

June 2016

Adapting to CECL

Part I: Identifying portfolio risks

An article by Michael J. Budinger, CAMS, and Ryan A. Michalik, CRC

The new Financial Accounting Standards Board (FASB) standard for estimating expected credit losses has been called “the biggest change in the history of bank accounting.”¹ In addition to changing the way they calculate the credit impairment, entities will need to make significant process changes in the way they collect data and must adapt their existing technology, financial models, and governance structures to be consistent with the new standard.

This series of articles outlines a comprehensive approach to help adapt to these far-reaching changes and successfully make the transition to the new standard.

The current expected credit loss (CECL) standard removes the “probable” threshold for loss recognition and requires institutions such as banks, insurance companies, finance companies, and credit unions, to calculate credit impairment using a more forward-looking approach to take into

account expected losses over the lifetime of a financial asset. Determining the lifetime of a financial asset is not always clear-cut because institutions may have to factor in expected prepayments (or anticipated troubled debt restructurings) to the estimate.

More than an accounting issue

The impact of the new standard extends far beyond accounting and financial reporting alone. The credit management function is directly affected as institutions must continue to actively monitor, analyze, and manage their portfolios in a way that improves income and maximizes capital efficiency, even as they adapt their reserve calculation policies and processes to accommodate the new standard.

The new standard also directly affects credit risk management programs including risk assessment, credit recommendations, and related structural and operational components. Institutions also must reassess their model risk management approaches and implement new processes that address the changes to adopt a CECL model.²

Above all, adopting a CECL model to comply with the new standard may require much more data gathering than was required for previous credit impairment calculation methods. Institutions may have to consider the need to redefine their data management requirements to include more robust portfolio data, borrower and economic data, exposure-level data, historical balances, risk ratings, charge-off and recovery data, and appropriate peer and industry data.

A program for managing the change

For institutions that meet the FASB's definitions of a public business entity (PBE) and a Securities and Exchange Commission (SEC) filer,³ the new CECL standard goes into effect for fiscal years beginning after Dec. 15, 2019, including interim periods within those fiscal years. PBEs that are not SEC filers must be in compliance for fiscal years beginning after Dec. 15, 2020, including interim periods within those fiscal years. All other institutions, including not-for-profit organizations and employee benefit plans, are required to comply for fiscal years beginning after Dec. 15, 2020, and for interim periods within fiscal years beginning after Dec. 15, 2021.⁴

Many smaller institutions are likely to find that many of the new model and data requirements are more robust than those they customarily have employed. But even large, national institutions could find themselves struggling to comply with all of the new standard's requirements in time to meet the deadlines.

Although no simple solutions exist, it is possible to outline a comprehensive program to assess the challenges and begin planning for the changes the new standard requires over the next few years. At the highest level, such a program would be composed of five components, as illustrated in the exhibit.

Exhibit: Making the transition to a CECL model

RISK IDENTIFICATION

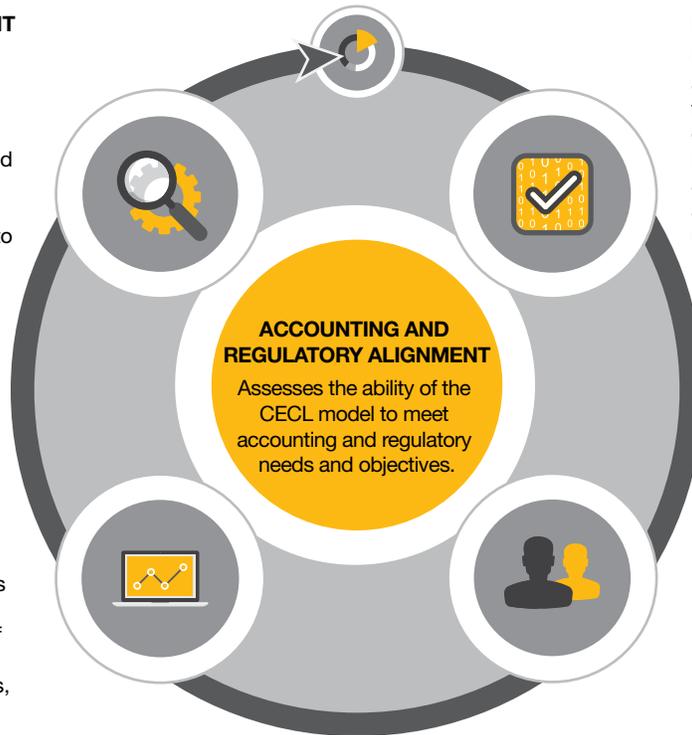
Understanding portfolio characteristics and drivers of portfolio performance, including lending attributes, loan structures, prepayment risks, and changes in the macroeconomic environment. This component will enable the bank to appropriately segment and model the portfolios based on common drivers of risk.

GOVERNANCE AND OVERSIGHT

Understanding risk management practices surrounding the development, execution, and maintenance of the CECL model. This includes established roles and responsibilities of the board and senior management, as well as policies and procedures in place to articulate the expectations of the CECL model and ongoing execution of the model.

DATA INVENTORY

Understanding the availability and limitations of data required to develop and maintain an effective CECL model. This includes the reliability and accuracy of data elements in addition to the historical time horizon of data availability.



ACCOUNTING AND REGULATORY ALIGNMENT

Assesses the ability of the CECL model to meet accounting and regulatory needs and objectives.

ENABLING TECHNOLOGY

Understanding the existing systems, including the capabilities and limitations of those systems that may support the execution of the CECL model. This includes source systems, data warehouses, modeling systems, financial statement spreading software, and vendor technology specially designed for CECL.

