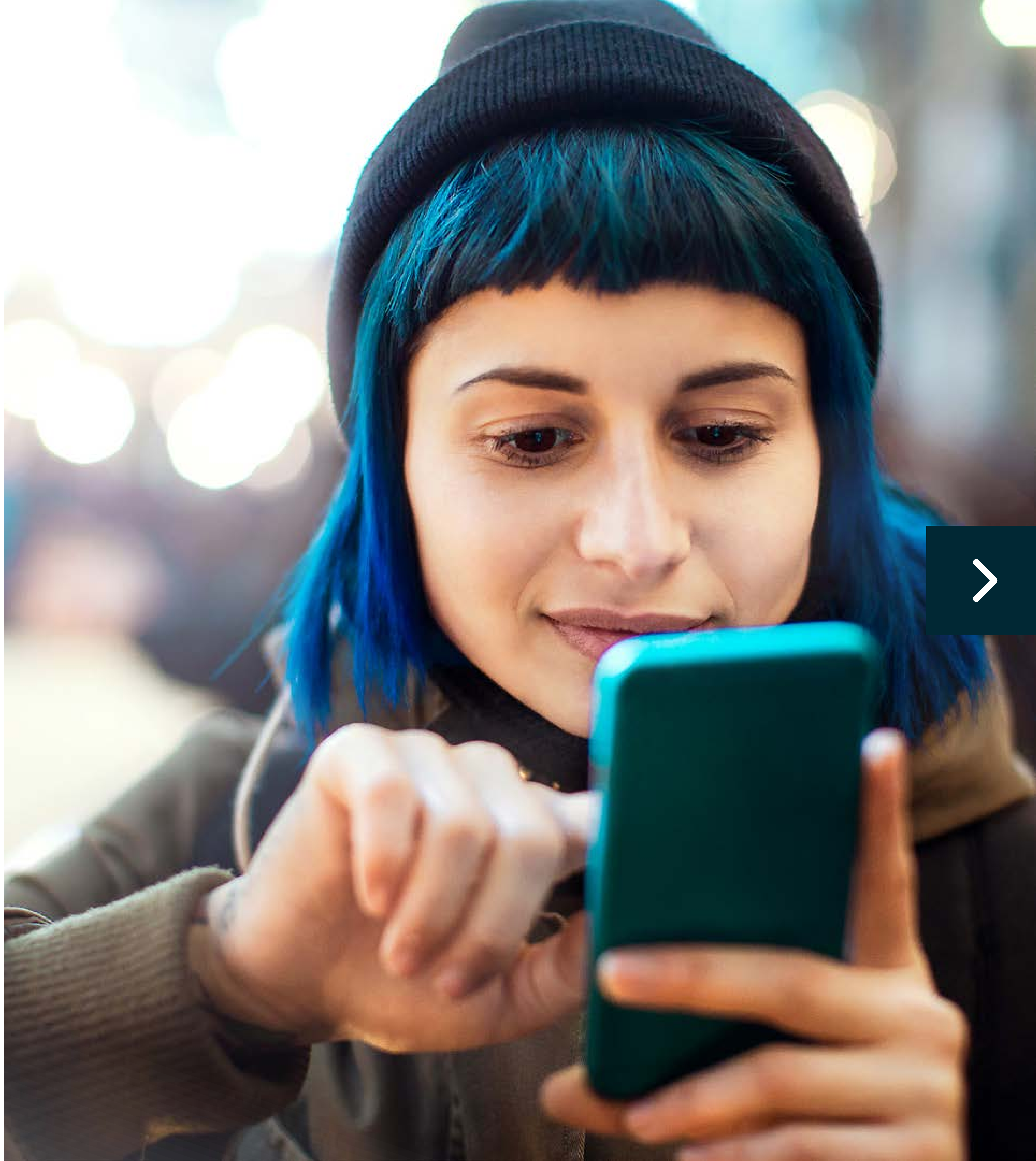
STAYING THE COURSE WITH CECL IN THE MIDST OF COVID-19

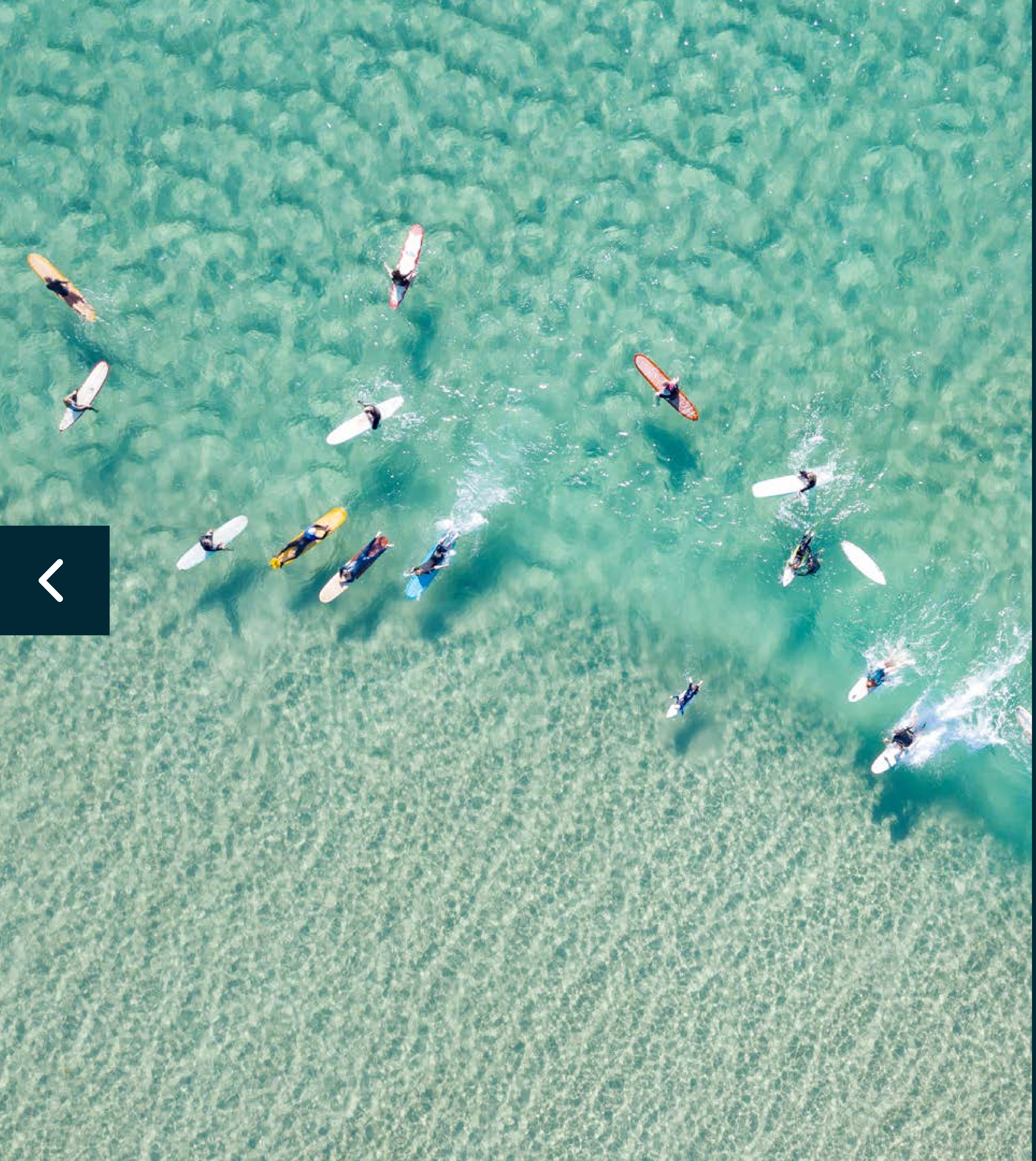
CECL BACKGROUND

In 2016, the Financial Accounting Standards Board (FASB) passed a new GAAP reporting construct called Current Expected Credit Losses (CECL). The new CECL standard replaces the incurred loss model, and requires a degree of default forecasting that takes micro- and macro-economic conditions into account.

The intention of CECL is to address three shortcomings of the incurred loss model that came to light as a result of the Great Recession.

