WHITE PAPER

Effective CECL Adoption Timelines confirmed. How to start preparing now

Why an early preparation is vital

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Ardmore Banking Advisors

FINTELLIX COMMUNITY BANKING SOLUTIONS

"The Ardmore/Fintellix team really knows their CECL stuff. Not only are they a pleasure to work with, but I was impressed with their 'quant' abilities and the process even helped me learn more about the capabilities of my bank's core system to address the data needs of CECL."

Deb Evans, CFO
Bank of Lancaster,
Kilmarnock, Virginia.

On Nov 11th, FASB decided the effective dates of adoption for the CECL guidelines. For staggering the dates of adoption for financial institutions (FI) of various sizes, FASB took a different approach from asset size range and used the definition of Public Business Entities (PBE).

- Dec. 15, 2018, including interim periods – For PBEs which are SEC Filers
- Dec. 15, 2019, including interim periods – For PBEs which are non-SEC Filers
- Dec. 15, 2020, including interim periods – For all other entities

The final guidelines on CECL are expected in Q1 2016, hence for the first adoption date, FIs would have eleven quarters to take the required action for a successful transition. Since, even the regulators identify the transition for current "incurred" loss models to "expected" loss model as not just a tweak but a foundational change to how ALLL is calculated, it is important that the FIs start estimating the impact and act in well-coordinated fashion.

Not-To-dos for Financial Institutions

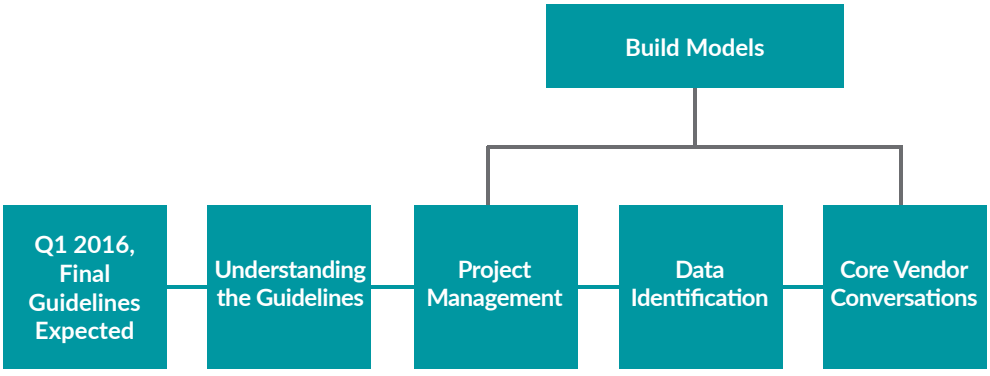
It is expected that FIs would be concerned about the new "expected loss" model, but don't treat it as a panic situation. The biggest takeaway of the Nov 11th FASB meeting is not the announcement of effective timelines, but FASB's intentions of making the guidance simpler and clearer. The removal of two complex clauses: 'cost basis adjustment from allowance calculation for TDR' and 'consideration of length of time the fair value of AFS securities is less than its amortized cost' underscores FASB's motives of making the guidance easier to understand and implement.

On similar lines, it is expected that the dependence on statistical techniques required for "expected loss" models would be minimal and the probability of FIs being forced to adopt PD-LGD models is zero. To summarize, FIs should try and focus on planning on "how" rather than be alarmed on the complexities of "what".

- FASB is trying to make things easier to understand and less complex to implement
- Do not rush into building CECL models as soon as the guidelines are released
- The probability of FIs getting forced to adopt 'Probability of Default" Models is zero
- Get educated by attending as many sessions conducted by FASB and regulators

To-Dos for Financial Institutions

Since we have already discussed the not-to-dos for FIs, let's focus on the to-dos:



Understanding the Guidelines

There are multiple educational sessions being conducted by the regulators and FASB to clear the air around the "expected loss" calculations. More sessions similar to "FedPerspectives" (Oct 30th 2015) are expected. Moreover, after the guidelines are finalized in Q1 2016, we expect that the Transition Resource Group (TRG) would conduct sessions to help bankers understand the nuances of the guidelines and create a transition plan.

