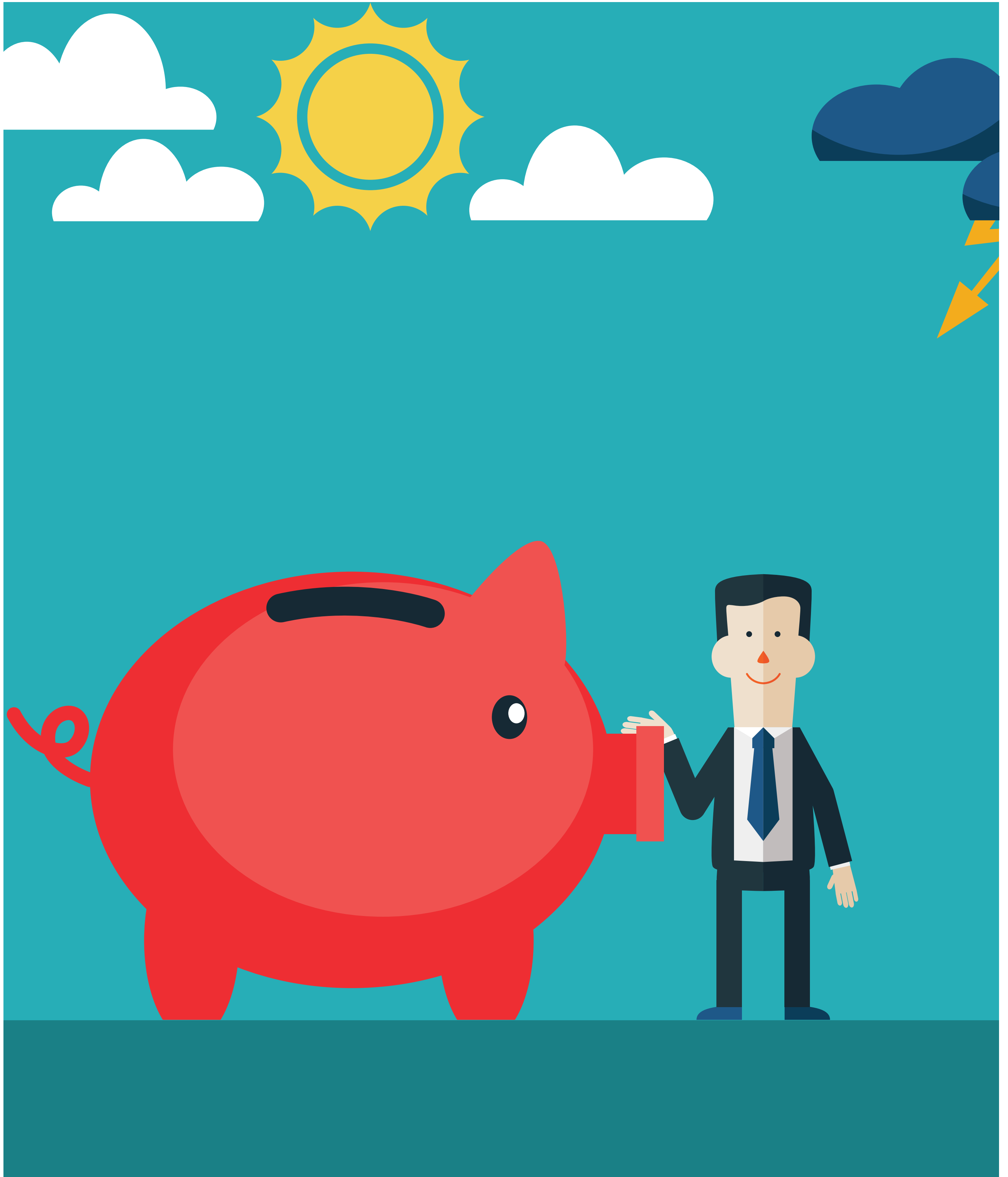

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CECL Implementation Considerations for Smaller, Less Complex Institutions

Small Banks Must Find the Data, Say Regulators

BY PETER CHERPACK

Banks of all sizes have found implementation of the new CECL accounting standard difficult to understand, but it is the smaller institutions that have been the slowest to start preparing for it.

