Current Expected Credit Losses(CECL): What's next and best practices

Presented by: Plante Moran

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Speaker Biography

As an assurance partner and the industry technical leader for financial institutions, mortgage, and finance companies of Plante Moran, I serve both public and private institutions, perform quality control reviews, and advise our clients and team so that they stay on the forefront of industry and regulatory developments.

I began my career in 2004 and was fortunate to be one of the first financial institutions team members focused on building and serving a practice in Chicago. After helping grow our Chicagoland practice, I'm now proud to be part of our team in the Rocky Mountain region, bringing my enthusiasm and technical guidance to our clients in Colorado and beyond.

I speak regularly for several different associations on topics such as new accounting standards, regulatory changes, and industry developments. Additionally, I author various thought leadership pieces for our clients and their boards. Lastly, in my free time, I enjoy opportunities to get to the Rocky Mountains for skiing and hiking, and I enjoy the humbling game of golf.

Agenda – In this session, attendees will:

- Be provided a high-level overview of the impact CECL has had on the industry
- Understand how CECL's impact compares with those yet to adopt
- Hear about lessons learned for those that adopted
- Understand data issues and variations in model effectiveness
- Gain awareness around key model risk management issues
- Be provided data and model validation perspectives
- Understand changes to CECL on the horizon, best practices and words of advice for those yet to adopt

Setting the stage of CECL

The CECL standard effective dates (calendar year-ends):

January 1, 2020 for SEC issuers that are not classified as smaller reporting companies

Everyone else adopts January 1, 2023

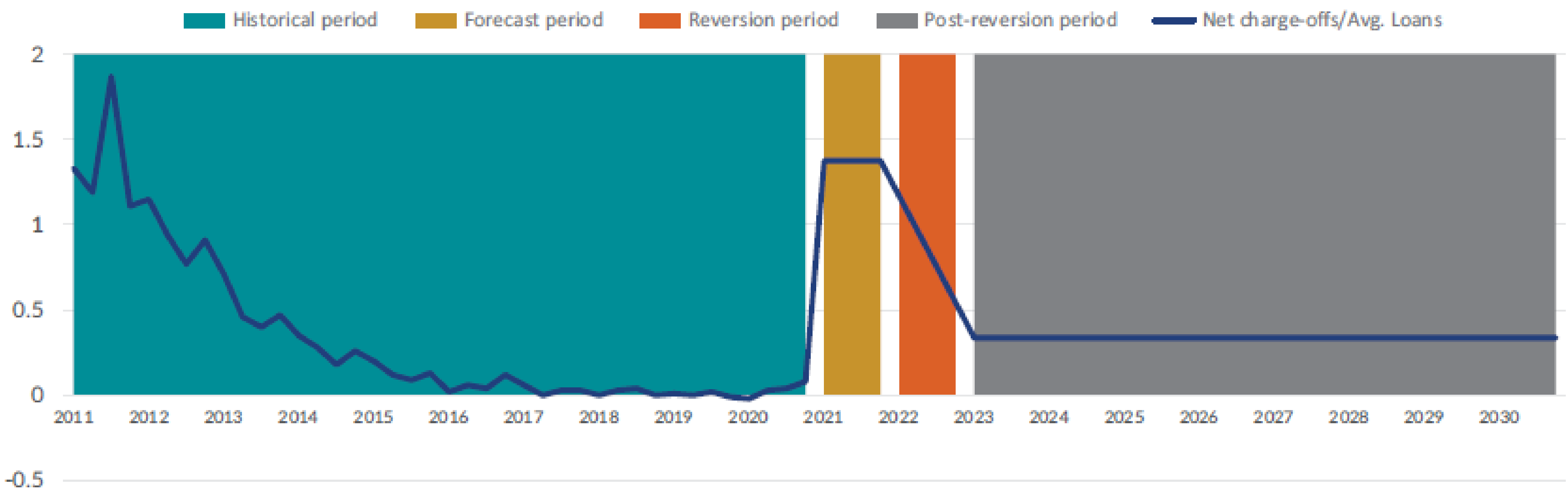
Change in the ACL recorded to equity, net of tax impact