It is imperative for the FIs to attend these sessions and get a complete understanding of what is required and what is not. Multiple vendors would provide multiple points of view which might lead to misperceptions. So, getting first-hand information and then validating with the regulators would be the perfect choice.

"The OCC is readying its examiners and supervised banks with regulatory expectations, 'years ahead' of the shift to CECL and its implementation."

Louis "Rusty" Thompson
Acting Deputy Comptroller &
Chief Accountant

Project Management: End State Finalization

A general misconception in the market is that "building complex models is the priority" for the "expected loss" calculation. That is misleading and can be detrimental to a FIs transition plan. There are two flaws in the statement. The regulators would not force FIs to build "complex models" such as PD-LGD, Monte-Carlo Simulation, etc., which would make the existing infrastructure redundant. And the priority is not the models, but what goes into the model.

The FIs should form an "Internal Transition Group (ITG)" within the organization which should include stakeholders from Board, Finance, Risk and Business divisions. The primary responsibility of the ITG would be to define the probable end state, considering the aspects below:

I. **Pooling:** Current pooling methodologies based on call codes might not be relevant anymore. The CECL methodologies might not be as accurate for high concentration pools. Moreover, for methods such as migration (cohort) analysis, the focus would be on risk grading at individual loan level. An observation across community banks is the lack of comprehensive risk grading mechanism for all pools. A focus group with business owners and risk managers should create policies around risk grading and pools and validate the same with the Board.

II. **ALLL Methodology:** The business owners and risk team should brainstorm to confirm which CECL method suits each pool defined in the previous step. For example, a vintage analysis might be more suitable for a commercial & industrial loan (with a shorter term). Whether the Board decides to include prepayments and external data into overall calculation has to be confirmed in this step itself.

III. **TDR and Impaired Loan Identification:** Much has been talked about TDR during the course of finalization of CECL guidelines, and it is now the onus of FIs to lay down a TDR and impaired loan identification methodology. Moreover, with the option of including TDRs under CECL methodologies, FIs need to finalize on how they would provision for TDRs.

IV. **Reporting and Documentation:** The current sections in call reports and the advised disclosures for 10Q and 10K would require a sea change. FIs should think about their strategy to create these reports along with other reports to be provided for audits and examinations. Moreover, all internal MIS reporting pertaining to ALLL, delinquencies, migrations and impairments needs to be revisited. The FIs might also be required to provide extensive documentation in terms of assumptions made for calculation, so the question to ask is - where would they store these documents on regular basis?

V. **In-house vs Vendor vs Third Party:** FIs need to decide at an early stage based on inputs from above steps on whether they would go for an in-house build or buy a third party solution or outsource the entire calculation and related requirements to a third party. The primary reason we suggest that the vendor/third party engagement happens at an early stage is that the FIs can get requisite inputs and can also tweak/customize the solutions based on their requirements, as most of the vendor solutions would come with pre-built models and credit data repositories. Being an adopter might save a financial institution from future last minute changes and complications.

VI. **Collaboration:** Post adoption of CECL guidelines, ALLL calculation would not just be the Finance team's baby. Inputs would be required from business owners, credit department and risk division. The ITG needs to decide how multiple divisions can collaborate and share information among each other.

VII. **Extensibility:** FIs would put in substantial effort to re-jig the processes and methodologies and to accumulate data. A prudent decision would be, to be a visionary and extend these efforts towards other areas such as Stress Testing, Portfolio/Risk Analytics, Reporting, Pricing, etc.

