Frequently Asked Questions:
CECL for Financial institutions

What is the current expected credit loss (CECL)?

Current expected credit loss (CECL) is a new GAAP accounting standard that will change how depository financial institutions of any size will account for expected credit losses. CECL requires financial institutions to record "life of loan" loss estimates at origination or purchase. This will replace the current "incurred loss" (ICL) accounting approach.

CECL eliminates the requirement to defer the recognition of credit losses until a loss is probable; consequently, applying this model will result in earlier loss recognition. All banking regulators have indicated that CECL is intended to be scalable for all depository institutions, regardless of their asset sizes.

When will this new accounting standard take effect?

The CECL standard, instituted by the Financial Accounting Standards Board (FASB), will take effect in Q1 2020 for financial institutions that are registered with the SEC, and in Q1 2021 for financial institutions that are not registered with the SEC. Bank that are not considered public business entities (PBEs) will have to file a CECL-based call report by December 31, 2021. Any financial institution can adopt the CECL standard early, beginning in 2019. Regardless, it is important for financial institutions to begin planning for the CECL transition immediately.

Why is FASB making the change?

In response to the global economic crisis, FASB, including various stakeholders, determined that the current approach used for measuring impairment of financial assets, the ICL model, delays the recognition of credit losses and overstates assets. The ICL model does not permit a loss that is recognized until it is determined that a loss is both probable and estimable. This process limits the loss estimate to current, objective evidence and ignores future expected events. As a result, incurred loss estimates serve more as a lagging indicator of impairment losses than a leading indicator of expected asset performance.

Why is CECL important?

According to federal banking regulators, CECL will not only affect how institutions calculate credit loss reserves, but also how organizations fundamentally manage their allowance for loan and lease losses (ALLL), and organizational processes for both finance and risk management.

The scope of these changes can be substantial depending on the complexity of the balance sheet. The changes required by CECL involve a much deeper level of modeling, analysis and reporting than what has previously been required. These are significant changes for institutions as they will need to manage risk and financial data, build analytic platforms and share information between departments. The impact of the CECL standard is expected to be significant.

What changes are expected?

As mentioned previously, with CECL, FASB will remove the probable and incurred criteria under current guidelines and replace them with a lifetime expected credit loss concept. CECL will extend the timeframe covered by the estimate of credit losses by including forward-looking information, such as “reasonable and supportable” forecasts, in the assessment of the collectability of financial assets.

The CECL model will institute a single credit loss model for all financial assets, both loans and securities carried at amortized cost. This means that CECL will change the accounting for the allowance for loan and lease losses associated with held-for-investment loan and lease portfolios, as well as the other-than-temporary impairment of held-to-maturity securities.

How does the new CECL approach treat the life of a loan?

CECL requires that financial institutions record "life of loan" loss estimates for unimpaired loans at origination or purchase. This replaces the current "incurred loss" accounting model, and it poses significant compliance and operational challenges.

Financial institutions that hold loans (and securities) with maturities beyond the next year or two will be particularly affected by CECL. Many hold large allocations of assets with longer maturity dates - usually arising from real estate loans. This adds to the complexity of the calculation. For example, since real estate loans have maturities of 10-30 years, and borrowers often want the ability to pay off or refinance these loans early, this prepayment optionality must be included in valuing the loan life.

How will this impact single-family loan calculations?

For real estate loan calculations, financial institutions will need to look at a number of different factors to create an accurate life of loan. Specifically, they will need to use their historic data to determine historical prepayment rates. To properly value optionality embedded in the life of a loan, many will need to break them into distinct coupon groups to most accurately measure optionality (just like they do when they measure interest rate risk). The challenge facing financial institutions is both gathering and analyzing this data and determining how many similar groups should be modeled and which methods under CECL work best. Additionally, real estate and other loans with balloon payments will likely need to be separately grouped as balloons may alter both prepayment and default/loss expectations.

How do I start and prepare for the process?

