As Seen on BE BANKING EXCHANGE

mst

CECL and the CFO: Think implications, not just implementation

We've been hearing it from all sides: CECL will have institution-wide impact – greater, it is proposed, than any accounting change in banking history. Considering the breadth and depth of the impact, the transition to, implementation of, and ongoing execution of CECL demand oversight from the institution's top executives, and in particular, the CFO.

"Everything else on a financial institution's balance sheet is pretty straightforward," offered Paula King, a 25-year banking veteran and former CFO who advises banks and credit unions on their CECL preparations as a senior advisor with MST Advisory Services. "Deposits, loans, capital – you know the rules for booking those items. But the allowance, an estimate, is subjective."

That means judgment calls, and as the keeper of the institution's financial health, the CFO will be making those calls – all the way to the bottom line.

EXPECTED AND EXPECTATIONS

In anticipation of a January 2020 implementation deadline, most institutions have at least begun their CECL transitions. They are compiling the data they need for CECL and finding where they have data gaps. They are looking at their pools and deciding whether or not adjustments to their current incurred loss allowance segments are appropriate. They are trying to figure out how they will forecast future loan performance. And some of them have reached the point of testing prospective methodologies.

"These are issues of planning and budgeting," King said, "which require direction from the highest levels of management."

Most subjective, King pointed out, is the requirement to consider "expected" credit losses. That aspect of CECL clearly calls for the involvement of the CFO.

"Because CFOs play the major role in strategic planning and long-range forecasting, they must lead the charge in deciding what is expected, that is, to forecast such economic factors as unemployment rates, local as well as national, and changes in the GDP, and determine how far out they can make educated guesses about how those factors will influence portfolio performance."

In the transition to CECL, King notes, the CFO and team must consider how to reshuffle portfolio pools or segments.

"Where a current pooling might include all commercial real estate loans, CECL may require segmenting into owner occupied and non-owner occupied real estate pools" says King.

To further segment these pools, the institution could sub-segment them by risk grades.

This highlights a technical challenge.

"One of the problems with core processors is that available reports don't always provide the level of data required to segment under CECL," King said. "The CFO needs to get the IT department to play a bigger part in the allowance than it has, to dig through the data, to explore more of the history. Credit, loan review, loan operations, IT – the CFO needs representatives from all those departments to understand what will be required from each on an ongoing basis to comply with the chosen CECL methodology."

As well, she added, the CFO needs to direct the effort to make transition and ongoing compliance as efficient as possible. That includes leveraging current allowance assets, adopting as much as possible from what's being done today into the CECL model.

"Many institutions already use migration analysis and that's going to play a big role in CECL," King explained. "They might be able to expand on that in their conversion to CECL. Some already track risk ratings movements; they can piggyback on that or augment it for the more detailed methodology CECL will require."

BEYOND ESTIMATING

According to Larry Sorensen, "expected" extends beyond estimating future losses to understanding CECL's implications for a variety of practices and policies critical to the financial management of the institution.

Most local economies have enjoyed steady, solid growth in the wake of the so-called "great recession." But, Sorensen warned, institutions must be wary of not-so-rosy economic times, and consider the impact of CECL given the inevitable: an economic downturn.

"The current accounting standard is flawed and tends to drive ALLL levels lower through an economic expansion until a recession hits, and just when you need a robust ALLL, you don't have it," he said. "CECL tries to remedy this, but in disconnecting expense from revenue – and front-loading expense – it will increase capital and financial performance volatility.

"FASB's proposition is that CECL can prevent another financial crisis by having banks prepared in advance. In 2005, no one saw a financial crisis coming, and not many did in 2006; in 2007 and 2008, it depended on where you were. So, the question is. when do you see a crisis coming?"

History tells us recognition will come relatively late, Sorensen said.

"With recognition of an impending credit wave, loss expectations will increase and the provision expense will be accelerated and concentrated into fewer reporting periods," he noted. "A negative forecast will require you to recognize the provision expenses for losses for years down the road, but without the revenue to cover the expense. That could crush earnings and increase earnings and capital volatility. That complicates the job of the CFO to responsibly manage the financial affairs of the bank across that economic cycle.

