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ProBank Austin

CECL: ONE YEAR LATER

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One year ago, on June 16, 2016, the Financial Accounting Standards Board issued ASU No. 2016-13 "Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments", which introduced the current expected credit loss methodology for establishing allowances for credit losses. In the banking industry we have come to know this now by "CECL". As a banker, you may be on your way to developing a plan or you may be like many and wondering when and how you should start.

We here at ProBank Austin wanted to provide a quick recap of CECL for those that are still in the planning stages and our thoughts on steps to be taking now to be prepared for implementation. If you have further questions or would like to discuss your institution's plan for CECL, we are available to help. As always, it is the purpose of ProBank Austin to make formidable tasks more manageable for you and your staff.

WHAT:	In June 2016 the Financial Accounting Standards Board (FASB) released a new accounting standard for estimating ALLL – introducing the Current Expected Credit Loss (CECL) methodology – which will estimate expected loss over the entire life of the loan at origination as opposed to when losses become probable. To estimate expected credit losses under CECL, institutions will use a broader range of data than under existing guidance. This data will include information about: 1) Historical events 2) Current conditions 3) "Reasonable and supportable" forecasts relevant to assessing the collectability of the cash flows of financial assets In addition to a change in methodology, FASB's goal is to provide greater transparency about the extent of expected credit losses and to improve the ability of the financial statement user to understand the realizability of assets. This will be accomplished through expanded credit quality disclosures for any financial statements presented in accordance with Generally Accepted Accounting Principles (GAAP). The industry expectation is the new CECL methodology will result in an increase in the required reserve. The increase will be recorded as a one-time adjustment through retained earnings on the effective date and be re-measured on at least at a quarterly basis.
WHY:	After the financial crisis in 2007-2010, FASB concluded that the existing approach for estimating the ALLL (based primarily on the "probable" threshold and "incurred" notion) simply did not recognize losses in a timely manner (i.e., too little, too late) and decided to revisit how banks calculate the ALLL. The new CECL model is expected to result in an earlier recognition of credit losses.

WHO:

The new accounting standard applies to **ALL** institutions – regardless of size. However, methods for estimating credit losses should be scaled for the size and complexity of the entity. CECL guidance is intentionally non-prescriptive, so institutions have flexibility in deciding which methodologies work best for their portfolio or segments of their portfolio. Appropriate methodologies include: Historical Loss, Migration Analysis, Vintage Analysis, PD/LGD – each requiring different data points that will need to be captured. **However, regulatory agencies expect that smaller and less complex institutions will be able to adjust their existing allowance methods to meet the requirements of the new accounting standard without the use of costly and/or complex modeling techniques.** [1]

WHEN:

Implementation is dependent upon your entity's classification as a public business entity and SEC filing status. The definition, per FASB, of a Public Business Entity (PBE) is provided in the appendix. The chart below is specific to entities with December 31 year-ends.

Entity Classification	**2020**	**2021**	**2022**
PBE & SEC Filer	Annual & Interim		
PBE & non-SEC filer		Annual & Interim	
All other entities		Annual	Interim (call report)

HOW:

Expected loss estimates should follow the formula below; however, FASB provides flexibility in estimating each piece of the formula:

Current Expected Credit Loss =

- Historical Losses +
- Current Conditions +
- Reasonable & Supportable Forecasts

Much of the flexibility in the estimate will come in how an institution segments its loan portfolio into pools having similar risk characteristics. FASB gives the following examples and states one or a combination may be appropriate, but the examples are not meant to be all-inclusive.

- Credit Score
- Risk Rating
- Financial asset type
- Collateral type
- Size
- Effective interest rate
- Term
- Geography
- Industry of the Borrower
- Vintage
- Historical loss patterns
- Reasonable and supportable forecast periods

FASB states that there is no one single method to estimating expected losses and explicitly states "*while the range of reasonable outcomes is not unlimited, the Board concluded that it is rare that there will be only one acceptable choice in estimating credit losses*"[2].

Given this flexibility, the more data gathered now, the more options you will provide yourself when forming the methodology for your institution.

	Finally, in addition to loan receivables, the new CECL standard applies to other financial assets measured at amortized costs including but not limited to: • Held-to-maturity debt securities • Off balance sheet loan commitments that are not unconditionally cancelable

OLD vs NEW	**Incurred Loss Model**	**Expected Loss Model**
	Losses are recognized when probable and the level of loss is limited to the amount already incurred.	There is no recognition threshold. Expected losses over the life of the credit are recognized at origination and updated on an ongoing basis.
	Estimates are based on historic annual loss experience and current conditions.	Estimates are based on historic lifetime loss experience, current conditions, and reasonable and supportable forecasts.
	Specific to loans and leases.	Applies to financial assets measured at amortized cost including held-to-maturity debt securities and loan commitments not unconditionally cancelable.

Now

Implementation

1. Continue to follow current GAAP.

2. Do not add qualitative factors to prepare for CECL.

3. In order to perform more robust, forward-looking calculations - start capturing/warehousing loan level detail now. The more data points collected – the more granular future calculations can be; e.g. pool segmentation.

4. Understand what steps your core provider is taking to accommodate their customers in regards to data warehousing.

5. Consider creating an Implementation Committee (CFO, SLO, I.T., Audit, etc.).

6. Incorporate CECL into your institution's capital planning now. With industry expectations of an increase to the ALLL, institutions may need to take steps prior to CECL becoming effective to protect desired capital ratios.

7. Begin developing your method. It will be important to be confident in your methodology prior to implementation. This requires two main steps: (1) aggregating loan level historical data and (2) giving yourself at least four quarters of live CECL modeling and observations prior to full implementation.

8. Keep your regulator and auditor updated. While they can't tell you how to develop your estimate they'll be able to communicate any concerns they have with it.

9. Keep the Board and Sr. Management team informed and up-to-date.

10. Annually, your model and methodology will need to be independently verified either by your institution's internal audit or by a third party.

11. The goal of CECL is to ensure the financial institution industry recognizes credit losses earlier than under the current methodology. Be prepared to document and defend how your estimate accomplishes this goal at implementation and how it will continue to consistently over time.

Definition of a Public Business Entity (PBE), Per ASU No. 2013-12

A public business entity is a business entity meeting any one of the criteria below. Neither a **not-for-profit entity** nor an employee benefit plan is a business entity.

a. It is required by the U.S. Securities and Exchange Commission (SEC) to file or furnish financial statements, or does file or furnish financial statements (including voluntary filers), with the SEC (including other entities whose financial statements or financial information are required to be or are included in a filing).

b. It is required by the Securities Exchange Act of 1934 (the Act), as amended, or rules or regulations promulgated under the Act, to file or furnish financial statements with a regulatory agency other than the SEC
c. It is required to file or furnish financial statements with a foreign or domestic regulatory agency in preparation for the sale of or for purposes of issuing securities that are not subject to contractual restrictions on transfer.

d. It has issued, or is a conduit bond obligor for, securities that are traded, listed, or quoted on an exchange or an over-the-counter market.

e. It has one or more securities that are not subject to contractual restrictions on transfer, and it is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available on a periodic basis (for example, interim or

[1] Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency, "Joint Statement on the New Accounting Standard on Financial Instruments – Credit Losses," June 17, 2016, https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160617b1.pdf

[2] ASC 326-BC50: "While the range of reasonable outcomes is not unlimited, the Board concluded that it is rare that there will only be one acceptable choice in estimating credit losses."