During a March webinar given by my firm, Ardmore Banking Advisors, banks were asked where they were in their preparations for CECL. Of the institutions with less than $500 million in assets, 44% answered that they were "doing research." The month before, the CEO of a small community bank in the Midwest admitted to this writer, "I am in a group of some 25 CEOs of local community banks, and we all agreed that we weren't going to do anything about CECL until the FDIC or the state tells us we have to."

Until this past February, the general message from the regulatory agencies had been this: The current expected credit loss standard, or CECL, is scalable. If a bank is smaller and less complex, it can probably continue to calculate its allowance for loan and lease losses much as it has always done.

As an example of this messaging, on April 7, 2016, the FDIC Advisory Committee on Community Banking presented some thoughts on CECL. Robert Storch, chief accountant of the FDIC's Division of Risk Management Supervision, stated, "If you have a fairly straightforward approach today, even using Excel® spreadsheets and so forth, there is an expectation that you should be able to continue to use that

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type of an approach…" Subsequent webinars, presentations, and FAQs from the regulatory agencies typically repeated that same line of thinking.

Buoyed by the agencies' stated view that implementation of CECL was essentially a nonevent for small community banks, most of them have done little or nothing to prepare for it—other than to gather industry information, attend vendor webinars, and wonder what they may have to do in order to be compliant by 2021.

A Game-Changer for Smaller Institutions?

Then along came the Ask the Regulators webinar on CECL this past February. Entitled "Practical Methods That Smaller, Less Complex Community Banks Can Use for a Starting Place for CECL," it featured speakers from the FDIC, the Federal Reserve, the Conference of State Bank Supervisors, the Financial Accounting Standards Board, and the Securities and Exchange Commission.

While most of the speakers conveyed lower expectations for CECL compliance for the smaller, less complex institutions, many of their comments indicated that CECL compliance was still going to be difficult and costly for even the smallest banks.

Some key concepts articulated during the webinar included the following:

- A bank can do the actual CECL loss rate calculations in many ways, and some banks may be able to use various spreadsheet models to do so.
- The agencies expect all banks, no matter how small, to give their best efforts to complying with the CECL standard, and these efforts need to get better over time.
- Creating a reasonable and supportable life-of-loan estimate is very difficult and challenging, particularly for a smaller institution.
- Most smaller banks will need some type of data warehousing to hold and manage in a controlled fashion the data needed for CECL.

WHILE MOST OF THE SPEAKERS CONVEYED LOWER EXPECTATIONS FOR CECL COMPLIANCE FOR THE SMALLER, LESS COMPLEX INSTITUTIONS, MANY OF THEIR COMMENTS INDICATED THAT CECL COMPLIANCE WAS STILL GOING TO BE DIFFICULT AND COSTLY FOR EVEN THE SMALLEST BANKS.

- A bank's internal data will often be insufficient for CECL loss modeling, and smaller banks will probably need to acquire third-party or peer data.
- All banks should start collecting risk-characteristic data for CECL now, and they must develop data-retention plans.
- No bank, no matter how small, will be exempt from CECL.

While these concepts may not be new, the webinar made it clear that smaller, less complex institutions do have to worry about CECL, that they may have to change loan segmentation, and that they will probably have to acquire third-party or peer data and establish some kind of data warehouse. That is a very different message from "You can probably keep doing what you have been doing."

Additional Bank Resources and New Practices

During the webinar, the FDIC's Storch discussed the challenges that smaller banks, in particular, have with managing the credit data needed to support CECL. He reviewed how difficult it would be to establish meaningful and supportable CECL life-of-loan loss calculations when 1) loan losses are minimal or nonexistent for particular segments of a loan portfolio; 2) loan losses are so sporadic that there are no observable, predictable patterns; and 3) loan pools or portfolio segments have a limited number of loans. He advised that this "typically means management needs to look to loss data from external sources such as peer data."