- **First,** a delay in the recognition of substantial credit losses caused a sudden widespread need to account for those losses as they reached the probability threshold. This was achieved by moving available capital into reserves, thereby taking it out of the asset pool for issuing new credit. At scale, this created a vacuum of credit availability and exacerbated the problem.
- **Second,** because of that delay and a perceived lack of transparency into lenders' exposure, investors were left to their own devices to estimate credit losses and behave accordingly. Investors' estimates were higher than what was being reported on financial statements, causing bank share values to fall, further tightening the capital available for lending. (Notably, the recent optional delay offered by the CARES Act exacerbates this, allowing large lenders for a limited time to not report consistently and therefore comparably to each other, reopening the door for investor uncertainty.)
- **Third,** FASB has pointed out that a proactive, predictive reserve calculation would insulate lenders from drastic increases in reserve requirements during a crisis. In other words, a forward-looking estimate of credit losses aligned with anticipated economic conditions will maintain credit availability by padding reserves, an ongoing basis in a way that was not possible prior to CECL.





WHO IS IMPACTED AND WHEN?

GROUP	INSTITUTION TYPE	ORIGINAL EFFECTIVE DATE	CURRENT EFFECTIVE DATE
1	SEC-filing Public Business Entity	Fiscal years beginning after Dec. 15, 2019	Optionally, after Dec. 31, 2020 or the end of the national emergency, whichever comes first. 5-year phase-in period (transition) of the additional reserves required by CECL versus ALLL
2	Non-SEC-filing Public Business Entity	Fiscal years beginning after Dec. 15, 2020	Fiscal years beginning after Dec. 15, 2022. 3-year transition
	Non-Public Business Entity	Fiscal years beginning after Dec. 15, 2021	Fiscal years beginning after Dec. 15, 2022. 3-year transition

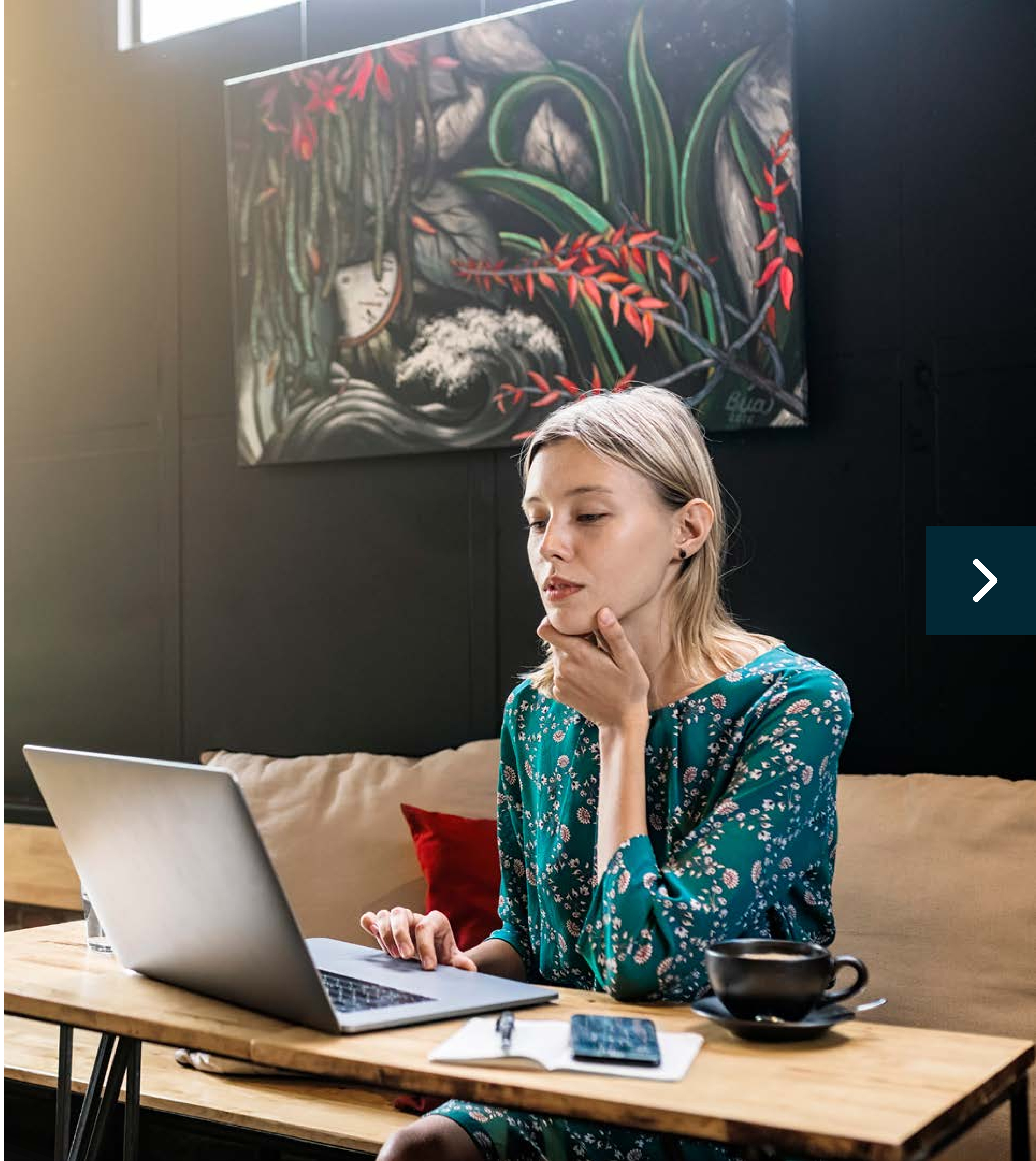
IF I'M IN GROUP 2, WHY SHOULD I THINK ABOUT CECL RIGHT NOW?

