Managing Fate

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By Dalton T. Sirmans

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Since early in 2016, when the Federal Accounting Standards Board was putting the final touches on the Current Expected Credit Losses (CECL) accounting standard for estimating reserves, lenders have been working to understand CECL and how to minimize any negative impact on their organizations. Initial revelations and realizations were that data needs would be substantial, that lenders would need a different ALLL methodology than their current historical losses approach, and that, as a result, estimating based on future performance would require greater sophistication than a manual, Excel-based ALLL process could provide.

“We upgraded to an automated system to save us time and resources as we transition to CECL,” said Sarah Cowan, senior vice president at National Bank of Middlebury in Vermont. “We expect supporting documentation to satisfy our regulators, auditors and loan review people, and that the system (the MST Loan Loss Analyzer) will grow with us, support us, not only under a more complex accounting standard, but as we become a more complex institution.”

Proactive lenders believe that addressing CECL means developing and executing a plan of preparation. They are starting by automating their allowance processes so they can begin assessing their data and data quality, then testing methodologies to identify one or more suited to their institutions and portfolios. And they know that being proactive in their preparations gives them a competitive edge over those who fail to act in time to avoid consequences.

“Do you make loans of five or more years?” Shane Williams, a senior consultant with MST Advisory, asks. “Then you are making loans today that will be subject to the new CECL allowance accounting standard. And the longer the terms, the more impact CECL will have on your bottom line. It would be wise to determine that now as opposed to being surprised by your first estimation under CECL in four or five years.”

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Wait-and-see

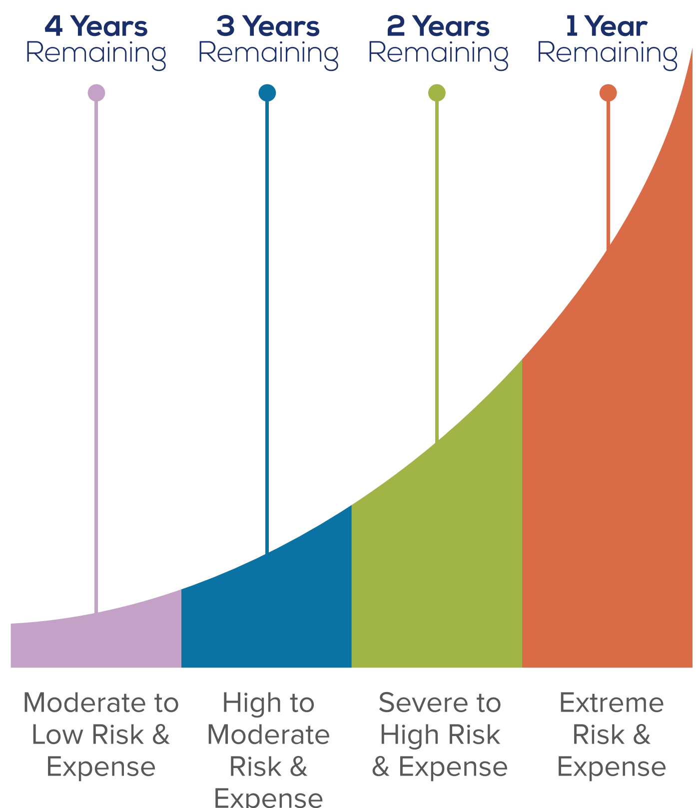
In a poll of attendees at the 2016 MST National Conference on the ALLL – admittedly a more CECL-concerned group if only by their attendance at a conference dedicated to issues related to CECL – 63 percent said they have begun CECL preparations. That leaves almost a third of even those institutions seeking education on CECL that haven't started preparing.

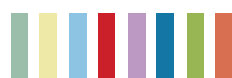
> **"It's natural for businesses to wait and respond to change to see how their peers address the issues. CECL is not optional. It is unavoidable for all institutions."**
>
> ***Tom Cunningham***
> ***Senior Economist (retired)***
> ***Federal Reserve Bank of Atlanta and***
> ***MST Advisor- Economics***

There is a limited supply of external expertise available for both the process and the technology. As the implementation deadline approaches, demand for that expertise will increase, and we all know what happens when supply is limited and demand is surging. Establishing relations with the external support necessary for CECL early in the process will assure both availability and cost. Waiting until late in the process when other last-minute institutions are gobbling up resources and bidding up prices is not a sound business decision.

"The technical answer is that as a deadline approaches, demand becomes more price inelastic, so the increase in demand results in a larger proportionate increase in price than earlier. How much costs increase depends on the shift in elasticity and the shift in demand."