While much of the webinar was spent demonstrating different spreadsheet methods for calculating life-of-loan loss rates, there was also an emphasis on other, more complex components of CECL compliance.

Several times the presenters stated that it was not recommended for a bank—even a smaller, less complex one—to store its credit data in spreadsheets, noting that "some warehousing is needed," though that could be achieved with the assistance of the bank's core accounting system provider. While the CECL loss calculations themselves can be based in spreadsheets, the presenters emphasized that the data eventually needed for input into spreadsheets would likely be too voluminous to control adequately.

Further, it was mentioned that the smaller institutions' current ALLL collective asset-pooling and segmentation methods, typically by regulatory call-code category, may or may not be appropriate for CECL—though no specific criteria were given. This point is important for smaller banks because

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if the FAS 5 pools need to change, so does their associated loss history.

Kyle Thomas, vice president of accreditation and supervisory processes at the Conference of State Bank Supervisors, suggested that "CECL allowances are based on lifetime loan losses. This is the starting point…. If you don't have lifetime historical loss data you will need to turn to other sources of data for your starting point." Thomas noted other credit data management challenges for smaller institutions:

- "The methods you use may be determined by how much data is available to you. You may start out thinking one method is better than the other and find out that it just does not work—either because of data issues or improperly skewed results."
- "You may need to consider peer data, other external data. You may need to consider proxies. And there are other extrapolations [and] interpolations."

What Can Smaller, Less Complex Institutions Do?

It is obvious to the industry and the regulators that smaller, less complex institutions typically have fewer resources and less staff, data, and automation than their larger brethren. There is also a stated desire by the regulatory agencies that CECL should not cause an undue burden or add significant additional expenses for smaller institutions. Nevertheless, as evidenced at the webinar, most smaller banks' data, data management automation, and controls will likely be inadequate for CECL compliance. So where do they go from there?

Let's take a look at what historical and current credit data and resources are available to most community banks, even the smallest ones:

- Individual historical loan-loss events by asset pool (current ASC 450-20 method ALLL pools, usually call code).

ASK THE REGULATORS

Since this article was written, the regulators clarified their view on a number of related issues during the July 30 "Ask The Regulators" webinar.

The CECL implementation date for non-PBEs is being pushed back.
FASB will delay CECL implementation for non-PBEs (non-SEC filers, nonpublic business entities) until 2022. The agencies note that banks should not stop or delay their CECL readiness process and planning. In 2018, regulators will not examine community banks for CECL, but they will examine CECL readiness.

Acceptable pooling/segmentation methods for community banks.
It is acceptable to use the Uniform Bank Performance Report and FDIC call report data, as peer loss data to augment internal loss and portfolio performance history. However, a bank is expected to use this data only until it builds up enough internal loss and portfolio data.

For institutions with smaller portfolios and/or few historical losses, call code segmentation can be used as a starting place for CECL. The method for pooling should be granular enough to show like risk characteristics in the loans pooled together, but not be so granular that the pools are too small to show meaningful loss patterns.

While call code segmentation is considered a valid starting point, it was also pointed out that loan-term contractual periods are a key risk characteristic, and risk ratings are important risk characteristics and good indicators of risk profile—a good basis for pooling under CECL.

Smaller banks are still not taking direct action on CECL implementation.
It was reported during the webinar that "thousands of bankers" from institutions of all sizes were listening. According to the video poll, approximately 40% of all banks stated that they were either "building awareness" or "mobilizing a team and building a plan." Only 24% stated that they were performing testing, validation, or running parallel.

