CECL IS COMING – IS YOUR BANK PREPARED?
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CECL IS COMING — IS YOUR BANK PREPARED?

By Chad Kellar, CPA, and Nate Hathaway, CPA

The current expected credit loss (CECL) methodology is a significant departure from the way the allowance for loan and lease losses (ALLL) has been calculated in the past. CECL has new rules regarding the methodologies to be applied in order to capture the expected credit loss over the life of the financial asset. As a result, many banks will need to identify more robust data collection methods. Banks need to begin planning for this significant change and ensure they are capturing and storing robust loan level loss information that will adequately allow for segmentation of risk and allow for dynamic forecasting capabilities associated with those risks. This white paper provides an overview of CECL beginning with a timeline of its evolution.

### MILESTONES

<table>
<thead>
<tr>
<th>Date</th>
<th>Event Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>May 26, 2010</td>
<td>FASB issues comprehensive proposal to record all financial instruments at fair value.</td>
</tr>
<tr>
<td>Jan. 31, 2011</td>
<td>FASB and IASB propose common solution (3 bucket approach).</td>
</tr>
<tr>
<td>Dec. 20, 2012</td>
<td>FASB proposes CECL model as alternative to 3 bucket approach.</td>
</tr>
<tr>
<td>July 24, 2014</td>
<td>IASB issues IFRS 9 independent of FASB.</td>
</tr>
</tbody>
</table>
THE CECL MODEL DEFINED

The CECL model recognizes an allowance for expected credit losses on financial assets. It departs from the incurred loss model, which means the probable threshold is removed. This model also removes the prohibition on recording day one losses.

This concept is best depicted visually. As illustrated below, the cumulative credit losses recognized at the final resolution of the asset (charge-off) are the same whether the incurred loss model or the new CECL model is used. However, the allowance recognized in earlier periods is likely to be different.

**CECL vs. Current GAAP (Incurred Losses)**
10-year asset class with loss estimates determined at inception and revised in years 3 and 7.

Source: Crowe Horwath LLP analysis
The model considers more forward-looking information than is permitted under current U.S. GAAP. The following excerpts are taken from the “Financial Instruments: Credit Losses (Topic 326) Measurement of Credit Losses on Financial Instruments”:

“...an entity shall consider available information relevant to assessing the collectability of cash flows. This information may include internal information, external information, or a combination of both relating to past events, current conditions, and reasonable and supportable forecasts.”

“...an entity shall not rely solely on past events to estimate expected credit losses. When an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated.”

Based on this information, banks need to project the expected losses as far as can be reasonably estimated and revert to a historical lifetime loss experience for the future periods, beyond which the entity is able to make or obtain reasonable and supportable forecasts. The model provides flexibility to use different methodologies. The table on the next page illustrates the scope for the CECL model.
<table>
<thead>
<tr>
<th>In CECL</th>
<th>Not in CECL</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financial assets measured at amortized cost basis, including</td>
<td>• Financial assets measured at fair value through net income.</td>
</tr>
<tr>
<td>• Financing receivables.</td>
<td>• Available-for-sale debt securities.</td>
</tr>
<tr>
<td>• Held-to-maturity (HTM) debt securities.</td>
<td>• Loans made to participants by defined contribution employee benefit plans.</td>
</tr>
<tr>
<td>• Receivables that result from revenue transactions (Topics 605, 606, and 610).</td>
<td>• Policy loan receivables of an insurance entity.</td>
</tr>
<tr>
<td>• Reinsurance receivables that result from insurance transactions (Topic 944).</td>
<td>• Promises to give (pledges receivable) of a not-for-profit entity.</td>
</tr>
<tr>
<td>• Receivables that relate to repurchase agreements and securities lending agreements (Topic 860).</td>
<td>• Loans and receivables between entities under common control.</td>
</tr>
</tbody>
</table>

Net investments in leases by lessors (Topic 842).

Off-balance-sheet credit exposures not accounted for as insurance (doesn’t apply if unconditionally cancelable):
• Off balance sheet loan commitments.
• Standby letters of credit.
• Financial guarantees not accounted for as insurance.
• Other similar instruments, except for derivatives and hedges (Topic 815).
CHANGES TO METHODOLOGIES UNDER CECL

Implementing the CECL model requires changing the methodology, by either modifying the existing methodology or making a wholesale change in methodology. The “Inside the New Credit Loss Model” article issued by Crowe Horwath LLP and referenced on the “Resources” page includes a comparison of models under both the new and old standards. Banks are required to develop estimates that clearly are more forward-looking than they were in the past. However, banks should forecast only as far as can be reasonably estimated, and should revert to historical losses after this point. The history may be the hardest element to capture on longer-term assets.

As a part of this analysis banks may need to re-evaluate the current primary drivers of loss, and in many cases there will likely be more than one driver of expected losses for each portfolio.

Changes in the methodologies implemented or the risk characteristics used to organize the portfolio could require new data to be historically gathered and prospectively tracked (examples include credit scores or other underwriting criteria). Banks need to consider remaining-life exposure to not overstate loss, which requires an understanding of the expected lives and terms of the loans, which will likely result in more discrete pooling than

EFFECTIVE DATES

Effective dates previously determined were extended by one year as follows:

- Public business entities (PBEs) that meet the definition of a Securities and Exchange Commission (SEC) filer: fiscal years beginning after December 15, 2019, including interim periods within those fiscal years (Q1 2020 for calendar year ends).
  - SEC filer – An entity that is required to file or furnish its financial statements with either of the following:
    - SEC.
    - With respect to an entity subject to Section 12(i) of the Securities Exchange Act of 1934, as amended, the appropriate agency under that Section.