"Getting started, determining priorities and learning what information you will need and how you will get it is imperative," MST Advisory's Williams warned. "If you put it off, it's going to be expensive, both securing the resources and support to make the transition as well as CECL's impact on your earnings and capital."





Ahead of the curve

Financial institutions like the National Bank of Middlebury were ahead of the curve in learning about CECL and taking on the tools they'll need for CECL compliance. But now the curve has taken the industry around the proverbial corner, and the pressure to begin preparations is taking hold at most institutions. Momentum toward step one, adopting a system that can manage the data and methodology required by CECL, is picking up.

Eighty-four percent of financial institutions responding to a 2014 Loan Loss Reserve Survey by RSM US, an auditing, tax and consulting firm, were using manual, Excel-based methods to estimate their allowances. The firm's 2015 survey indicated 73 percent were still using Excel, a decline of 11 percent. So by the time of that 2015 survey 27 percent of the institutions surveyed had moved beyond Excel, presumably to an automated solution, meaning our industry had entered the "early majority" phase of automation adoption, according to The Technology Adoption Life Cycle, a sociological model that describes how a new product or an innovation is adopted over time.

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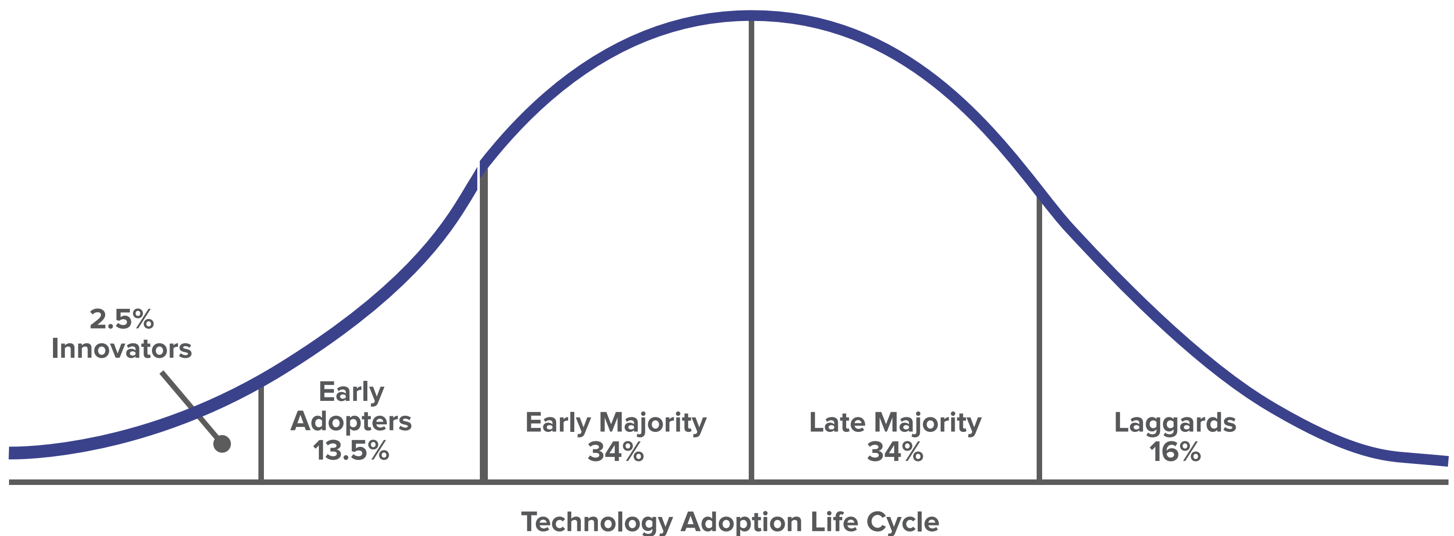
Technology Adoption Life Cycle

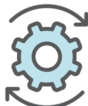


Factors relative to adoption of ALLL automation that can be subjectively/objectively measured through the Technology Adoption Life Cycle:

Investment: As demand for automation increases – and as regulators and auditors weigh in – there is ample reason to expect rising prices. It is unlikely that automating the ALLL will be commoditized because of the customization required for each financial institution.

Expertise: There is a shortage of available ALLL expertise.

Control: Early adopters will be able to spend more time on data quality, modeling, trial and error (Shadow Loss Analysis), conversations with peers, etc.



Resources: Waiting to adopt will place more pressure on the lender's internal resources.

Auditors & regulators

The advisory community is urging proactivity, promoting the urgency of the situation to their financial institution clients.

