CECL: Common Themes and Challenges

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McQueen's CECL model was developed nearly 3 years ago, and we are preparing parallel reports for clients nationwide. Over time, we've learned a great deal about data challenges, the potential day one CECL impact, likely examiner expectations and difficulty in writing an adequate rationale for model choices. We'd like to take this opportunity to share what we have learned.

Common Themes and Challenges

In our daily consulting work across the country, we learn a great deal about our industry's challenges. For quite some time, many people believed that CECL adoption would be delayed as a result of the pandemic. It is very clear now that CECL adoption will not be delayed. CECL reporting will be required for fiscal years beginning after December 2022. While none of our clients have elected early CECL adoption, we are already preparing CECL reports for clients across the country. For many of them, we have been reporting for over a year. These reports are a parallel run that allows us to fine-tune model inputs, request more robust data, and compare output from our CECL model to the client's allowance. We are very fortunate to have gained critical insight about CECL data challenges, the expected CECL day-one impact, and the volatility of allowance calculated using CECL methodology.

Data Challenges

Our number one recommendation remains unchanged. Start early. For anyone reading this who still thinks they have a lot of time, we strongly encourage you to start now. There is much to do and there are no shortcuts. There are two primary data needs:

"Start Early"

- Ongoing Monthly Loan Files: Core-processor system files are generally very complete and include all fields necessary to calculate CECL and measure trends. Most of our clients also provide us with off-system files related to mortgage loans, charge cards, student loans, or participations. Often, these files are not available quickly and may not include sufficient details.
- Historical Charge-Off & Recovery Files: Your CECL report will include multiple segments in which loans are grouped by common risk characteristics. The first step of CECL calculations is to calculate historical average net charge offs for each segment. However, CECL segments may differ from your historical charge off & recovery data. Many times, we find that the history required to run this analysis is incomplete or difficult to gather.

Early Adopters

The key objective of the new CECL standard is to recognize lifetime credit losses looking forward over the life of loans, as opposed to the current incurred-loss method. Given the forward-looking scope of these calculations, we can expect that allowance calculated using CECL methods will be higher upon adoption of the new standard. We analyzed bank & credit union call report data to determine the early impact of CECL adoption and volatility over time:

- Banks: In early 2020, many large and mid-sized banks adopted CECL. There is a great deal of data available for us to measure the early impact of CECL adoption and volatility after adoption. Banks adopting CECL saw an immediate 37% increase in their allowance. This is to be expected because CECL is forward-looking over the remaining loan life.

Over the next few quarters, the pandemic had a major impact on the entire industry and CECL adopters rapidly increased their allowance in response. Non-adopters also increased their allowance in anticipation of potential COVID-related losses, but their average increase was not nearly as large. The U.S. Government pandemic response was massive, putting money in the hands of consumers and businesses. It quickly became apparent that COVID-related losses would not be as large as originally feared. As such, both early CECL adopters and non-adopters lowered their allowance over several quarters. Early adopters lowered their allowance more quickly, consistent with unwinding the rapid increase a year earlier. Overall, we note that CECL methods used by early adopters resulted in more volatility than non-adopters.

- Credit Unions: As of September 2021, only 15 credit unions had adopted CECL early. The small sample size doesn't tell us much about the industry. Most of the results are in the expected range, with allowances increasing in the range of 30% immediately upon CECL adoption. However, we do see some surprising results. It is important to note that we are NOT seeing large differences like these in parallel runs for our clients. Here's an example of 3 surprisingly high post-adoption CECL numbers:

"Elimination of TDRs"

Asset Size	Pre-Adoption	Post Adoption	$ Change	% Change	
$19 million	$22,000	$307,000	+ $285,000	+ 1,300%	
$28 million	$441,000	$2,324,000	+ $1,883,000	+ 427%	
$1.2 billion	$5,827,000	$24,740,000	+ $18,913,000	+ 325%	[1]

[1] After adopting CECL, the credit union reduced their allowance from the initial $24.7 million to approximately $8 million over the next 2.5 years.

Separately, half of early adopters reported a lower allowance in the most recent quarter compared to their first CECL reporting period. Most of the early adopter allowances quickly dropped by over 50%. A handful of credit unions reported no change over time and only two reported a higher CECL allowance after adoption. There is a very wide range of results, from up 110% to down 85%. We also found that the CECL-calculated allowance in this small sample was more volatile than the allowance trend of non-adopters.

Elimination of TDRs

In early February 2022, FASB announced a unanimous vote to eliminate TDR accounting guidance for creditors who have adopted the CECL standard, with an effective date of Dec. 15, 2022.