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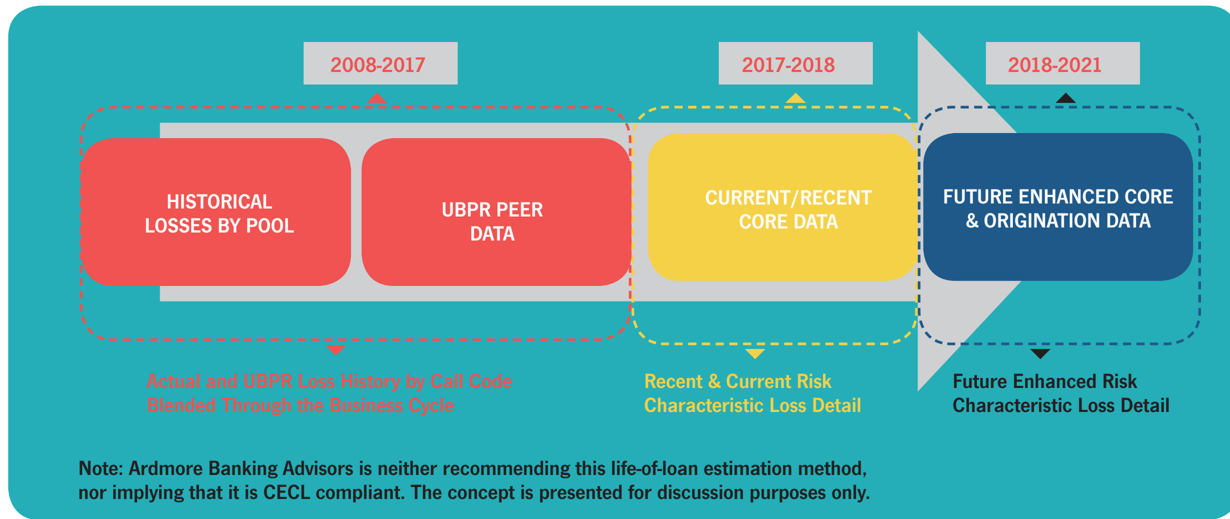
FIGURE: CECL INDUSTRY BRIEF



- FDIC/UBPR peer loss data.
- Current and recent (six to 12 month) loan performance data from the core accounting system.
- Future enhanced core risk characteristics and loan origination data.
- Other data sources provided by third parties.

There are clearly some viable components of credit data and loss history by asset class that can be readily accessed by a smaller institution. But would piecing together historical data from multiple sources at different levels of detail and categorization be acceptable to the accounting firms and CECL regulators?

For example, all banks have saved their ALLL spreadsheets for years, and these contain valuable bank-specific loss and segmentation information. Unfortunately, the data is typically limited to more blunt credit categorizations like call code, account number, charge-off amount, and date. This alone is not sufficient to create loss patterns or curves with any real credit risk characteristics, asset performance history, or meaningful trending.

All banks can access the FDIC peer group website and create aggregate historical portfolio performance data at the call-code level. This data can be aggregated based on certain bank characteristics to make it more relevant for a particular institution.

Every bank usually has at least a year of its core data available at no significant additional cost, and this data typically is linked to some risk characteristic categories like origination date, industry and purpose codes, risk rating, and possibly even borrower financial data like LTV, DSCR, and credit score (quality and consistency notwithstanding).

On a go-forward basis, institutions can do a much better job of creating historical loss patterns and loss curves by collecting more granular underlying risk-driven data in its core system. As these data collection practices become the "new normal," even the smallest banks over time will have better historical data to use for CECL loss modeling. As the years pass, the oldest and least specific data will fall away and be replaced with newer, better data.

While third-party data on portfolio performance at the asset level can be purchased today, smaller banks face some additional challenges if they pursue that approach. First, the cost can be significant because most vendors have developed their data services for larger institutions that have significantly deeper pockets and more analytical resources in-house.

Second, the type of data available typically contains national and agency-rated credits that may not be relevant for smaller community bank borrowers. Peer data-sharing groups are usually limited to actual loss history and do not contain the loan performance history needed over time to establish meaningful loss curves and patterns for CECL justifications.