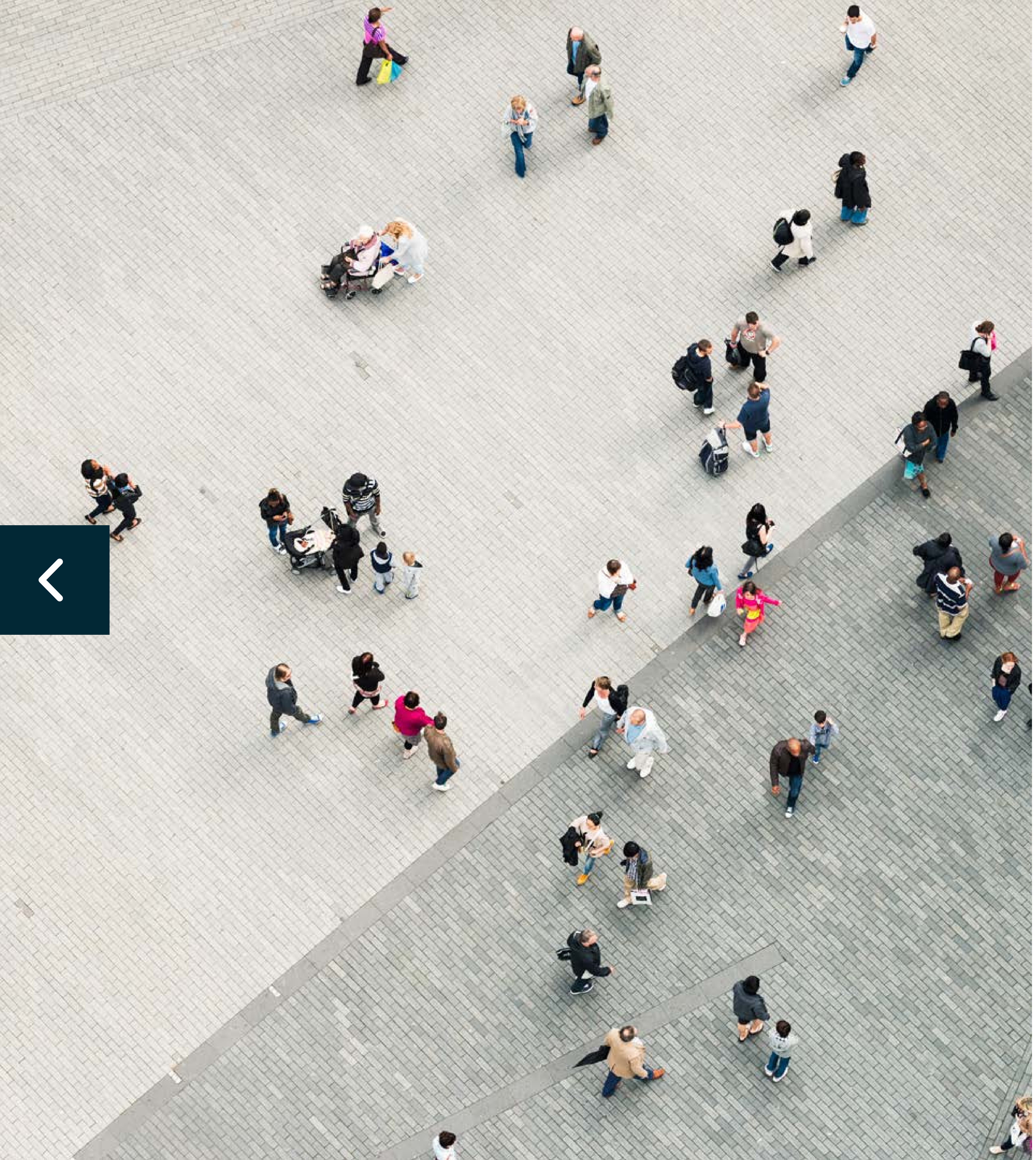
It is more important than ever to make sure access to credit remains available as the economy contracts at a record-breaking pace in response to COVID-19. Because this recession and recovery will be different than any we have previously experienced, future indicators can be expected to diverge, suddenly and drastically, from historical patterns. CECL is intended to be counter-cyclical in the long term, mitigating the impacts of a downturn on capital liquidity by improving visibility into turbulent times before the resulting defaults take a devastating hit to a lender's balance sheet.