- Define the end state as the first step
- Each pool would require a different methodology, revolving loans would need special attention
- Expect sea changes in reporting/ disclosure requirements
- CECL will require collaboration between multiple departments
- Few banks are expected to be visionaries and opt for revamp of credit portfolio management

Data Identification

From the policies and disclosure frameworks defined by the ITG, the financial institution should form a "Data Focus Group (DFG)" comprising of IT, Risk and Finance. The primary responsibility of DFG should be to work on the data needs for CECL transition.

- Data identification is the most critical step in overall CECL transition
- Get a holistic view of data requirements from end-state definition
- 30 years of loan history is not mandatory. Filter the noise
- Strategize on prepayments, external data and charge-offs and recoveries

I. **Data Elements:** A sample set of all data elements that a financial institution might require can be seen in the list above. Again, this is a laundry list and a lot of information is dependent on the decisions the financial institution takes in the previous step of the end state finalization. For example:

   a. If a bank decides to continue with the existing pools, then most of the customer data and collateral data are not mandatory

   b. If a bank believes that the pre-payment impact on pools is low, then the transaction data is not mandatory

   But a few data elements which would become mandatory in the world of CECL are risk grades at loan level, origination and maturity dates, and in-depth information of charge-offs, recoveries and TDRs.

II. **Data History:** The other aspect which has been misinterpreted is the history of information. 30 years of loan history is not mandatory. Let's take an example to substantiate: For a long term loan such as Residential Real Estate, if the pre-payments are taken into consideration, the average maturity comes down to 7-10 years. So, for using a vintage analysis on a residential real estate, the historical data required would not be more than 7-10 years.

III. **External Data:** For reasonable and supportable forecasts required under CECL, the FIs might be required to forecast economic conditions. If enough loss data is unavailable, peer data might be required to calculate loss rates. FIs have to decide a strategy on whether they would subscribe to such data from an external vendor or create an in-house external data mart.

It is also important to note here, that if the financial institution decides beforehand to implement a vendor solution, the data identification process is smoother and faster, primarily because most of these data elements would be pre-defined based on the vendor models and external data would be a part of the solution itself. Only the delta work would be based on the disclosure requirements and extensibility envisaged.

"Banks are encouraged to consider their data collection needs."

Jeffrey Geer
OCC Deputy Chief Accountant
adding that "vintage," or historical loan data may become much more important in adhering to the new accounting standard.

Core Vendor Conversations

Once the data elements and history required are identified by DFG (external data to be handled separately), the IT team needs to start conversations with the core system vendor.

I. **Data Availability:**

   a. **Data Elements:** The IT team should ask the core vendors on whether each data point is available in the core systems. If some of the data elements are unavailable, then the IT team needs to go back to DFG and strategize on how the data elements can be derived from available ones. For example, most core systems are incapable of providing pre-payment information and so most downstream solutions derive pre-payments using in-built functions. Charge-offs and Recoveries are mostly stored in excels and most FIs do not depend on core systems for the same. Since, more information on Charge-offs and Recoveries would gain prominence, IT teams need to ask relevant questions.

   b. **Data History:** Most core systems store 13 months of historical data. FIs need to confirm with the core vendors on how historical data can be fetched and what would be the cost. Secondly, FIs must start this process as early as possible so that at least for the next 11 quarters, they can get a dump of data on a timely basis from core systems, instead of increasing the history of data required. Be mindful of the fact that getting historical data would have cost implications.

- Prepare before you start a conversation with core vendors
- Start getting data "dump" from core vendors as early as possible to reduce costs and create history internally
- Focus on Data Quality, don't assume the business usable data quality from core systems

II. **Business As Usual:** Most core banking vendors have an interface from where the files, as required by FIs, can be generated. These interfaces might require a change after the new data requirements for CECL become effective. FIs need to question the core vendors on how would the interface change and what would be the cost of such a change.

III. **Data Quality and Integrity:** Though, FIs might successfully be able to trace all the data in core systems, quality of data is another aspect which needs attention. For example, data is often spread across multiple systems (mortgages, cards, facilities, etc.), which might store customer information differently. To be able to use customer information for one standardized calculation such as ALLL, FIs need to standardize the customer information across multiple systems.

