



The Timeline for Implementing CECL Has Already Begun

As of October 2019, financial reporting under the Financial Accounting Standards Board's (FASB) current expected credit loss (CECL) methodology is still a little more than three years away. The requirement to begin reporting is several periods out. But, for several reasons, the time to gather data to comply with CECL has already begun:

- Vintage analysis requires data gathering that covers one full maturity cycle.
- A thoughtful approach to tracking qualitative loan factors may take months or years to develop.
- Delivery time for requests of new data from your core processor could take months.

Several other aspects of formulating your institution's response to this change in accounting standards also add months to the implementation process:

- Adopting CECL requires coordination across all functional groups within the institution.
- The decision to build or buy a solution can be a lengthy process.
- There will be a time period prior to full implementation of CECL that parallel methodologies will be concurrently run so comparisons can be made.

This paper is a primer for financial institutions currently entering their planning process for CECL implementation. We submit that while final implementation of the new rule is years away, the process required to comply should begin immediately.

Regulatory Background

FASB released Accounting Standards Update (ASU) No. 2016-13 during June of 2016, with a proposal to delay in July of 2019. The content of this ASU is specific to the methodology that financial institutions use for determining their allowance for loan and lease losses (ALLL). Current FASB standards recognize the incurred loss method as proper accounting practice. For the incurred loss method, losses are reserved for when the loss on the loan in question becomes "probable." In practice, probable has meant when the loan is seriously delinquent or is actually in default. The new methodology, CECL, recognizes loss at the origination of the loan and continues this recognition throughout the life of the instrument. Expected loss is determined by applying statistical techniques to the historic performance of similar loans as well as several qualitative factors. The expected loss may increase or decrease over time based on that instrument's performance. Expected loss can also vary as the qualitative factors change or the economic outlook changes.

Implementation dates for ASU 2016-13 differ based on the ownership structure of each financial institution are now:¹

- | | |
|---|----------|
| ▪ SEC – Large Reporting Companies | 1/1/2020 |
| ▪ SEC – Small Reporting Companies | 1/1/2023 |
| ▪ Private Business Entities (PBEs)/Non-PBEs | 1/1/2023 |

With the deadline for compliance being pushed out, one can see how CECL might still be a low priority for the next 12-24 months. But, further consideration of what is needed to be able to comply should make a clear argument that the required homework needs to begin immediately.

¹https://www.fasb.org/cs/Satellite?c=FASBContent_C&cid=1176173179331&pagename=FASB%2FFASBContent_C%2FNewsPage

Data Requirements

Under CECL, institutions will use a broader range of data than under current accounting principles. This data includes information regarding:

- Past events
- Current conditions
- Reasonable and supportable forecasts

One of the recommended attributes of your portfolio to be considered under current conditions is the vintage. Vintage refers to the time period which the loan was originated and has 2 major implications on expected loss.

First, segregation by vintage allows analysis that shows how loans that are similar in all aspects except age often experience different rates of default, different loss severities and different recovery rates. As a loan ages and the pool shrinks via principle pay downs, the risk profile changes. The changing expected losses will change the ALLL requirement (perhaps even to the financial institution's advantage).

Secondly, the performance of different vintages typically reflect the different economic conditions prevalent at the time of origination. Consider the data below produced by FNMA². Data clearly shows higher loss rates for the vintages immediately preceding the housing crisis of 2008. Vintages from 2005 through 2007 have all experienced greater loss rates than the other vintages. Performance for the 2009 vintage changes greatly and reverts back to the "typical" experience of the pre-2005 loans. Using the average performance of all vintages to forecast future losses would likely overstate the risk to the portfolio components that were not originated during those periods. By segregating the loans, the data tells a story about the pre-crisis underwriting guidelines that we're all familiar with by now. The "dirty" vintages were written during a period when underwriting standards and loan documentation were comparatively aggressive.