Financial institutions need to start to prepare for CECL today. The first step that PCBB helps institutions with, as part of its comprehensive solution, is assessing their historical data and determining what data they need and what data they do not need. Organizations also need to get multiple departments involved in the CECL preparation. It can't be left to one department, individual or piece of software alone.

How does my management team prepare for CECL implementation now?

Although implementation of CECL is more than two years away for many institutions, the time to start preparations is now. Financial institutions are preparing to be CECL-compliant, which means they need to collect the appropriate data, select the appropriate methods, test assumptions robustly, and create comprehensive documentation. Financial Institutions need to consider the type of data required to make a lifetime loss estimate. Many financial institutions may not have collected and stored the type of information and data that may be necessary to perform the loss and life of loan analysis required for the CECL models.

Everyone should use this interim time until implementation to review these changes with external auditors and regulators, as they prepare for implementation. It is important to consider the type of modeling methodologies that might be appropriate for different loan portfolio types as well as the data requirements for the different methods. This includes reviewing accounting and servicing systems across multiple departments to determine whether the institution is able to capture the necessary data for CECL's implementation. Getting an early start is particularly important if the institution will need to adjust data collection practices, modify its internal controls, or update its IT systems to prepare for implementation.

Can I wait until 2019 or 2020?

Federal bank regulators suggest everyone should be looking into CECL now, and will add further scrutiny beginning in 2018. Rather than waiting until closer to implementation deadlines, PCBB's recommendation is to begin preparing now by examining various methods and archiving loan-level data. The more time you have to understand the various allowable methods and analyze your data, the more options you may have to select the ideal methods for CECL.

How much work will be required in 2018 through 2019?

There will be a substantial amount of work required during the interim period before implementation. Specifically, the following steps should be completed:

- Inventory available data inputs
- Analyze data (repayment terms, default and loss history, changes in underwriting and grading, etc.)
- Determine workarounds for missing loss history vs. asset life
- Identify similar loan groups and check to see if sufficient information is available to use
- Test each method (do the calculation) to understand data requirements and determine if a method produces meaningful results
- Choose methods for each similar group by its unique characteristics
- Generate results including sensitivity analysis around key assumptions (prepays, migration, rising/falling past-due/non-accrual)
- Determine the financial impact of the method(s) used
- Vet findings with management, board of directors, auditor and examiners
- Run parallel until cutover

Will the analysis be different for community banks, thrifts and credit unions?

The short answer is no. FASB rules apply to all institutions equally. The analysis required will also be the same. The only differences that will likely exist in the end will be with respect to the definition of similar loan groupings as well as issues related to determining life of asset.

What issues will community-based financial institutions specifically face?

Community bankers, which traditionally focus on real estate finance, will need to do additional work with respect to loans that lack highly similar repayment characteristics (CRE and Multifamily versus Single Family). Many times, commercial real estate transactions are referred to as deals versus loans, which would be an indication that they lack similar repayment characteristics, and thus will need to use component versus loss rate methods.

What staff do I need and how much time should it take?

Time requirements for CECL will be more than your current process as you will need to integrate the life of loan component into the measurement as well as adding an overlay for the forward look component. The amount of additional time will vary depending on the complexity of the portfolios [longer dated and structured loans (balloons) will require additional time versus shorter term fully amortizing loans]. Additionally, if HTM securities are present, they will need to be valued as well, for both default/loss risk as well as any embedded optionality (prepayments, call, puts and other structures).

What changes to staffing, or communication, should I be considering?

Financial institutions need to involve numerous departments from the C-level down to risk and compliance. Typically, individuals involved will come from the following areas:

- Credit: CCO and loan operations
- Finance: CFO and controller
- IT: CIO and DBA's

Under CECL, these individuals will need to work as a team, but management should identify a single person to lead the group. Given this is an accounting rule and the CFO will be signing off on the financial statements, the CFO is the logical candidate to lead the group.

How can PCBB help?