While there has been some temporary, optional relief for large publicly traded lenders in the short term through Section 4014 of the CARES Act, one reason to expect that many large institutions in Group 1 will report as required by CECL, ignoring the optional delay, is that they have already invested significant resources to implement a solution. Another is that the respite expires either at the end of the crisis or the end of 2020, whichever comes first. Finally, there is some evidence in the market that lenders are willing to roll recent gains into reserves now in order to preserve their ability to service customers more predictably through uncertain times.

Meanwhile, the deadline for Group 2 remains unchanged and is not anticipated to shift due to COVID-19, given the runway still available for compliance far exceeds reasonable expectations of the duration of the pandemic.

For institutions in this group, there are substantial challenges to solving for CECL reporting compliance. Here, we break it down in order of consideration:





DATA GOVERNANCE AND MANAGEMENT

Lenders must resolve both getting the right data in the first place and maintaining it over time. Thinking about these things can provide the foundation for an overall data management strategy as well as defining, building and maintaining ‘reasonable and supportable’ forecasts.

- **This includes a wide breadth of data points:** historical and current loan portfolio data including origination dates and balances, maturity dates, changes to delinquency status, loss history, borrower information including risk indicators, and other segmentation data over a period of six years.
- **It also incorporates storage considerations:** in a recent survey of NAFCU members, respondents reported that they anticipate collecting 22 percent more data points than they do presently. Building a data warehouse environment to aggregate and maintain this data is a key consideration in terms of time and cost.

While the FASB believes that non-prescriptive guidance on the standard allows the standard to scale up and down based on institutional complexity, the requirement that the forecasting model be ‘reasonable and supportable’ implies that some level of sophistication is expected. This could ultimately include incorporating extensive 3rd party data including borrower employment/industry stability information, geography, net worth/asset portfolio and other factors that could impact collectability as specific industry sectors are impacted disproportionately by global current events.