"Capital levels under pressure," Sorensen argued, "could prompt a tactical decrease in loan activity, in order to protect the institution's capital ratios, restraining credit availability and exacerbating an economic downturn."

mst

BALANCE SHEET STRENGTH SHIFT

CFOs also need to consider that the strength in their balance sheets could shift from capital to allowance, Sorensen continued.

"If you expect a credit crunch coming, you're compelled by life-of-loan estimating to project losses and get to an allowance position sized to cover all those losses," he said. "So, what happens to my capital adequacy requirements? My capital ratios don't take into consideration my elevated allowance position. Capital adequacy is what protects the enterprise from failure, but so does the allowance, so to omit it from the conversation about capital adequacy make that an incomplete conversation."

In adverse credit conditions, allowance levels will increase significantly. But how much? Sorensen posed.

"The forecast of economic and credit conditions will be a powerful lever on allowance levels," he said. "A tricky part of the forecast will be accurate and timely recognition of an emerging economic downturn."

SHORTER LOAN MATURITIES

The life-of-loan concept also favors shorter loan maturities, Sorensen noted, adding that "the change in provision expense recognition on a life-of-loan basis could have significant and long-term implications for such loan products as the 30-year mortgage, small business loans and loans to non-prime consumers. Credit availability and the impact on traditional credit structures is a topic CFOs need to concern themselves with sooner than later."

At least, he offered, a lender might change the way long-term structures are priced.

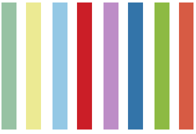
"These are issues the regulators have yet to weigh in on," Sorensen said. "We've been focused on implementation issues, but CFOs must consider supervisory issues."

EXTENDED RESPONSIBILITIES

"As CFO, you will have to defend to your institution's choice of methodology and support your decision – to your regulators, auditors, your board and CEO," King said. "You can enlist the expertise of a third party, but you ultimately own the decision. So, you have to know it backwards and forwards to articulate your rationale.

"Your model is up to you," she added. "It's your choice. No one is telling you how you have to comply. So CECL is an opportune time to enhance your risk management practices and your credit risk policies and processes.

"You have to be knowledgeable if you expect your team to be," King concluded. "You have to provide training for employees. And you have to keep your CEO and board updated about the impact of CECL and the decisions you are making. That's the CFO's responsibility."



ABOUT THE EXPERTS

Paula S. King
Senior Advisor
MST Advisory Services

Paula King is Senior Advisor for MST Advisory Services, part of a team of subject matter experts assisting financial institutions nationwide in the interpretation and application of Current Expected Credit Loss (CECL), the new federal allowance accounting standard. Paula has held executive positions, including as Chief Financial Officer, in the banking industry for more than 25 years. She has been responsible for SEC and financial reporting and presentations, capital raising efforts and strategic planning, and has served as a Chief Risk and Compliance Officer. Paula has extensive experience in the preparation and reporting of the allowance for loan and lease losses, including ensuring compliance with regulatory and audit requirements, and creating allowance policies, procedures and processes.

Larry Sorensen
Chief Financial Officer
Washington Trust Bank

Larry Sorensen is the Senior Vice President and Chief Financial Officer for Washington Trust Bank, a $6 billion institution headquartered in Spokane, Washington. He counts more than 30 years in banking and has been with Washington Trust since 2008. He began his career as a thrift regulator for the FSLIC at the Federal Home Loan Bank of San Francisco during the thrift crisis in the 1980s. He then shifted to the private sector, working in the Corporate Development department of Golden West Financial Corporation, the holding company for World Savings, where his responsibilities included mergers and acquisitions, market research, branch system and market expansion, and corporate real estate. Following a year of global travel, then work with an internet startup, he returned to banking as the CFO of Sonoma National Bank, a billion-dollar institution located in Santa Rosa, Cal., and after its sale in 2006, joined Commerce National Bank in Newport Beach, California, as CFO.