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CECL: COMMON THEMES AND CHALLENGES

3 Minute Read

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CECL: Common Themes and Challenges

The introduction of the Current Expected Credit Loss (CECL) standard marks a major departure from the previous approach. CECL's forward-looking methods prompt financial institutions to recognize potential credit losses earlier than previous models. By requiring lenders to account for expected credit losses over the entire life of loans, the CECL model has resulted in increased loan loss provisions for most institutions. There has also been a considerable shift in data gathering and forecasting methods, a need for detailed written rationale for model choices, underlying assumptions, and adjustments. We'd like to take this opportunity to share what we have learned.

Common Themes and Challenges

In our daily consulting work across the country, we learn a great deal about our industry's challenges. Well before the deadline, we were preparing CECL reports for many clients. These were parallel runs that allowed us to fine-tune model inputs, request more robust data, and compare output from our CECL model to the client's allowance. We continued to collect this information post-implementation. We are very fortunate to have gained critical insight about CECL data challenges, CECL's day-one impact, and the volatility of allowance calculated using CECL methodology.

Data Challenges

Our number one recommendation has not changed: retain lots of data. Calculations under the CECL standard require two types of data:

- Ongoing Monthly Loan Files: Core-processor system files are generally very complete and include all fields necessary to calculate CECL and measure trends. Most of our clients also provide us with off-system files related to mortgage loans, charge cards, student loans, or participations. Often, these files are not available quickly and may not include sufficient details.
- Historical Charge-Off & Recovery Files: Your CECL report will include multiple segments in which loans are grouped by common risk characteristics. The first step of CECL calculations is to calculate historical average net charge offs for each segment. However, CECL segments may differ from your historical charge off & recovery data. Many times, we find that the history required to run this analysis is incomplete or difficult to gather.

We are off and running

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Early Adopters

The key objective of the new CECL standard is to recognize lifetime credit losses looking forward over the life of loans, as opposed to the current incurred-loss method. Given the forward-looking scope of these calculations, we can expect that allowance calculated using CECL methods will be higher upon adoption of the new standard. We analyzed bank & credit union call report data to determine the impact of early CECL adoption and volatility over time.

- Banks: In early 2020, many large and mid-sized banks adopted CECL. There is a great deal of data available for us to measure the impact of early CECL adoption and volatility after adoption. On average, banks adopting CECL saw an immediate 37% increase in their allowance. This is to be expected because CECL is forward-looking over the remaining loan life.

Over the next few quarters, the pandemic had a major impact on the entire industry and CECL adopters rapidly increased their allowance in response. Non-adopters also increased their allowance in anticipation of potential COVID-related losses, but their average increase was not nearly as large. The U.S. Government pandemic response was massive, putting money in the hands of consumers and businesses. It quickly became apparent that COVID-related losses would not be as large as originally feared. As such, both early CECL adopters and non-adopters lowered their allowance over several quarters. Early CECL adopters lowered their allowance more quickly, consistent with unwinding the rapid increase a year earlier. Overall, we note that CECL methods used by early adopters resulted in more volatility than non-adopters.

- Credit Unions: Very few credit unions adopted CECL early. The small sample size doesn’t tell us much about the industry. Most of the results are in the expected range, with allowances increasing in the by about 30% immediately upon CECL adoption. However, we did see some surprising results. Nearly half of early adopters reported a lower allowance in the most recent quarter compared to their first CECL reporting period. Most of the early adopter allowances quickly dropped by over 50%. A handful of credit unions reported no change over time and only two reported a higher CECL allowance after adoption. There is a very wide range of results, from up 110% to down 85%. We also found that the CECL-calculated allowance in this small sample was more volatile than the allowance trend of non-adopters.

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Elimination of TDRs
In early February 2022, FASB announced a unanimous vote to eliminate TDR accounting guidance for creditors who have adopted the CECL standard, with an effective date of Dec. 15, 2022.

Investments
Debt securities may be designated as either trading, available for sale (AFS), or held to maturity (HTM). The CECL accounting treatment will differ depending on these designations.