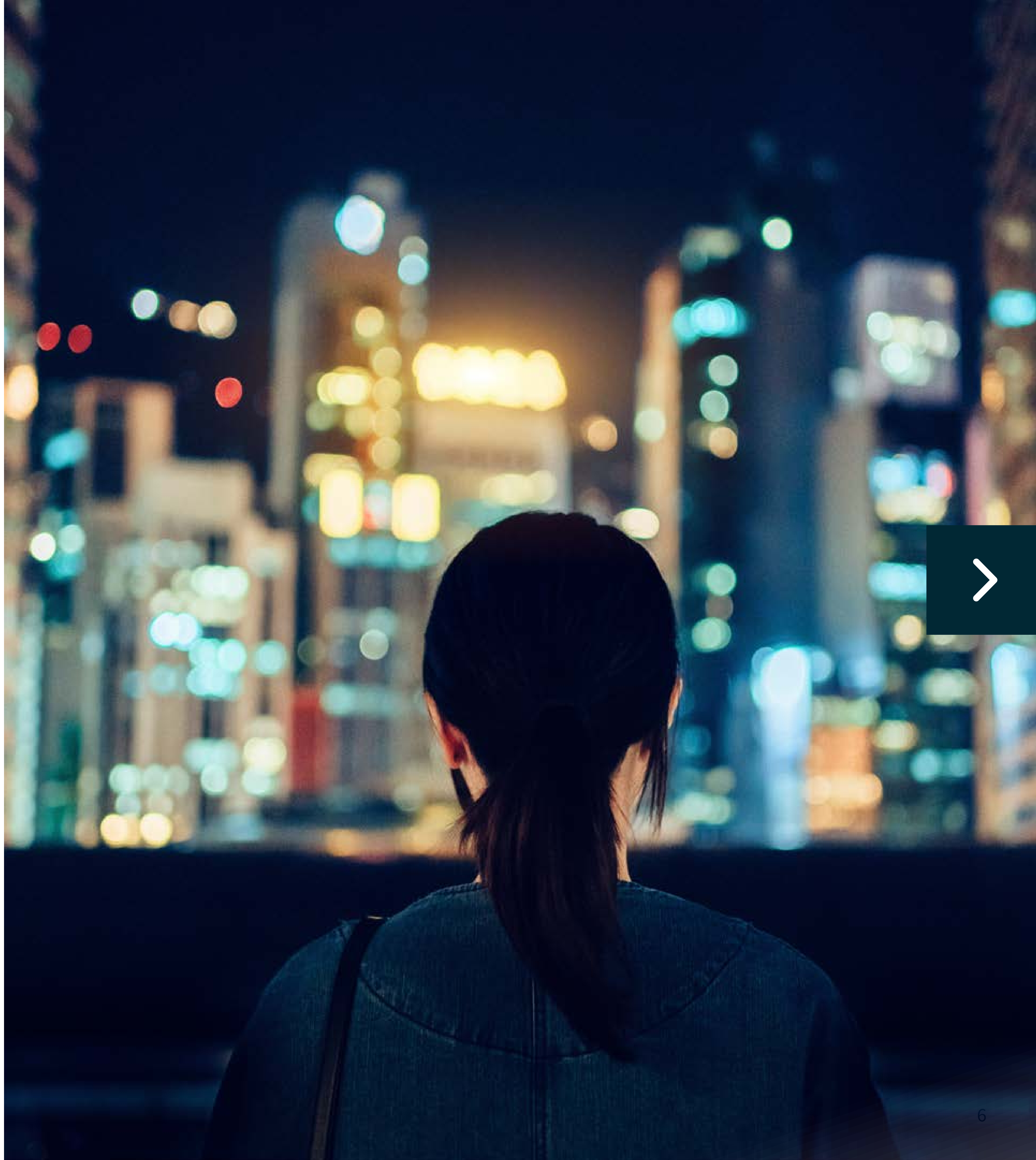
DATA SCIENCE

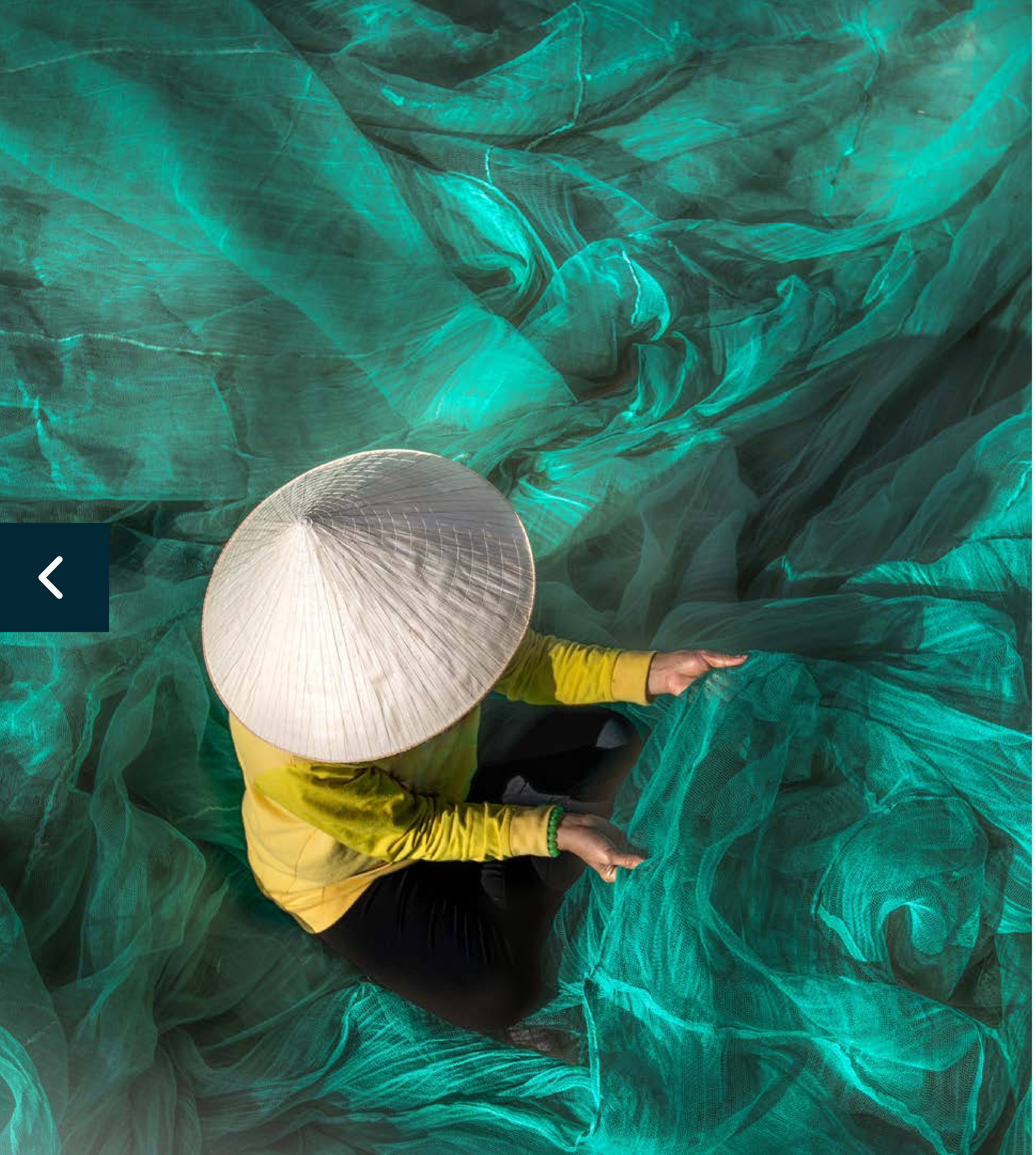
Pulling the data together and preparing it can be a monumental effort. In terms of building expected loss scenarios, it is critical to leverage experienced data scientists who can develop forecasts that consider both unknown and predictable effects of a pandemic. This expertise is rare and can be prohibitively expensive; however, industry experts are watching closely to learn and apply the new forecasting methods that are emerging.

TIMING OF SOLUTION READINESS

Many sources are advising banks and credit unions to have their CECL processes in place one year or more prior to the effective date, in order to allow for parallel reporting of CECL and the incurred loss model. This will provide greater clarity into expected changes to capital reserves well in advance of compliance, allowing institutions to avoid a drastic reduction in buffers and potentially immediate corrective action, as well as time to refine their processes overall.

As an important side effect, parallel reporting for an extended period provides the time lenders need to test and optimize their risk mitigation strategies for the most positive impact on the reserves at compliance time. Factoring in time to select and implement a solution and make operational changes to prepare for reporting changes, institutions should start preparing at least two years in advance.