Build Models

FIs should not jump into building models as soon as the guidance is released, primarily because the same methodology is not relevant to all FIs and all pools. The risk team should first figure out the relevance of these models by understanding the guidelines and should build these models in parallel to the activities mentioned above, rather than building it too early and making numerous changes based on market feedback or building them too late to be unable to get the right data elements for the model.

Though the new CECL models is a vast topic in itself which we would cover in our subsequent perspectives, this section gives a brief overview of the prescribed methodologies:

Vintage Analysis: FIs need to track homogeneous loans pooled on the basis of either originating quarter or year. Losses are accumulated across life of loan and the expected loss is calculated as the expected loss rate for the remaining period of maturity for a pool of loan times the amount originated in the quarter.

Cohort Analysis (Migration Analysis): Create cohorts based on similar risk characteristics at the beginning of a "Loss Accumulation Period" and track each loan's performance across the period to accumulate losses in a particular cohort over the accumulation period.

The eleven quarter transition period for the first adoption is quite adequate for precise advance planning leading to a flawless implementation.

Probability of Default: The simplest depiction of this method is PD*LGD*EAD. The method requires calculating the probability of a loan defaulting along with the calculation of expected losses at the time of default.

Discounted Cash Flow: Estimate the expected (not contractual) cash flow, based on impact of economic and internal factors, from each loan or pool and apply the effective interest rate to calculate the present value of all cash flows.

In summation, there will definitely be quite a bit of agitated deliberations (and confusions) around the focus on statistical models and on an early shift to the new CECL models. Financial Institutions (FIs) need to filter out the noise and focus on the preparation, rather than jumping to conclusions. CECL is not merely a new set of calculation methodologies. It is more about how Financial Institutions methodically prepare themselves to embark on the transition. Post the final guidelines in the first quarter of 2016, FIs should focus their energies towards preparing for the expected final end state, the data resident in their core systems, the core vendors and simultaneously start work on the new models. The eleven quarter transition period for the first adoption is quite adequate for precise advance planning leading to a flawless implementation.

About the Author:

Sourav Sekhar, Product Manager, Fintellix Solutions.
Sourav is a Product Manager at Fintellix Solutions where he conceptualizes and drives the implementation of risk and analytics technology solutions for Banks. His product portfolio includes ALLL, Credit Portfolio Management and Regulatory Reporting. His extensive knowledge of banking operations, risk and technology helps design and deliver an integrated approach for automating and implementing solutions around regulatory requirements and strategic initiatives. His prior experience as an investment banker at Deutsche Bank and as a banking technology consultant for HSBC, Americas involved advising banks and financial institutions on M&As and implementing core banking solutions. His perspectives have been published in prominent journals including Community Banking Insights, International Banker, Financial IT, Analytics India Magazine and BFSI Vision. Sourav is a Mechanical Engineer from the National Institute of Technology, Warangal, India and an MBA in Finance from the Indian School of Business, Hyderabad, India.

About Fintellix Community Banking Solutions and Ardmore Banking Advisors

Standardization of banking supervision is driving change across the banking industry globally, especially considering enhanced financial reporting, risk measurement and management. These initiatives have been steadily expanding the regulatory burden on community banks and increasing the cost of regulatory compliance. The Ardmore - Fintellix alliance addresses the need for a comprehensive solution that can help community banks more easily manage their regulatory compliance needs, and enable bank management to focus on business growth and profitability. The Fintellix - Ardmore partnership delivers a unique 'global/local' alliance that combines global expertise, local experience, and next generation technology solutions to lower the cost of compliance for community banks. Through this alliance, community banks have the advantage of a CECL-ready ALLL solution powered by a comprehensive credit data warehouse as Software as a Service (SaaS). Ardmore's seasoned credit professionals ensure that the ALLL solution is tailored for each bank's specific needs and business model.

Comprehensive Credit Portfolio Management Solutions