Financial statements for other entities that are not otherwise SEC filers whose financial statements are included in a submission by another SEC filer are not included within this definition.

- Other PBEs: fiscal years beginning after December 15, 2020, and interim periods within those fiscal years (Q1 2021 for calendar year-ends).
- All other entities: fiscal years beginning after December 15, 2020, and interim periods within the fiscal years beginning after December 15, 2021 (as of 1/01/2021, but recorded in Q4 2021).
- Early adoption is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.
today. In addition, this change in methodology will not eliminate qualitative adjustments and may result in an increased number of qualitative factors than before for some institutions.

It should also be noted that the purchased credit impaired (PCI) concept has been revised and renamed to purchased credit deteriorated (PCD). This change in approach will result in the establishment of a day one allowance, and the allocation of the noncredit component to each asset. Lastly, banks will be able to immediately recognize the effect of increases in expected cash flows as applicable.

**CECL EXPECTED IMPACTS: HOW TO ESTIMATE**

Institutions are required to evaluate financial assets on a collective (pool) basis when similar risk characteristics exist; however, banks can’t offset expected credit losses with separate contracts such as credit default swaps or freestanding insurance contracts. Banks should always reflect the risk of loss, even when remote; however, banks are not required to recognize a loss when the risk of nonpayment is greater than zero, yet the amount of loss would be zero (that is, the financial asset might default but an entity is expected to collect all amounts due).

**BEYOND THE FORECAST**

As previously stated, banks need to project expected losses as far as can be reasonably estimated. They need to revert to a historical lifetime loss experience for the future periods beyond which the entity is able to make or obtain reasonable and supportable forecasts. Reversion should occur at either the component level or the entire loss estimate.

<table>
<thead>
<tr>
<th>Example</th>
<th>Historical Experience</th>
<th>Forecast Period (Years 1–2)</th>
<th>Periods beyond Forecast (Years 3 and beyond)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Portfolio A</td>
<td>Historical loss experience</td>
<td>Expected losses in forecast period</td>
<td>Expected losses based on reverting to historical loss experience</td>
</tr>
</tbody>
</table>

Permission to revert can occur:

1) Immediately.
2) Over the financial asset’s estimated life on a straight-line basis.
3) Or over a period and in a pattern that reflects the entity’s assumptions about expected credit losses over that period.
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Banks will need to disclose the pattern of reversion as well as changes in the reversion period within the financial statements.

**DISCLOSURE AND TRANSITION**

Under the standard, the information to be disclosed will likely need to significantly expand. More specifically, the following are examples of items that will need to be disclosed beyond the current disclosures:

- Description and discussion of the factors that influenced management’s approach, including reasonable and supportable forecasts about the future.
- Method applied to revert to historical credit loss experience.
- A disaggregation of the credit quality indicators, or all classes of assets that are currently disclosed by year of the asset’s origination (requirement varies dependent on PBE classification).

The transition approach will vary depending on the individual assets, but the general rule will be a modified retrospective approach with a cumulative effect adjustment to the balance sheet.

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**About Crowe Horwath LLP**
Crowe Horwath LLP is one of the largest public accounting, consulting, and technology firms in the United States. Our dedicated professionals create value for our clients by connecting deep industry knowledge with innovative technology, while maintaining a commitment to independence, integrity, and objectivity. By listening to our clients, we learn about their businesses and the unique challenges they face. We forge each relationship with the intention of delivering exceptional client service while upholding our core values and strong professional standards. We invest in tomorrow because we know smart decisions build lasting value for our clients, people, and profession.

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CECL SERVICE

To help your transition to The Current Expected Credit Loss (CECL) Methodology, you can subscribe to RMA’s CECL Service. This members-only service captures, stores, and reports on loan level loss information.

If you have any questions, or if you are interested in participating, please send an email to cecl@rmahq.org; include the contact information for the person at your bank who should receive further information about this service.

Learn more about the RMA CECL Service.

CECL RESOURCES

Find links to articles, whitepapers, and more on our CECL resources Web page.
ABOUT RMA

The Risk Management Association (RMA) is a not-for-profit, member-driven professional association serving the financial services industry. Its sole purpose is to advance the use of sound risk management principles in the financial services industry. RMA promotes an enterprise approach to risk management that focuses on credit risk, market risk, operational risk, securities lending, and regulatory issues.

Founded in 1914, RMA was originally called the Robert Morris Associates, named after American patriot Robert Morris, a signer of the Declaration of Independence. Morris, the principal financier of the Revolutionary War, helped establish our country’s banking system.

Today, RMA has approximately 2,500 institutional members. These include banks of all sizes as well as nonbank financial institutions. RMA is proud of the leadership role its member institutions take in the financial services industry. Relationship managers, credit officers, risk managers, and other financial services professionals in these organizations with responsibilities related to the risk management function represent these institutions within RMA. Known as RMA Associates, these 18,000 individuals are located throughout North America and financial centers in Europe, Australia, and Asia.

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ESTATEMENT STUDIES

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