CECL IS COMING: ARE YOU READY?

Ted Goldwyn

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Prepare now for this significant and potentially disruptive approach to plan for credit risk.

The new Current Expected Credit Losses (CECL) standard is among the most significant accounting changes affecting credit unions.

Following the financial crisis of 2008, many financial institutions found themselves underreserved and unprepared for the losses incurred in their loan, investment, and mortgage portfolios. The Financial Accounting Standards Board (FASB) approved a new standard in June 2016 that's meant to limit the impact of potential losses from a future crisis by requiring banks and credit unions to reserve for future losses over the life of the loan at the time of origination.

The standard goes into effect in 2020 for U.S. Securities and Exchange Commission (SEC) filers and 2021 for all financial institutions. Credit unions may implement CECL in 2019 through the early adoption option.

CECL signals a major change in how credit unions will need to calculate their loan reserves, says Douglas Winn, president of Wilary Winn Risk Management LLC, which specializes in asset/liability management (ALM) for credit unions.

"It departs from the incurred loss model in that financial institutions need to estimate lifetime credit losses on day one, and those losses don't have to be probable," says Winn. "Under the prior standard, you had to make an assertion whether the losses were probable, and organizations interpreted that in a lot of different ways."

CUNA has been tracking NCUA's CECL implementation guidance closely. Last June, CUNA President/CEO Jim Nussle wrote a letter to NCUA seeking the agency's assurance that it would "make assisting credit unions with implementation of the new accounting standard a top priority."

NCUA leadership promised to work with industry practitioners and communicate regularly with credit unions to address CECL preparation, readiness, and implementation. The agency may also add a new capital ratio to examination reports to illustrate that "total reserves" haven't changed with CECL implementation.

Prepare now

The new standard will affect credit unions of all asset sizes, and many have begun preparing for implementation. Experts identify five best practices.

1 **Review balance sheet concentrations.** Winn recommends starting with a comprehensive review of loan concentrations by category.

"This is an important first step because it really drives the credit model you're going to select, and it's going to affect the data you need to collect," he says.

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Focus

- ▶**The Current Expected Credit Losses (CECL)** standard signals a major change in how credit unions will need to calculate their loan reserves.
- ▶**Begin CECL preparation now** because early planning is crucial.
- ▶**Board focus:** Expect challenges as your CU implements CECL, but ask others for guidance along the way.

CECL SIGNALS A CHANGE IN HOW CUs WILL NEED TO CALCULATE THEIR LOAN RESERVES.

Douglas Winn

For example, a credit union with a significant concentration in member business loans would want to review the risk rating of each individual loan to determine the likelihood of default. But if the credit union has a high concentration of used indirect vehicle loans, it would want to select a statistical model that considers such factors as dealer concentrations, credit score, and unemployment data.

"Look at those loans statistically because you can't possibly re-underwrite hundreds or thousands of loans each quarter as you're trying to make this estimate," Winn says.

2 **Collect and validate your data.** Begin the exhaustive process of collecting and storing historical data based on the predictive inputs of the specific loan category to be analyzed.

"A lot of credit unions are accumulating this data now," Winn says. This includes updating credit scores, residential real estate values, and loan-to-value ratios.

Once credit unions collect this data, the scrubbing and cleanup process can take months if not longer.

"After building the inventory of historical data, the integrity and governance of the data are natural next steps in preparation for exploring the models or methods available," says Julie Renderos, executive vice president/chief financial officer (CFO) at $8 billion asset Suncoast Credit Union in Tampa, Fla., and chair of CUNA's Accounting Advisory Committee.

3 **Choose the right model(s).** FASB gives financial institutions room to select the analytical models that work best for their organizations. While many credit unions see this flexibility as a positive aspect of the standard, it does create challenges.