A 'Modest Proposal' for Smaller Institutions

Based on the resources readily available to smaller, less complex financial institutions, it is possible that loss history and justification for CECL loss estimations could be assembled based on the concept shown in the figure above.

Under the scenario depicted in the figure, an institution would start by collecting historical peer data from

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the FDIC website for as far back as is practical and available—hopefully, through a full economic cycle (10 years or more). At the same time, it would gather its own ALLL loss history and then blend and smooth these data sources to come up with a “bare bones” loss history for a full economic cycle.

Other free sources of viable historical credit loss data for residential portfolios could include Fannie Mae and Freddie Mac. For most smaller community banks, CRE is a significant exposure, but currently there is little publicly available CRE historical data outside of the FDIC database at the call-code level.

As a next step, the institution could layer in current and most recent loan performance data, likely for the most recent 12 months, and include more risk characteristic data available in its core system. Even with inconsistent quality, this approach would be better than no data at all. With current and recent portfolio data, a bank can begin to do some loss patterning by looking at origination dates, asset types, and risk ratings.

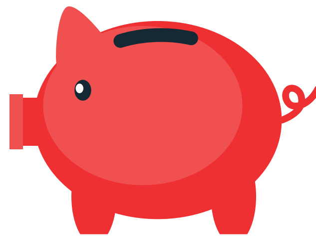
Finally, on a go-forward basis, better, more detailed and controlled credit data will be collected and archived by the institution as soon as it completes its internal data assessment and reviews its data management practices. The amount of such data would increase as time passes and become more meaningful and justifiable as the old data drops away.

There are, however, a number of concerns in using a methodology like this for CECL compliance. Using FDIC call-code peer data is not really “risk characteristic” based, which is a stated key tenet of all CECL estimations. Changes in quarterly loss rates would not be reasonably supported by the bank’s own data or any actual explainable credit activities.

Historical pools based on call codes can represent a mix of origination dates, maturities, and risk rated/nonrated credits, making it difficult to estimate loss curves or patterns. The institution would have to come up with a supportable method to “blend” peer Uniform Bank Performance Report loss data with the institution’s own internal data and use extensive Q factors to account for adjustments.

Would this method qualify as a “good faith” effort by smaller community banks in 2021? How small and “less complex” would a bank have to be in order to use a methodology like this one?

WHILE BEST PRACTICES RELATED TO CECL COMPLIANCE ARE STILL EMERGING, MOST INFORMATION ABOUT CECL DATA MANAGEMENT COMES FROM LARGE BANKS AND INSTITUTIONAL EARLY ADOPTERS.



Conclusion

While best practices related to CECL compliance are still emerging, most information about CECL data management comes from large banks and institutional early adopters. Most CECL methodologies and tools assume that the institution has extensive data availability, as well as the appropriate accounting and modeling resources in-house.

Considering the amount of subjectivity and flexibility purposely built into CECL, the road to compliance will be long—with many twists and turns that require testing, research, and support. Unfortunately, smaller institutions are the least equipped to cope with uncertainty and open standards. And they are now looking for answers from their auditors, accounting firms, regulators, and vendors.

Nevertheless, as revealed in the webinar, even the smallest banks and credit unions should start preparing now to collect and retain more of their own risk-characteristic data and likely obtain third-party and peer data as well. All of this data needs to be archived in some type of auditable data warehouse, with appropriate controls and data management practices.

Can the smaller, less complex institutions use data and resources readily available from FDIC peer groups and other free resources to build their data on CECL life-of-loan losses? While there are ways to do it, practical best practices have yet to emerge. It is time for the industry to look hard at what really are “reasonable and supportable” CECL expectations for our smallest banks and credit unions, as these companies represent the largest number of institutions in today’s financial marketplace. Ⓡ

PETER CHERPACK is executive vice president and partner, Ardmore Banking Advisors Inc. He can be reached at pcherpack@ardmoreadvisors.com.

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