Credit mark of PCI loans is reclassified into the ACL

Incurred vs. CECL

CECL Framework

- Estimate credit losses over estimated life of loan
- Includes four components:
  - Historical period
  - Forecast period
  - Reversion period to the long-term historical
  - Post reversion to the long-term historical



Impact of CECL on the Industry

Question	Answer
What was the average impact of institutions that adopted CECL?	On average, an increase of 119% from the Dec. 31, 2019 allowance.
What was the average ACL compared to total loans upon adoption?	On average, the ACL coverage ratio approximated 1.04% on December 31, 2019. Adjusted ACL coverage approximated 1.23% on January 1, 2020.
How did COVID impact the ACL compared to total loans?	Significantly. Provisions in Q1, Q2, and Q3 were significant and increased coverage to approximately 1.71%. Q4 ACL levels remained relatively flat.
What about PPP loans? What impact did these fully guaranteed loans have on the ratio?	Excluding PPP loans from the coverage ratio, the resulting ACL approximated 1.82% at Q3 2020.
What has happened in 2021 given items such as the vaccine?	Many took negative provisions to refine a previous overly conservative estimate.

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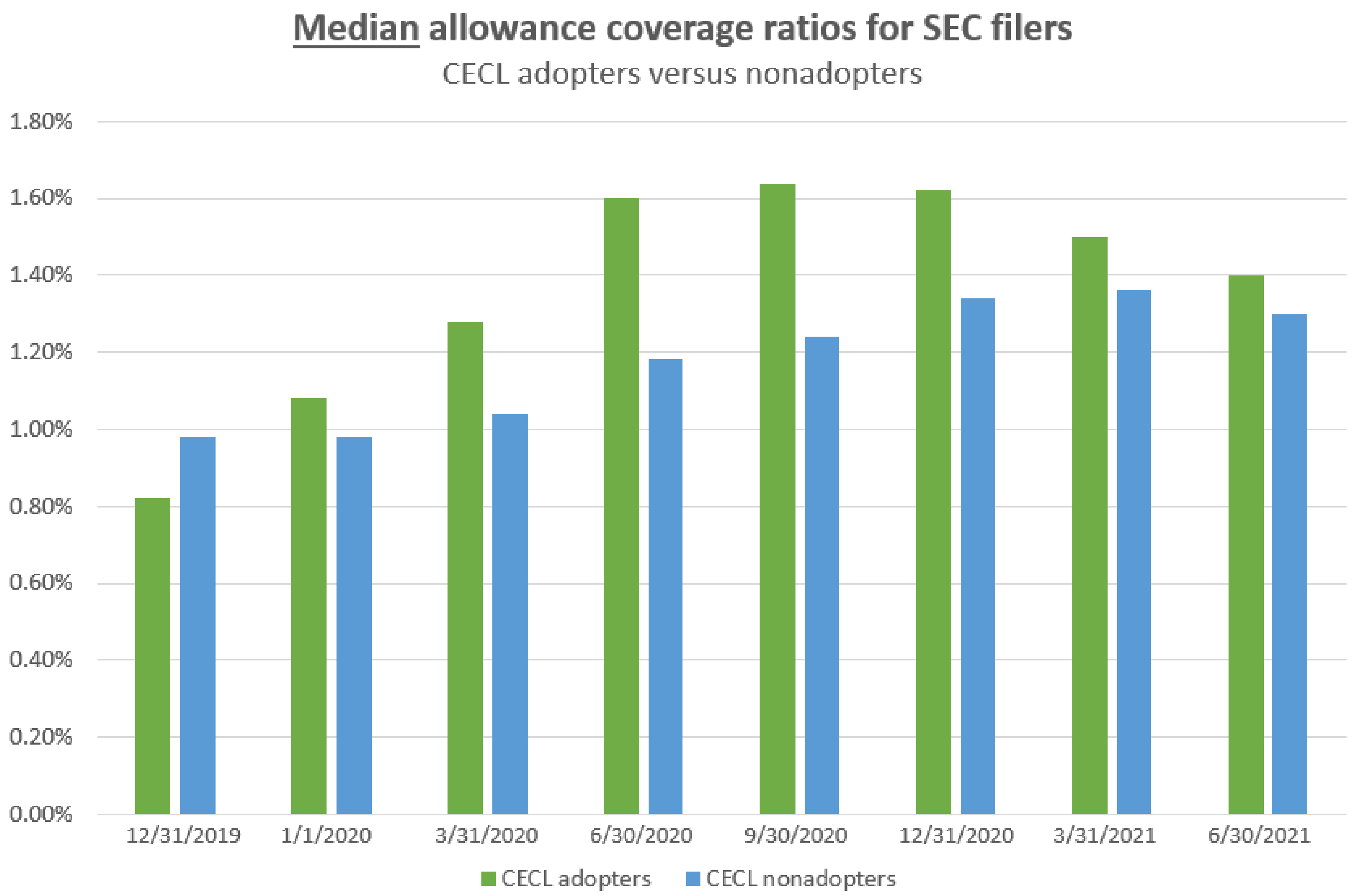
How does CECL's impact compare to those yet to adopt?



