common CECL Methodologies - Vintage Analysis

- This method measures and tracks loan performance based on the origination period to estimate lifetime losses.

- Tracks performance by origination year, resulting in a strong life-of-loan origination.

Common CECL Methodologies - Discounted Cash Flow

- This method estimates losses by projecting expected future cash flows for each loan and discounting them at the effective interest rate.
- This figure is then compared to the outstanding balances and collateral values to determine the expected losses.
- Best for individually evaluated loans as opposed to evaluating a portfolio.

Common Challenges and Implementation Considerations

- Having no preferred method designated by the FASB creates challenges:
  - Financial institutions are left on their own to “figure it out” and hope that their regulators/auditors agree with their practices.
  - Audits/regulators have very little consistency with what their auditing from one entity to another, creating the need to “start over” with each client.
- The data requirements make it much harder for smaller entities to comply with this new requirement. Banks with $1B in total assets have the same requirements as banks with <$100MM.
- The subjectivity found throughout the process leaves ample room for error or financial manipulation, while also making it more difficult for regulators and auditors to uncover issues.

What Are Regulators Looking For?

- Supportable assumptions
  - Because the guidance doesn't prescribe any specific set of methods, if it can be logically defended, validated, and is well documented you've likely checked all the boxed.
- Internal controls
  - As the reserve holds the greatest concentration of risk on a bank's financial statements, it is important to implement and maintain solid internal controls.
- Governance
  - Each relevant member of management should have a basic understanding of, and agree with, how the allowance is calculated.

Thank You!