"While I personally like having flexibility to choose, it makes it more onerous for some because now they need to test each model to determine which is best for their credit union," says Susan Gruber, senior vice president/CFO at $5.5 billion asset Patelco Credit Union in Pleasanton, Calif., and a member of the CUNA CFO Council Executive Committee. "If you're running thin on staff or you don't have deeper pockets to do analytics, it makes it more difficult."

"I recommend discussing your proposed approach with your auditors to ensure it's appropriate," adds

CUNA ADVOCACY TAKES SOME STING OUT OF CECL

CUNA was an active voice as the proposed Current Expected Credit Losses (CECL) standard moved from proposal to final form, bringing concerns and questions about the standard to the Financial Accounting Standards Board (FASB) throughout the process.

While CUNA hoped the final standard would exempt credit unions completely, several victories for credit unions are present in the final standard.

First, the final standard delays the effective date by a year from the date tentatively agreed to during the deliberation process. The impairment standard will be effective for credit unions for annual periods beginning after Dec. 15, 2020, and interim periods within fiscal years beginning after Dec. 15, 2021.

CUNA urged FASB to provide credit unions with at least three years (from issuance of a final standard) to comply with the changes.

Another major improvement is the additional flexibility the standard affords covered entities. Specifically, the changes will not require complex modeling and will allow for various estimation methods.

FASB's intent is for each institution to apply the method that is appropriate for its portfolio based on the knowledge of its business and processes.

CUNA specifically pushed for this improvement in a March 2016 letter.

In addition, CUNA successfully urged NCUA to issue resources to help credit unions comply with the new standard.

A FAQ document federal financial regulators issued in December includes a summary of the new standard's effective dates, scope, transition, and measurement approaches.

The FAQ document also outlines steps financial institutions should take to prepare for the transition to the new accounting standard.

‘ONE OF MY CONCERNS IS THE IMPACT IT WILL HAVE ON CUs DURING A RECESSIONARY PERIOD.’

Julie Renderos

Ashlee Micale, executive vice president/CFO at $7.9 billion asset San Diego County Credit Union and a member of the CUNA CFO Council Executive Committee. “The more time you have to understand the various allowable methodologies and analyze your data, the more options you may have to select the best CECL option for your institution.”

4 **Create a project plan.** CFOs recommend devising a detailed plan of action early.

“While there’s seemingly a lot of time to prepare, it’s a monumental change requiring resources, planning, and time,” Micale says. “We meet monthly to track progress, which keeps the project top of mind and moving forward.”

Involving the right personnel is another critical piece of the puzzle.

“We’ve developed an internal credit analytics committee,” Renderos says. “It’s a cross-functional team of leaders from accounting, lending, and collections that meets quarterly and looks at changes and trends in the loan portfolio. Additionally, we have developed a data analytics division to assist our credit union in the important management and analysis of the data.”

5 **Educate yourself and key stakeholders.** Continuous education will help credit union executives stay on top of the latest guidance and best practices. Many industry consultants and vendors offer classes, webinars, and online courses to help credit unions get up to speed.

At the CUNA CFO Council Conference this month, a panel of CFOs will share their experiences with CECL preparation.

“I would encourage credit union leaders to absorb as much knowledge as possible and educate key stakeholders about the change,” says Micale, who will be on the panel.

Concerns and challenges

Even with a rock-solid game plan, credit union leaders anticipate challenges down the road.

“The impact of CECL will depend on the complexity of your balance sheet, as well as the size of the credit union,” Gruber says.

“I think it’s going to hit midsize credit unions the hardest,” she adds. “These credit unions originate mortgages, auto loans, and business loans, but they may not be able to afford the analytical power and the talent you need to run CECL.”

Management at ServU Federal Credit Union in Painted Post, N.Y., is tackling CECL with gusto. Christa Nellis, CFO of the $280 million asset credit union, is analyzing every loan on the credit union’s books. She’s segregating each by loan category, year of origination, and macroeconomic trends such as unemployment rate, consumer price index, and fuel prices.

