FEATURE STORY

CECL: The Unpaved Road Ahead

By Tony Hodson

Today, many financial entities still find themselves questioning what their bank's course of action for CECL implementation should be. Although many iterations of FASB text and timelines are available, very little exists in the form of practical guidance.

Fast forward to 2016 and the Financial Accounting Standards Board (FASB) proposal for an alternative risk management solution—Accounting Standards Update on Financial Instruments – Credit Losses (Topic 326). These provisions were intended to introduce a new methodology related to how financial institutions account for Current Expected Credit Losses (CECL). The new CECL standard would address delays in the recognition of credit losses and help banks and lending institutions determine the appropriate level of balance sheet reserves. Once implemented, they will eventually replace today's "incurred loss" standards for loss accounting (FAS-5 and FAS-114).

The Biggest CECL Challenge

There's no doubt that banks face many hurdles when it comes to implementing CECL: when to get started, how to collect the massive amounts of required data, how to segment portfolios, and what analysis methodologies to use. However, there is one major challenge that underpins all others: a dearth of pragmatic implementation guidelines.

The banking sector is among the most heavily regulated in the world-- and, at their core, banks are compliance machines. To banks, compliance is a binary concept: you're either in, or you're out. Historically, this has been an arduous undertaking-- but it has also largely delivered on its intent and produced a sense of predictable order across the sector.

CECL is Different

Today, there are neither absolutes, nor a universal guide on CECL implementation. In fact, the FASB rules were intentionally written to provide maximum flexibility and allow for adoption by different types and sizes of institutions. Expanding on this, regulators have described a continuum of options for banks ranging from "smaller, less complex" to "larger, more complex," and specific details of how CECL is implemented for those institutions will vary depending on where an institution falls on this continuum.

There are no hard and fast rules, thresholds, or guardrails that can help a bank discern how large or complex they are or what that implies when selecting CECL methodologies. To the contrary, regulators have routinely declined to define what a term like "smaller and less complex" actually means.

Instead, regulators have proposed that the details of a CECL implementation are largely left up to each bank, as long as an informed analysis is performed in good faith and in alignment with the FASB standard. To this end, there are two common themes we have been hearing from chief examiners, particularly where smaller community banks are concerned:

Regulators are not expecting smaller community banks to delve into complex discounted cash flow, vintage, or migration analysis. Most community banks will be well served by using some form of CECL's simple and more familiar "cumulative loss rate" or Weighted Average Remaining Maturity (WARM) methodologies.

Regulators are not interested in playing a game of "CECL Gotcha!" in which they penalize banks for having immature or incomplete models. Instead, they are expecting a more collaborative and iterative approach that will allow banks time to organically improve their models. As expressed by one chief examiner: "This is new for everyone. Right now, we're focused on a bank's preparation and progress. It's not about compliance or completion."

CECL Implementation

Smaller community banks, regulators, auditors, and bankers actually share a common desire for a simple CECL implementation. Regulators are not seeking an exhaustive or complex model, but rather a practical model supported by sound assumptions. Similarly, auditors don't expect banks to predict the future, but rather to methodically consider it and document their analysis.

Unfortunately, well-meaning consultants and vendors may have unnecessarily complicated things by creating complex solutions that don't really scale to the limited scope and capacity of smaller community banks. In fact, Michael Gonzalez, former Professional Accounting

Fellow with the Board of Governors of the Federal Reserve System, was quite clear on this point as well: "Smaller and less complex institutions are not required to build costly or complex [CECL] models or hire third-party providers."

In pursuit of the best CECL system, process, or model, many community banks may not be focused on the bigger picture. The "best" model isn't the one with the greatest number of inputs, the most complex algorithms, or the most technical jargon. For the vast majority of community banks, the best model will be the one that bank management can reliably maintain internally and explain externally.

CECL Solutions

Over the last couple of years, through our continued engagement with hundreds of community banks across the U.S., CECL has increasingly become a focal point of client discussions. We noticed that larger, more complex institutions were being showered with attention and solutions. Meanwhile, smaller community banks were left with few options, aside from buying a big bank software solution, using a limited excel model, or hiring a team of consultants (usually an extension of their existing CPA or loan review engagements.) None of these options produce a desirable outcome for smaller banks, nor do they adequately contain costs. Instead, community banks need a turnkey approach, designed around a Q&A workflow that walks bank management through each of the critical decision points associated with CECL. Community banks can be ready to comply with CECL without disrupting the community-minded approach to their business.

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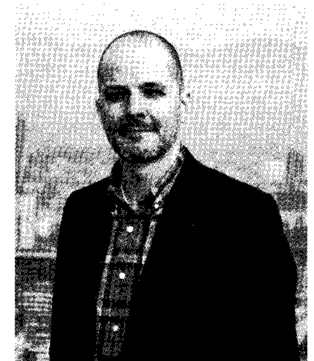

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