Parallel Reporting

We are currently preparing CECL reports for clients across the country that have no plans to adopt CECL early. Parallel reporting allows us to fine-tune model inputs, request more robust data as needed, and compare output from our CECL model to the client's allowance balance. These reports give management and the board insight about the expected day-one impact and volatility of the allowance using CECL methods.

"We are carefully monitoring FASB developments"

Investments

Debt securities may be designated as either trading, available for sale (AFS), or held to maturity (HTM). The CECL accounting treatment will differ depending on these designations.

- Trading: Securities designated as trading are marked to market monthly and the change in value is recorded to income. CECL does not apply to securities designated as trading.
- Available For Sale: The CECL standard does not apply to securities designated as available for sale.
- Held To Maturity: CECL will require institutions to measure expected credit losses on financial assets carried at amortized cost on a collective or pool basis when similar characteristics exist. Pooling may be performed based on credit scores, asset types, collateral, terms, location, industry, historical or expected loss patterns, or reasonable and supportable forecasts. Smaller and less complex institutions may conclude that the segmentation practices they have used under the incurred loss methodology are also appropriate under the expected loss methodology or they may refine those practices.

Treatment of Acquired Loans from Merger

FASB has been performing a post-implementation review of the CECL standard and made decisions in February 2022 that may impact loans acquired in a merger. We are carefully following the FASB developments and will incorporate the final ruling into the CECL model. If your institution has acquired loans and you are holding a contra account for potential future charge-offs, reach out to us so that we may discuss the accounting implications upon CECL adoption.

Treatment of Unfunded Commitments

The CECL standard defines unconditionally cancelable accounts as those in which the unfunded portion of the line may be unconditionally canceled at any time. If a loan commitment is unconditionally cancelable, institutions do not need to apply expected losses to the unfunded portion. Charge card agreements are likely to include language that allows lenders to unconditionally cancel them. However, some aged credit lines may not include this clause. A handful of our clients have had to review old agreements to determine CECL treatment.

First Report Timeline

Estimating the amount of time that will be necessary to prepare your first report is challenging because the answer largely depends on available data. Our analysts will spend considerable time with your data and may contact you for clarification or additional files.

Examiner Expectations

Very few banks and even fewer credit unions have been subject to a CECL exam, simply because most have not adopted CECL yet. However, based on the standard and what we have learned from a handful of clients and auditors, we can expect:

- Examiners will not likely comment on whether a forecast is correct, since no one can predict the future with certainty
- Implementation review will likely consider CECL good faith efforts, the selection of a team of individuals assigned to review and participate, a policy, planning, identification of issues, and robust meeting minutes

"Value Added Services"

Examiner Expectations (continued)

- A written rationale for model choices and assumptions
- Examiners should not prescribe any particular calculation method over any other
- Assignment of forward-looking forecasts, not reliance on only historical trends
- Possible need for trend analysis & shock testing

Written Rationale for Model Assumptions

The goal of CECL is to recognize lifetime credit losses at inception. This requires forward-looking assumptions, which are based on the condition of the loan pool or economic forecasts. The guidance calls for both current condition adjustments and forecast adjustments. These adjustments may result in a higher or lower final allowance. We have seen the following (and more) for our clients:

- Positive Current Condition Adjustments (adding to allowance):
- Historical trend is zero, but this can't be supported over the remaining life of loans
- Relaxed underwriting standards to boost loan volume
- Delinquency trend has deteriorated sharply, and higher losses are anticipated
- The largest local employer announces mass layoffs
- Negative current condition adjustments (lowering allowance):
- Tighter underwriting standards to improve loan quality
- Exit of a troubled loan program now in run-off mode
- Some uncommon adjustments which may invite examiner questions

Value-Added Services

Before selecting a CECL provider, it is important to know the level of service included in the price. McQueen provides a very robust CECL solution:

- McQueen's team of dedicated CECL analysts provide data transfer reminders, assists with data-related questions and will respond to inquiries about timing and process
- Every client is assigned a dedicated advisor who will interpret reports, answer technical questions and assist with setting current condition adjustments
- CECL policy review/development
- Assistance with writing an adequate rationale for model choices
- Help with examiner & auditor questions

We encourage you to ask other providers if they offer these value-added services before making your final decision.

Summary

As a nationwide consulting firm, we are very fortunate to have gained critical insight about CECL data challenges, the expected day-one impact, special treatment of certain asset classes and a variety of other CECL issues. Each institution is unique, and we invite you to contact us for further discussion.