Smiling About ALLL With CECL In Mind

CECL

Hey, if you want to be happy in life, there are some things research shows you should do. These include spending 25% of your time each day socializing with friends and family; staying healthy (about 20% happier than average); spending 20 minutes outside when the weather is good; exercise; trying to eat poultry, fish, bananas and drink milk; getting enough sleep and trying to have 5 positive experiences for every 1 negative experience.

Now that you know what to do to be happy in life, we pick up where we left off yesterday to try and keep your team happy about CECL. As we noted, all banks are gearing up and there are many elements of this new accounting approach to take into consideration. The first of which is how your current ALLL system will serve you in the transition. Some quick questions to answer here are whether it will provide you with the forward-look you need and whether it provides the broader scope of data required.

If you are like many community banks, you may do your allowance for loan and lease losses (ALLL) using a loss by asset class approach or grade migration. Some even may use a dual grade model with probability of default (PD) and loss given default (LGD). No matter the approach, things will be changing.

For instance, the first two options just outlined are simple to use and implement, but they will not provide the depth or complexity needed for CECL. Using future controls to create scenarios for forward-looking forecasts is important, so you will need to be sure to account for that.

As you do, know that the future is not the only way you are asked to view your assets. Your scope needs to include historical data with a longer look back under this new approach. The expectation is to use a variety of methods and historical periods to see how they each impact the forward looking forecasts.

Further, if you are going from loss by asset to grade migration, you will need to look at potential defaults and not just potential losses. The default rate on a loan that is Grade 3 might be worse than Grade 4 (since you comingle PD and LGD which can skew the results). As such, remember to account for such differences. Further, the anticipated changes from these different views and scenarios as well as the degrees of change based on distortion risk will also be needed in your ALLL system for CECL.

If the review of your current system is showing that it is not robust enough for some of the requirements under CECL, you will need to dig deeper into what changes you will need to make.

Finding out whether you need more granularity, a broader time range, or other elements are all important.

Most likely, bankers will need to supplement existing ALLL systems in some way. However, bankers are already addressing many of the questions CECL will ask. So, a roadmap to successful implementation includes identifying the changes needed, having a plan in place for these changes to happen, starting to work on the steps to make them happen, and verifying the changes before the deadline.

We know this is a lot to digest. So, it is important that you have your examiners and accountants review your ALLL system features and outputs based on the new guidelines of CECL. Then, your team can be sure any recommendations are incorporated. This is a marathon and not a sprint so you have time, but it is important to start the process. When you do, know that you certainly don't need to have all the answers.