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Lessons learned from those that adopted

- The more complex your method, the earlier you need to start
- Lots of variation in methods = the devil is in the details of the math and inputs
- Ensure the complexity of the model is commensurate with the complexity of your institution
- Designate one person as a point person and ensure this person has the capacity to handle (hint, more complex = more time)
  - ***BUT*** make sure this person is adequately supported
- Completeness and accuracy are everyone's new favorite words
- Ensure collaboration and communication between different department heads (IT, lending, accounting)
- Who’s on first? Finger pointing between vendor and institution.
- Criticisms were not on the level of the ACL but rather documentation such as:
  - “Journey memo”
  - Method understanding
  - Inputs needed (ensure you understand ***specifics*** such as prepayments re-amortize or not)
  - Key assumptions
  - Forecasts
  - COVID

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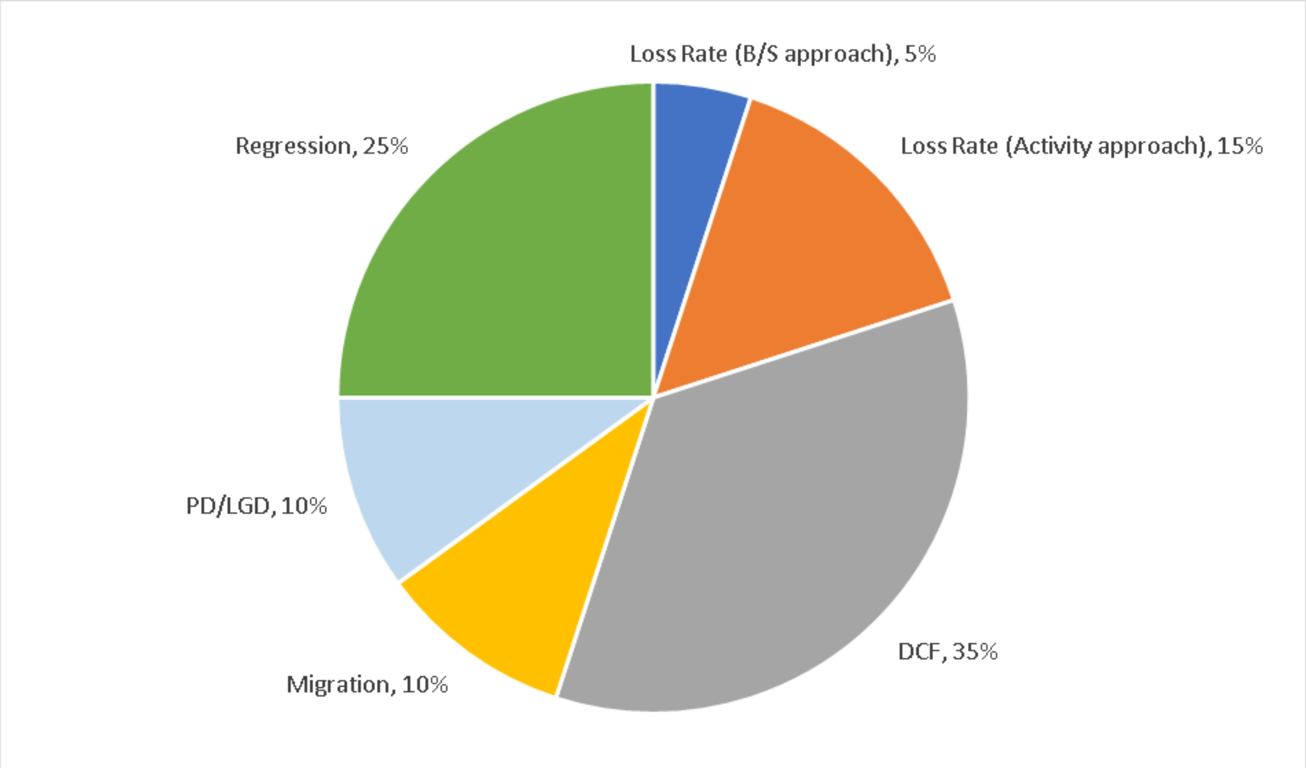
Methods selected by those that adopted



- Note that not all methods are calculated the same way between software providers. Again, devil is in details of the math and the inputs for that math.
- Expect this pie chart to change significantly when all others adopt in 2023.

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Lessons learned from those that adopted

Methodologies

SCALE (new in 2021)

Loss Rate

- WARM
- Snapshot/ open pool
- Static pool
- Vintage

Migration (roll-rate)

Probability of default/ loss given default (PD/ LGD)

Discounted cash flow

More computational and complex

- Understanding the costs and the variation of those costs
- What is your institution looking for? Is it a model to solely calculate the ACL or are you seeking a model that will do more?

Understanding data issues and variations in model effectiveness