"We are talking with our clients' audit committees on an ongoing basis about their progress toward a CECL-compliant model, starting with 'Show me your plan,' and as you get closer 'How's it coming?'" noted Graham Dyer, Partner, Accounting Principles Consulting Group of Grant Thornton, and member of FASB's Transition Resource Group. "We'll likely want to have a dry run with a proposed methodology, maybe a year before, just to make sure they're ready to go when it's time to get the annual reporting."

> **"Forget about the answer, think more about the process, the different steps that you need to be thinking about and implementing that will help you transition to CECL."**
>
> ***Graham Dyer, Partner, Accounting Principles Consulting Group, Grant Thornton LLP***

Steve Wagner, a partner with Crowe Horwath, LLP, is pressing for risk assessment as a precursor to determining data quantity and quality.

"For example, for consumer lending in terms of credit risk, we're thinking about FICO scores or debt-to-income ratios, or loan-to-value. Once you hone in on the credit drivers specific to your portfolio, then your data people can look to see how far back in history you can go relative to that driver.

"Some lenders are realizing they could have completely different data needs depending on the lending product. The driver for commercial loans might be debt service coverage, so how good is your data there? Or internal loan grades, so how far back can you go and have you changed your loan grading so that consistency is an issue?"

The regulatory agencies recognized early the challenges for their charges, and have focused on ensuring they have a firm grasp of their own on CECL and its requirements.

"We have spent much of our time and focus on CECL since its release," FDIC Deputy Chief John Rieger told attendees at the September 2016 American Bankers Association CFO Exchange conference. "The three agencies have been meeting and working on getting our arms around CECL. We've been meeting with examiners, state regulators, vendors and the PCAOB (Public Company Accounting Oversight Board)."

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Getting Specific

Auditors and regulators are getting down to specifics, honing in on what lenders should do now to be ready for CECL.

According to Crowe Horwath's Wagner, "Consistency and accuracy are critical considerations. Let's say you have commercial loan data for five years back, but you changed your internal loan rating system a couple years ago. That would cause consistency issues; you're not comparing apples to apples.

"Accuracy is a huge issue for lenders if you don't have controls in place to ensure all the data get into your system, for example, prepayment speeds that might be important in some models. Much of this has not been audited historically, so the questions are, 'Where did you get this data and how do you prove it is accurate?'"

Grant Thornton's Dyer proposes a step-by-step process toward implementation to the lenders he works with:

- Scoring – Inventory financial assets at amortized cost and group according to similar risk characteristics into pools.
- Measurement – Consider each pool to determine an appropriate method for determining losses. (Banks are likely to use different methods for different pools.)
- Data – Determine historical loss experience for each pool and assess data for quality, completeness and accuracy.
- Processes and Controls – Consider implications for IT, the need to automate the estimation process and embed IVFR into relevant operational areas.
- Governance – Establish and document policies, procedures and reporting; adopt model validation as a formal process.
- External Input – Engage auditors and regulators in planning.
- Optimization – Extend information and processes built for CECL to other management activities.

Among FDIC Deputy Chief Rieger's suggestions to lenders:

- Talk to your examiners . . . Examiners have been instructed and will expect to discuss your progress toward a CECL methodology and address issues of concern. Such informal dialogue will have you and your examiners working together and on the same page.
- Read the standard . . . Regulators will want to know the institution has educated itself on the standard and understands its requirements.
- Review existing data and data accessibility . . . While there is no prescribed number of years of loan level data needed to comply with CECL, lenders must have access to sufficient data for this more demanding estimation process – and they will have to go through the process of ensuring data is accurate and consistent.
- Document assumptions . . . Again, regulators won't prescribe a path to compliance, but financial institutions will have to demonstrate and document how they are getting there.

"Lenders should be preparing for CECL," Crowe Horwath's Wagner summarized, "What each does should be based on its risk profile as defined by management, its auditors and regulators."

Dalton T. Sirmans is CEO and cofounder of Atlanta-based MST (MainStreet Technologies, Inc.) developer of loan portfolio risk management software for banks and credit unions.

Since 2005, MST has implemented technology solutions to help financial institutions simultaneously simplify and sophisticate the way they manage the inherent risk in their loan portfolios. MST is the leader and pioneer in allowance software solutions and education. Financial institutions across the U.S. employ MST products and services to address their allowance compliance requirements, including compliance under the new CECL accounting standard. MST solutions are tailored to meet specific data management needs and integrate with core and other systems to exponentially improve efficiencies.

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