Performance File Summary Characteristics

(Reflects loan status in performance dataset for activity through June 2019)

Origination Year	Loan Count	Total Orig. UPB (\$M)	Active Loans		Inactive Loans (Loan Count)							Total Mods to Date ²	D180 UPB (\$M) ^{3,4}	D180 % of Orig. UPB ^{3,4}	Default UPB (\$M) ⁵	Loss Rate (%) ⁵
			Loan Count (Active)	Active UPB (\$M)	Prepaid	Repurchased ¹	Short Sale	Third Party Sale	REO	NPL	RPL					
1999	159,982	19,096	1,769	\$76	155,428	790	108	294	1,528	31	34	1,055	\$343	1.8%	\$169	0.1%
2000	1,267,892	160,707	9,606	\$443	1,237,834	4,150	763	1,847	13,243	237	212	7,491	\$2,489	1.5%	\$1,387	0.2%
2001	3,371,876	472,763	41,365	\$2,309	3,285,009	6,658	2,168	4,062	31,021	945	648	21,907	\$6,343	1.3%	\$3,500	0.2%
2002	3,857,280	564,709	83,378	\$5,440	3,719,429	5,983	3,026	5,417	37,216	1,678	1,153	31,540	\$8,361	1.5%	\$4,384	0.3%
2003	5,107,349	777,973	235,854	\$18,336	4,780,676	6,771	7,534	10,804	58,484	4,199	3,027	67,969	\$18,209	2.3%	\$8,783	0.4%
2004	1,744,509	274,060	122,306	\$10,018	1,562,561	3,049	7,250	5,427	38,532	2,649	2,735	43,394	\$12,533	4.6%	\$6,646	0.9%
2005	1,446,211	252,266	130,053	\$12,511	1,222,979	3,387	17,975	5,900	56,091	3,581	6,245	63,386	\$22,164	8.8%	\$13,550	2.4%
2006	1,080,840	198,702	84,785	\$9,303	898,478	3,725	20,230	4,433	57,977	3,333	7,879	65,905	\$24,239	12.2%	\$15,341	3.7%
2007	1,252,500	245,739	106,464	\$13,140	1,017,343	8,819	25,620	5,056	73,018	4,788	11,392	94,443	\$34,687	14.1%	\$20,508	3.6%
2008	1,491,728	315,003	115,619	\$13,370	1,292,502	9,314	15,275	3,428	45,782	3,288	6,520	67,444	\$23,691	7.5%	\$12,631	1.4%
2009	2,363,169	522,087	362,409	\$43,809	1,979,312	2,730	3,435	1,529	11,550	1,364	840	18,618	\$6,578	1.3%	\$3,052	0.2%
2010	1,951,533	432,393	481,822	\$57,367	1,461,513	1,403	834	927	4,132	582	320	8,622	\$2,429	0.6%	\$875	0.1%
2011	1,661,775	357,656	538,647	\$67,170	1,118,439	699	327	692	2,376	389	206	7,145	\$1,667	0.5%	\$468	0.0%
2012	2,680,141	608,103	1,434,186	\$235,718	1,241,226	1,505	267	640	2,041	167	109	7,692	\$1,842	0.3%	\$389	0.0%
2013	2,207,407	483,419	1,223,588	\$203,335	976,782	4,078	228	705	1,875	96	55	8,688	\$2,026	0.4%	\$359	0.0%
2014	1,444,944	310,374	739,572	\$122,234	700,712	2,446	192	534	1,405	57	26	8,539	\$1,914	0.6%	\$271	0.0%
2015	1,860,042	421,062	1,249,006	\$240,268	607,718	1,780	138	438	913	34	15	8,982	\$1,985	0.5%	\$182	0.0%
2016	2,298,500	540,662	1,870,678	\$398,388	425,646	1,193	85	307	574	6	11	8,768	\$1,820	0.3%	\$88	0.0%
2017	1,904,981	434,275	1,674,515	\$357,551	228,914	1,123	44	105	279	0	1	4,738	\$1,104	0.3%	\$24	0.0%
2018	1,070,223	249,456	987,655	\$219,392	81,917	583	5	10	53	0	0	84	\$195	0.1%	\$1	0.0%
Total	40,222,882	7,640,506	11,493,277	\$2,030,179	27,994,418	70,186	105,504	52,555	438,090	27,424	41,428	546,410	\$174,621	2.3%	\$92,609	0.5%