- General rule = the more complex the model, the more loan level data needed
- Lack of data for a full economic cycle – if you don't have recessionary losses in your historical data, how do you measure forecast adjustments when a recession is forecasted?
  - Result = much of the ACL effectively remained qualitative vs. quantitative
- Internal controls – historical controls don't always cover all loan level items needed for your model
- Economic information utilized – unemployment widely utilized
  - National vs. regional vs. more local
- Assumptions need to be consistent with other reporting (e.g. ALM)
- Ensure your methodology for applying forecast and current condition factors will work in all segments of an economic cycle (expansion, recession, recovery)

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Model Risk Management – Setting Expectations

Question	Answer
Do I need to get my model validated prior to going live?	Complexity is a factor here. The more complex, the more likely your examiners will expect/ require it so plan accordingly.
How might the validation of this model be different than historical validations on my incurred loss method?	From a theory perspective, shouldn't be different as the rules have not changed. However, if you increased the complexity of your model, a significant difference could be in your future. Ultimately, be prepared to answer tough questions that will test your depth of understanding.
How often will my model need to be validated?	It is likely you will rate your model as "high risk" as part of your MRM inventory and risk analysis. Thus, annual tends to be a common answer.
Won't my vendor have a validation done that I can rely upon?	Unfortunately, no…. Regulatory rules do not allow for the abdication of responsibility to the vendor. Even if that vendor had their math or calculation "validated", that does not cover the application at your institution. Ultimately, institution diligence and validation is not replaced by "vendor documentation".