RESOURCE CAPABILITIES

Understanding the capabilities and limitations of the human resources identified to develop and execute on the CECL model.

Source: Crowe analysis

Although these five components will be addressed sequentially in this series, they are not necessarily five steps in a linear process. Many of the activities will occur

concurrently. Nevertheless, it is logical to begin with the one component that is most overtly preparatory in nature: risk identification.

Risk identification – understanding the portfolio

Before developing new models or transforming existing models to be compatible with the CECL standard, it's a good idea to take a step back and consider the major types of risks that can affect portfolio performance. Comprehensive risk identification can help the management team gain a better understanding of the model methods and types of data that will be required.

The various risk factors within the portfolio could be organized and segmented in a number of ways, but for initial risk identification purposes, the following five broad categories can provide a useful structure:

It's a good idea to take a step back and consider the major types of risks that can affect portfolio performance.

1. Attributes and characteristics.

This category of risk factors includes the basic financial asset types, collateral, credit scores or credit rating, loan purpose, size, geographic location, age, effective interest rate, industry of the borrower, and economic conditions and underwriting policies that were in effect at the time of origination (or "vintage"). While previous credit impairment calculation methods also required such segmentation and pooling, the CECL-based model may require additional detail and granularity to capture the lifetime risk of loss.

2. Structures.

Financial assets, frequently loans but also securities, may be segmented according to their structural features, such as repayment and amortization schedules and maturities. This categorization can be somewhat difficult in a commercial loan portfolio because commercial lenders typically have more latitude for customizing terms to meet specific situations. Most institutions already have a fairly clear picture of their portfolio's structural characteristics, but under the new CECL standard they can expect additional scrutiny to determine that their credit impairment calculations are based on appropriate segmentation and risk identification.

3. Prepayment speeds.

Because the CECL standard considers expected losses over the life of the financial asset, prepayment risks may take on new importance. The prepayment speeds that are used for asset liability management purposes – especially those provided by a third party – might not be suitable for credit impairment calculations because they are based on industrywide factors rather than being calibrated to reflect the institution’s own portfolio, or they take a macro-portfolio segment view that may not represent the new CECL pooling characteristics. Many small to midsized institutions might consider developing the discipline of estimating and monitoring prepayment speeds internally, at the desired segment levels.

4. Macroeconomic risks.

Unlike the incurred loss models, which often estimated projected losses based on a recent lookback period, the CECL standard allows forward-looking projections over a much longer time period. Institutions can forecast not only what types of conditions are likely to occur but also what effect those conditions could have on portfolio performance. These often are inherently qualitative judgments, but to the extent management teams identify and track portfolio performance to key economic variables to better understand the relationships and impact, these projections will provide institutions with stronger factual evidence to support their assumptions. Going one step further,

developing a framework that encourages a consistent and repeatable process to assess economic conditions also will support the forward-looking estimations.

5. Other policies and practices.

Unlike external economic conditions, changes to credit policies, credit review systems, and loan servicing practices are risk factors that are controlled by the institution itself. It is important to understand the impact these actions may have had on portfolio behavior and performance. Being aware can help determine how to best segment or how to gauge which historical time periods to use as a basis for modeling.

Next steps in the transition

Accurate and comprehensive risk identification always has been an important element of credit impairment calculation. The adoption of the CECL standard means a more defined risk identification process is now in order, as part of the overall effort to support the potentially more complex models that may be employed.

Subsequent articles in this series will examine other components of the transition process including the identification of necessary data sources and capabilities, requirements for resources and technology, and the adoption and modification of appropriate governance and oversight structures.



Learn more

Michael Budinger is a principal with Crowe and can be reached at +1 216 623 7517 or michael.budinger@crowe.com.

Ryan Michalik is with Crowe and can be reached at +1 630 706 2069 or ryan.michalik@crowe.com.

-
- ¹ "ABA Spearheads CECL Workshop With FASB, Regulators, and Auditors," ABA Banking Journal, March 21, 2016, <http://bankingjournal.aba.com/2016/03/aba-spearheads-cecl-workshop-with-fasb-regulators-and-auditors/>
- ² CECL models could include discounted cash flow methods, loss rate methods, roll-rate methods, probability-of-default methods, or methods that use an aging schedule, among other types of models. Many predictive methodologies may be used, including credit rating and credit score transition matrices, reduced form, or structural models.
- ³ A Securities Exchange filer is any entity required to file or furnish its financial statements with either of the following:
- The Securities and Exchange Commission (SEC)
 - The appropriate agency under Section 12(i) of the *Securities Exchange Act of 1934*, for entities subject to the act
- Financial statements for entities that are not otherwise SEC filers and whose financial statements are included in a submission by another SEC filer are not included within this definition.
- ⁴ "Update 2016-13 – Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments," June 16, 2016, http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168232528

crowe.com/cecl

Text created in and current as of June 2016; Cover and artwork updated in May 2018.

The information in this document is not – and is not intended to be – audit, tax, accounting, advisory, risk, performance, consulting, business, financial, investment, legal, or other professional advice. Some firm services may not be available to attest clients. The information is general in nature, based on existing authorities, and is subject to change. The information is not a substitute for professional advice or services, and you should consult a qualified professional adviser before taking any action based on the information. Crowe is not responsible for any loss incurred by any person who relies on the information discussed in this document. Visit www.crowe.com/disclosure for more information about Crowe LLP, its subsidiaries, and Crowe Global. © 2018 Crowe LLP.

FS-17001-051A