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CPAs & BUSINESS ADVISORS

8 STEPS TO EFFECTIVE CECL IMPLEMENTATION

CREATING OPPORTUNITY THROUGH COMPLIANCE

The new Current Expected Credit Loss (CECL) impairment standard represents the biggest change to financial institution accounting in decades. The challenge for most financial institutions is not to think of CECL as a compliance exercise, but to leverage it to create business opportunity.

Here are 8 steps to gain insights into your financial institution's loan portfolio and risks through effective CECL implementation.

1 Analyze the Loan Portfolio

Credit risk is your institution's main focus, but do you know the concentration exposure within your loan portfolio? Concentration risk comes in all different forms from industries, collateral, geography, loan types, etc... While call codes are the regulatory framework for reporting loan segments, they give a limited view of your risks.

A thorough analysis is a critical first step to create better insights into your loan portfolio and identify gaps in your credit risk assessment. Segmenting the loan portfolio into specific pools/individual transactions, and better understanding the similar credit characteristics will help you make wise decisions on new loans, emerging concentrations, credit pricing and roll-out of new lending products.

2 Identify Relevant Credit Quality Indicators

It's one thing to understand your levels of credit risk, but without a good understanding of the credit quality indicators (CQIs) that affect your loan portfolio, you can overlook the most relevant CQIs to forecasting changes in credit quality.

Regression and vintage analysis can help determine which CQIs most correlate to actual losses. Institutions that pinpoint relevant qualitative environmental and macroeconomic factors are better positioned to understand eminent future portfolio losses and make better pricing and credit decisions.

3 Select the Appropriate CECL Model(s)

FASB has outlined multiple approaches to calculate the required reserve. The new standard allows entities to apply different approaches to different loan pools based on what fits best.

Sometimes a sophisticated model will be required to forecast future losses. In other cases, the institution's current approach will be acceptable. It is highly unlikely one model would effectively apply to all loan pools. The size of each loan pool, level of concentration, risk profile, and collateral types are factors for determining the right approach. Each selection will need to be well documented and supported.

4 Assess Resource Capabilities & Needs

CECL requires advanced data assessments, interpretation and validation to ensure you have the right data for a successful implementation. Software will not solve CECL, but it can be useful in improving efficiency and internal controls.

Evaluate your internal capabilities needed to develop and execute the CECL model(s). Then determine the level of external resources needed to fill the gaps. The assessment must determine cost and benefits to help management make a decision. Your financial institution's credit and accounting departments must collaborate to address all risks and needs. We recommend establishing a task force that takes ownership for the implementation.

5 Evaluate Software

Software evaluation should not be an institution's first step in implementing CECL. After careful assessment, if the expected benefits of purchasing software outweigh the costs, management should invite multiple software vendors to provide demonstrations for determining which solution best fits the needs of your institution's based on the results of steps 1-5.

A software program won't interpret the data and make sure it is relevant to your institution's unique loan portfolio segments. This is where data integrity and having sound judgment and insights are critical.

6 Perform Model Simulations

In statistical analyses, multiple scenarios are run and tested to come up with a reasonable answer. The analysis to ensure your institution is capturing the most relevant data will be no different under CECL.

You should perform multiple simulations to test the selected CECL model(s) for reasonableness. Allowance calculations must be researched, calculated, and determined "reasonable" in relation to past performance and future expectations. The reliability of the results depend on the accuracy of the CQIs and CECL model(s) applied to your loan pools.

7 Prepare Formal Policies & Procedures

Auditors and regulators will raise questions if there isn't clear and concise documentation around "WHY" management chose the path they did, and ultimately how the allowance is derived and validated. As the saying goes "if it isn't documented, then it didn't happen."

Management must ensure that policies and procedures are clearly expressed and that the newly implemented internal controls are appropriately monitored.

8 Set an Implementation Timeline

While the effective date of the new guidance is not until 2020 for SEC registrants and 2021 for all other financial institutions, implementation will not be easy. Start now to put your institution in the best position to succeed.

This process will take time and resources, but the knowledge gained will pay dividends even on the current methodology. Early implementation is not early adoption. Comparing the current allowance calculation results with the new CECL model(s) over time will provide the needed assurance and troubleshooting opportunities to ensure you have developed the right methodology for your institution.

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CECL implementation requires an experienced team to ensure a seamless transition. HORNE's Financial Institutions team is ready to collaborate with you to turn this compliance burden into an opportunity for better business insights. Contact us to help you prepare for an effective implementation.