²https://loanperformancedata.fanniemae.com/lppub-docs/FNMA_SF_Loan_Performance_Stat_Summary_Primary.pdf

Segregating by vintage requires historic data from the point of origination and continuing forward monthly until termination. If you're analyzing loans with a three-year full term, a full three-year cycle of data is required to capture the performance unique to that vintage cohort. If the financial institution is a publicly traded SEC registered bank, then data tracking needed to begin no later than March 2017. For loans with an expected term of seven years at a publicly traded SEC bank, the critical time to begin data tracking has already past.

Instrument level history with the required data fields for this length of time is likely not available from core processors for most financial institutions. At least, not at a justifiable cost. The typical course of action will be to begin gathering this data from today going forward.

Other loan attributes that demonstrate correlation to loss are qualitative factors (Q Factors). Examples of Q Factors commonly used are:

- Economic environment
- Credit enhancements (collateral value, mortgage insurance, guarantors)
- Growth rate of the portfolio

A robust CECL model requires that several Q Factors be input. For many financial institutions, these characteristics have not been tracked at the loan level prior to CECL. Effectively, financial institutions will be starting from zero. Not only do financial institutions have to consider which data fields to track, but also how to architect the storage of this data so that the processing of the data is efficient.

Most, if not all, of the required data components reside within the financial institution's core processing loan applications. The list of required data fields for CECL has significant overlap with core extract templates for other financial management tools that may already exist at the institution:

- Asset-liability models
- Product or customer profitability models
- Loan pricing models

The extract files for these analytical tools provides a template for CECL, but will likely require additional fields (delinquency indicators, vintage components, etc.). If the institution does not have custom report writing capabilities internally, they have a dependency on the core vendor to create their extract. The time from request to fulfillment varies widely between core vendors, but a work queue of several months is not uncommon in the industry.

Other Institution-Wide Considerations

In addition to the time invested during the data gathering process, changes to the ALLL methodology will require coordination across all departments of the financial institution:

- **Information Technology Area** – CECL has an obvious dependency on IT for data and systems support.
- **ALCO and the Board of Directors** – CECL has significant potential to impact capital planning and earnings.
- **Lending Function** – Changes in ALLL and Provision for Loan Loss expense will likely impact underwriting practices.
- **Integrating with other written policies** – Integrating risk policies and coordinating the CECL changes with existing committees takes considerable time.
- **Risk Management Function** – CECL modeling has significant overlap and should be consistent with interest rate risk modeling, liquidity modeling and capital modeling.

Organization-wide efforts such as those described above deserve a timeline commensurate with the level of senior management involvement that is expected. Not all of these projects can be delivered concurrently. Policy writing, for example, is dependent on the board of directors and ALCO to first create and communicate vision. Risk modeling is then in turn dependent on direction provided in the written policy statements. Planning for the five bullet points listed above would appear to easily be months or years of effort.

The decision to build or buy a CECL solution (and the subsequent implementation) can span several months:

Build:

- Identify or hire an internal analyst resource
- Design a model and construct it
- Create specs for CECL data, request data and begin to compile
- Validate the model with outside, independent source

Buy:

- Budget for the cost
- Proceed through the RFP / bid process
- Conduct vendor due diligence
- Create the data files necessary to conform to the vendor's data specs

A final consideration impacting the timeline of CECL implementation pertains to the implementation process itself. After implementation of CECL but prior to changing the ALLL calculations, there will be an extended period of time where the observed loss methodology results will be run parallel to the CECL results. Parallel processes is considered an industry best practice and provides several benefits:

- The institution can monitor the variance in the results of each method and receive early feedback on any impact.
- Resulting changes to business strategy can be modeled and properly budgeted for.
- Based on modeling results, the institution can identify if there is an optimal period in which to convert to the new methodology.

While 2023 may seem a long way off, the time to begin planning, data collecting and preparing for the implementation of a solution that will best suit your institution is right now.