Awareness around key model risk management matters

- Model documentation
  - Historical approval and revisions
  - Executive summary
  - Governance/control of model
  - Framework
  - Impact to your institution
    - Loans
    - HTM securities
    - AFS securities
  - Reporting and disclosure
  - Appendices

Data and model validation themes

- Which came first the chicken or the egg?
  - Issues arose in scenarios where a method/model was selected without **FULLY** understanding the necessary data.
- How good has historical data been?
  - Last five years – generally pretty good
  - 6-10 years – limitations are common
  - 11+ – few have this data
- Historical data testing – risk assess and test
  - Consider control environment in historical periods
    - CRITICAL – ensure all inputs are explicitly included in design of control
  - Results of historical period testing of these controls
  - Develop testing plan and execute
- Peer data or industry data is commonly leveraged especially in:
  - When limited loss experience exists
  - New lending products
- Data governance practices and Chief Data Officers!

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Potential changes to CECL on the horizon

Troubled debt restructures (TDR)

- Under CECL, impact of most concessions is already included in ACL
- Possibly removing creditor TDR measurement of ACL requirement for those that have adopted CECL
- Expect enhanced disclosures

Purchased credit deteriorated (PCD)

- Flaws with accounting for non-PCD loans
  - “Double dip”
  - Accretion to income of credit mark
  - Lack of comparability of ACL/ gross loans
- Additional outreach is happening

Clarification and conclusion on vintage disclosures

- Inconsistently laid out in GAAP
- Gross write-offs included by vintage year

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Best practices and words of advice for those yet to adopt

**Note that level of complexity plays a significant factor in time and money, but you could see benefits.*

Best practice and advice	Perspectives
Start early	Preparation took most institutions about 2 years to complete but should be less with less complex methods.
Weigh vendor solutions	Vendors are offering different solutions. Understand the specific data needed. Some vendors offer more than just an ACL calculator.
Thoroughly understand YOUR data	Understand your historical data and what you feel comfortable with. To me, understanding this should frame your decision on method/ model.
Measure twice, cut once	Choose your model/method carefully. This decision can lead to high costs in both time and money if not the right fit for you.
Plan for formal governance	Expectations will be higher, especially with complex models.

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Best practices and words of advice for those yet to adopt

A timeline for your consideration.

Calendar year 2021	Calendar year 2022
1. Assess and understand available methodologies	1. Verify new data
2. Identify available data	2. Perform shadow calculations
3. Assess data limitations against available methods (caution on different approaches between vendors)	3. Calibrate model accordingly
4. Select your methodology **carefully**	4. Finalize controls
5. Organize and validate data	5. Test controls
6. Finalize segmentation	6. Have model validation performed
7. Establish processes and controls	7. Measure impact as of Dec. 31, 2022, and record variance to equity, net of taxes, on Jan. 1, 2023

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Questions?

What our practice looks like

600+ Financial services clients

- **225+** *Community banks*
- **35+** *Banks that are or have been SEC registrants*