- **Trading:** Securities designated as trading are marked to market monthly and the change in value is recorded to income. CECL does not apply to securities designated as trading.
- **Available For Sale:** The CECL standard does not apply to securities designated as available for sale.
- **Held To Maturity:** CECL will require institutions to measure expected credit losses on financial assets carried at amortized cost on a collective or pool basis when similar characteristics exist. Pooling may be performed based on credit scores, asset types, collateral, terms, location, industry, historical or expected loss patterns, or reasonable and supportable forecasts. Smaller and less complex institutions may conclude that the segmentation practices they have used under the incurred loss methodology are also appropriate under the expected loss methodology or they may refine those practices.

Treatment of Acquired Loans from Merger
FASB has been performing a post-implementation review of the CECL standard and these decisions may impact loans acquired in a merger. There are too many variables to include here. If your institution has acquired loans and you are holding a contra account for potential future charge-offs, reach out to us so that we may discuss the accounting implications for your unique needs.

CECL Reporting Turn-Around Times
In the beginning, our metric for turnaround time was measured in days. However, after optimizing our procedures, we've managed to reduce that to hours. As a result, many of our clients now receive their CECL results on the very same day we receive their data.

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We have observed that users of other CECL models sometimes report substantial fluctuations in their CECL results on a month-to-month basis. In periods of economic stability, with consistent charge off patterns and moderately higher delinquency rates, CECL results should remain steady or grow slowly. Volatility is a clear signal to scrutinize model inputs and engage in a discussion with the model provider.

Examiner Expectations

Very few banks and even fewer credit unions have been subject to a CECL exam, simply because it's all new. However, based on the standard and what we have learned from a handful of clients and auditors, we can expect:

- **Data Collection and Maintenance:** Institutions are expected to have a robust system for data collection and retention, as the CECL model requires detailed and accurate data over the life of each loan.
- **Modeling and Assumptions:** The methodology chosen should be well-documented and supported with a sound rationale. Assumptions made in the modeling process should be realistic and consistent with the current and expected environment.
- **Governance and Oversight:** Institutions should have a strong governance framework over the entire CECL implementation process, including model development, validation, and ongoing monitoring.
- **Audit and Independent Review:** There should be an effective internal audit and independent review process to evaluate the appropriateness of the model, assumptions, and the overall CECL estimation process.
- **Staff Training:** Examiners expect that staff members who are involved in the CECL estimation process are appropriately trained and understand the model's underlying principles and assumptions.

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Remember, the goal of the CECL standard is to provide more accurate and timely estimation of expected credit losses, thus promoting greater financial stability. Institutions that show they are aligned with this goal are likely to meet examiner expectations. It is also reasonable to assume that examiner expectations will evolve over time.

Written Rationale for Model Assumptions

The goal of CECL is to recognize lifetime credit losses at inception. This requires forward-looking assumptions, which are based on the condition of the loan pool or economic forecasts. The guidance calls for both current condition adjustments and forecast adjustments. These adjustments may result in a higher or lower final allowance. We have seen the following (and more):

Positive Current Condition Adjustments (adding to allowance)

- Historical trend is zero, but this can't be supported over the remaining life of loans
- Relaxed underwriting standards to boost loan volume
- Delinquency trend has deteriorated sharply, and higher losses are anticipated
- The largest local employer announces mass layoffs

Negative current condition adjustments (lowering allowance)

- Decision to tighten underwriting standards to improve loan quality
- Exit of a troubled loan program now in run-off mode.
- A brief period when a loan officer approved loans that fell short of approved guidelines. That person is no longer part of the team.

Keep in mind that these and other uncommon adjustments may invite examiner questions.

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Value-Added Services

Before selecting a CECL provider, it is important to know the level of service included in the price. McQueen provides a very robust CECL solution:

- McQueen's team of dedicated CECL analysts provide data transfer reminders, assists with data-related questions and will respond to inquiries about timing and process
- Every client is assigned a dedicated advisor who will interpret reports, answer technical questions and assist with setting current condition adjustments
- CECL policy review/development
- Assistance with writing an adequate rationale for model choices
- Help with examiner & auditor questions
- We encourage you to ask other providers if they offer these value-added services before making your final decision.

Summary

As a nationwide consulting firm, we are very fortunate to have gained critical insight about CECL data challenges, the expected day-one impact, special treatment of certain asset classes and a variety of other CECL issues. Each institution is unique, and we invite you to contact us for further discussion.