Nellis has mined the data for individual borrower factors, such as divorce and bankruptcy, which correlate highly with charge-offs.

“I’m going to look at various factors to correlate my charge-offs to what’s happening in the economy,” she says. “So if something changes in the economy, I can look at the correlation to my historical data and predict what may happen in the future.”

SServU Federal CEO Nancy Williamson encourages leaders at smaller credit unions to reach out to colleagues at larger credit unions for help, and to use industry resources, including NCUA’s Office of Small Credit Unions.

‘IT’S A MONUMENTAL CHANGE REQUIRING RESOURCES, PLANNING, AND TIME.’

Ashlee Micale

“We’ve read everything we can on CECL,” Williamson says. “We’ve gone to classes and we’re trying to learn as much as we can. What I find is when people try to tell you about CECL, no one tells you specifically what you need to do. So we had to figure it out for ourselves.”

Future impact

Some industry experts are concerned with the timing of the CECL rollout. For one thing, no one is sure

CECL GOES INTO EFFECT IN 2021 FOR ALL FINANCIAL INSTITUTIONS

what the economy will hold in 2020.

"The economy is likely to slow right around the time credit unions are implementing CECL," says Mike Schenk, CUNA's vice president of research and policy analysis. "If we're not muddling through a recession while we're implementing, it might certainly be a recessionary environment soon thereafter. This will make CECL implementation more challenging."

Coupled with the near-simultaneous implementation of NCUA's new risk-based capital regulation, a downturn in the economy might cause compliance headaches for many credit unions.

The implementation date for NCUA's risk-based capital rule is Jan. 1, 2019, just prior to CECL, Micale says. "It will be important for credit unions with lower levels of capital to analyze the potential impact of these new requirements and make necessary strategic adjustments to maintain well-capitalized levels."

Renderos shares Schenk's concern about CECL's timing and the possibility of its effective date coinciding with a recession. "During the Great Recession, credit unions experienced significant losses. Under the existing incurred loss model we could increase our provision expense at a measured and controlled pace, allowing us to continue lending to help our local economy.

"Under CECL—with no recovery in sight—we would have booked significant losses at the time new loans were being made, causing a net loss on the new book of business," Renderos continues.

"Lending through a recession is an important practice credit unions use when working toward an economic recovery," she says. "The new CECL guidance threatens to discourage this powerful economic simulator."

SCHENK: CU LOAN QUALITY WILL REMAIN HIGH

The outlook for credit union delinquency and net charge-off rates over the next 12 to 18 months is rosy, says Mike Schenk, CUNA's vice president of research and policy analysis.

"The economy is doing quite well, adding jobs and nearing full employment," he says. "Consumers' incomes are rising, and they're rising faster than inflation."

Plus, Schenk says, consumer debt levels are at a cyclical low, and historically low rates have allowed borrowers to refinance higher-rate obligations into longer-term, lower fixed-rate debt, keeping debt payments at all-time lows. All of this means that members should continue to pay off their loans in a responsible, timely fashion.

"Strong loan growth also will buoy asset quality statistics for the foreseeable future," Schenk says. "We're expecting a fourth consecutive year of double-digit growth in credit union loans in 2017. Even though rates are going up, we think the unsteady recovery kept many potential borrowers on the sidelines, and that remaining pent-up demand should begin to express itself in more obvious ways.

"This," he continues, "will boost origination volumes and moderate any upward pressure on both delinquency and net charge-offs."

In short, "both an improving economy and strong loan growth will keep loan quality statistics quite high in the scheme of things."

RESOURCES

- ▶CUNA research and policy analysis: *cuna.org/economics*
- ▶CUNA CFO Council: *cunacouncils.org*
- ▶Financial Accounting Standards Board: *fasb.org*
- ▶NCUA FAQ document on CECL: *ncua.gov*
- ▶Wilary Winn Risk Management LLC: *wilwinn.com*

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