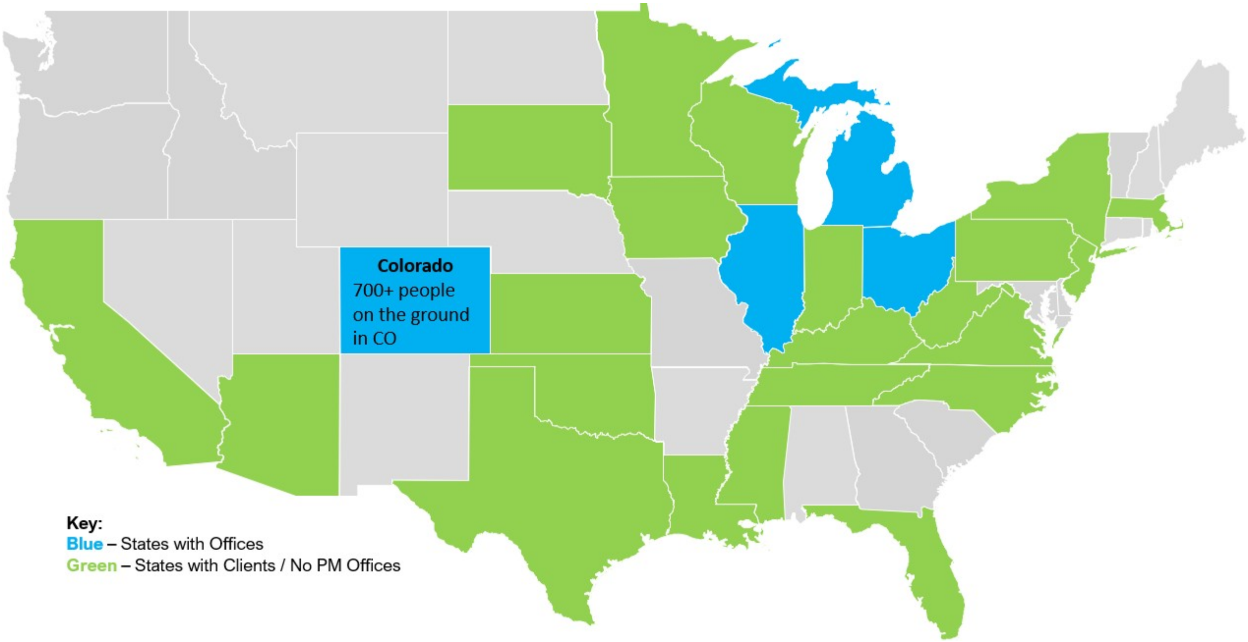
150+ Financial institutions served by the firm's risk management practice, for whom we provide outsourced or co-sourced internal audit services

50+ Years serving financial institutions

200+ Professionals dedicated to serving financial institutions, including 20 partners

Profile of clients with an asset size over $1 billion

50 Banks with more than $1 billion in assets → **25** Banks with more than $2 billion in assets → **12** Banks with more than $5 billion in assets



Plante Moran has the largest number of boots on the ground than any other accounting firm in Colorado.

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Thank you!

How we serve banks

Whether you need a single, specific function or comprehensive services, Plante Moran has the knowledge, experience, and resources to meet your needs.

★ Audit & accounting
- Financial statement audit
- Employee benefit plan audit
- Custodial, HUD, & USAP audits
- SEC matters
- Surprise audit
- Regulation AB attestation

Human capital
- Retirement plan design
- Nonqualified deferred compensation plans
- ESOPs
- Healthcare reform consulting
- Benefit plan design & review

★ Technology
- Cybersecurity
- Information security risk assessment
- IT general controls review (FFIEC CAT, InTREx, NIST)
- Privacy reviews (GLBA, Red Flags, PCI DSS)
- Network vulnerability assessment, penetration testing, & social engineering
- Application user access
- Remote deposit capture review
- Business continuity/disaster recovery
- Systems selection & project management
- Contract reviews
- SOC compliance including SSAE1

★ Tax
- Planning & compliance
- Minimization strategies
- IRS audit strategies
- ORE costs
- Conformity elections
- Nonaccrual loan interest
- Tax credit utilization
- Research & development
- New Markets
- Mergers & acquisitions
- Section 382 limitations

★ Risk management
- Internal audit
- Loan review
- Regulatory compliance
- BSA/Anti-money laundering (AML) review services
- Fair lending review and risk assessment
- Trust audit
- ALLL, ALM, BSA, and capital stress testing model validation

Strategy & operations
- Efficiency studies
- Profitability analysis
- Branch profitability analysis
- Strategic planning

Business advisory
- Business planning
- De novo bank consulting
- ★ Forensic & valuation services
- Merger & acquisition services

★ = Most popular

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