PCBB provides an end-to-end SaaS solution to financial institutions. This eliminates the need for time-consuming software installation, training and ongoing operations. Additionally, PCBB's CECL solution provides simultaneous results for multiple methods, allowing financial institutions to move seamlessly to alternative methods when conditions warrant. PCBB built its solution based on decades of risk management expertise in the areas of ALLL, ALM (life of loan) as well as lessons learned assisting community financial institutions in their navigation through the last financial crisis.

From the start, PCBB collaborates with institutions to guide them through the CECL integration. As a bank, PCBB understands the important nuances of CECL from a financial institution's perspective, including proper portfolio segmentation to match loss methods used, development and application of optionality assumptions that affect the determination of the life of loan, as well as the ongoing evaluation of portfolio segmentation which will likely change over time.

PCBB provides institutions with the ability to move their data and information to a flexible web application that is independent from the core system. Our SaaS solution permits the calculation of time series analysis necessary for both loss rate under the multiple methods as well as historical prepayment rates, which are necessary to determine life of asset. Additionally, this platform supports other complex analyses needed for both qualitative factors and the forward look.

How does PCBB work with me to determine the optimal approach for CECL integration?

As financial institutions prepare to be CECL-compliant, they will need to navigate through the process of inventorying and collecting the appropriate data. This includes analyzing the information to determine proper portfolio segmentations, testing various CECL methods to determine which methods best match each portfolio's segmentation, testing assumptions robustly, generating results and determining financial impact, if any, and then vetting those findings with management, board of directors, auditors and examiners, along with creating comprehensive documentation.

PCBB's consulting team of financial service experts works with institutions to help them through these processes to determine the optimal roadmap for CECL implementation.

Which methods are supported?

PCBB's CECL solution is the only offering to run all methods simultaneously – static pool, vintage analysis, average charge-off, roll-rate (migration), probability of default, discounted cash flow and regression analysis. This allows financial organizations, with PCBB's assistance, to mix and match these different methods for various portfolio segments to determine the optimal result. Additionally, this flexibility permits a seamless transition from one method to another as economic conditions warrant.

What are the benefits of using a SaaS CECL service?

An end-to-end SaaS solution eliminates the need for time-consuming software installation, training and ongoing support and maintenance, while providing business continuity as well as maintaining required documentation to support model governance and validation. Additionally, PCBB's CECL Solution provides simultaneous results for multiple methods, allowing financial institutions to move seamlessly to alternative methods when market conditions warrant.

Along with our team of PCBB banking experts, we deliver a seamless solution, migrating from ICL to CECL that provides benefits, including:

- Maintaining an end-to-end SaaS solution with no software for the user to maintain
- Providing the ability to mix and match methods for differing portfolio characteristics
- For maximum benefit, historical data is maintained independently of your core data
- On-demand, comprehensive documentation that meet and exceed regulatory and financial requirements
- Ongoing support and insight from PCBB banking and data experts from setup, to design, calculation, reporting and assistance with auditors and regulators

How is the depository financial institution ecosystem supported?

PCBB's CECL Solution provides board-level, CFO, CCO and management insights. Additionally, all reports support an open and transparent audit trail of all calculations and results. These reports quickly and efficiently provide documentation on the nature of the loan, performance, cash flow, views, loss calculation and peer comparison. Additionally, information can be extracted to support any one-off request from auditors and examiners.

Who is PCBB?

PCBB was created with the sole purpose of helping community-based financial institutions become stronger. Our goal was to create an organization that could provide fellow bankers with high-quality, competitively-priced correspondent banking solutions and personalized service. PCBB provides a comprehensive set of products and services covering multiple areas, including: correspondent and commercial banking, hedging, and international. PCBB also offers a variety of consulting services ranging from asset liability management, relationship profitability, loan reserve analysis, and stress testing. Our services are designed to help financial institutions compete more effectively, but we never compete against you for your own customers.

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Call to Test Drive our CECL Solution

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