RISK MITIGATION RUNWAY

Developing a strategic response is possible once an institution has a baseline of expected loan loss reserve changes across the portfolio. The ideal solution includes drill-down capabilities to identify the contribution of loan products to the overall Expected Credit Loss (ECL) that must be recognized. Using this as a prioritization technique allows institutions to focus efforts to revisit risk appetite and underwriting thresholds to the products that have the most impact to expected reserves. This will also provide insight into repackaging and resale tactics that could help institutions to write down or otherwise offload the products and loans that don't fit within post-CECL default risk strategies.

At the same time, institutions can source new insights into their decisioning logic for new loan issuance, such as alternative credit scoring models underpinned by machine learning and streamlined access to tax records and commercially available business viability scores. In addition to existing loans, new credit will also impact ECL. Therefore, it is critical to get a baseline quickly in order to navigate servicing customers through the coming months.

The opportunity to impact ECL on Day One underscores that while the deadline for Group 2 seems far off and may not be top of mind in the current environment, if a lender has not yet begun planning for CECL the time is now.

IN THE NEWS

EXTENSION FOR PUBLICLY TRADED LENDERS

We have covered the mechanics of the temporary delay offered by the CARES Act. Lenders that transition to the new CECL rules now are in position to benefit long-term as some of the pain of future losses would already start being recognized.

Additionally, CECL reporting allows for the build-up of reserves not formerly permissible. U.S. financial institution reserves as a percentage of loans are at the lowest level in years; this strategy would provide more coverage over the long term with minimal impact now, given the extended transition period and the Fed’s nearly unlimited ability to maintain liquidity in the short term. **NOTE: This move does not affect the timing for non-publicly traded institutions, so for these FIs, nothing has changed.**

WEIGHTED AVERAGE REMAINING MATURITY

Prior to 2020, institutions with minimal portfolio complexity had the option of applying the Weighted Average Remaining Maturity (WARM) methodology to calculate ECL compliant with the CECL standard. The WARM method is a spreadsheet-based formula that applies an average annual charge-off rate to the loan term and adjusts for estimated prepayments in order to determine the historical charge-off rate overall. Essentially, the WARM method extrapolates a purely historical charge-off rate average to the entire portfolio.

One of the pitfalls of employing the WARM method includes, but are not limited to, situations involving minimal loss history, losses that are sporadic with no predictive patterns, low numbers of loans in each pool, data that is only available for a short historical period, a construct with widely varied historical pattern, or changes in the economic environment. When those changes are material, the WARM method is inappropriate because the calculation does not include a reasonable and supportable forecast in that case. In other words, current events have rendered the WARM method in itself obsolete. Therefore, lenders need a solution that incorporates sophisticated economic indicators into forward-looking, predictive modeling.

FIS RECOMMENDATION TO OUR LENDING INSTITUTIONS

A critical consideration for institutions of all sizes is the impact of CECL on capital. FASB does not allow lenders to build up their reserves in anticipation of CECL's effective date. As a result, many institutions could experience a sharp increase in expected credit losses on the effective date, which could lead to a capital outage. The consequences of not being prepared can be significant to catastrophic. These dynamics highlight the importance of early testing of CECL models prior to 2022.

In fact, the NAFCU, among other industry groups, is encouraging members to begin the process for developing a CECL-compliant loss reserving methodology as soon as possible. Banks in Group 2 should ostensibly follow the same guidance. CECL is a massive departure from the incurred loss method, and for most institutions will involve the collection of a broader range of data, require additional staff training and coordination, and result in available capital when new reserves are recognized. That said, all institutions in Group 2 have an immediate opportunity to use the time leading up to implementation to mitigate the business impact of CECL.

SOURCES

NAFCU CECL FAQ 3

Dow Jones Newsletter: Banks May Not Need Loan-Accounting Help

FASB Staff Q&A

Developed in cooperation with our partners, industry experts at Oliver Wyman

https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2020/apr/Oliver_Wyman_Coronavirus_and_CECL_2020.pdf

Further Reading

https://www.verisk.com/resources/COVID-19/

https://thinksetmag.com/insights/covid-cecl-banks

FIS can help. We have partnered with industry leader Oliver Wyman to develop a turn key cost effective solution that will ensure clients have the reporting they need to satisfy CECL requirements and to help them avoid the exorbitant expenses associated with other third party solutions or trying it in-house with limited IT staff resource and expertise. We're ready for CECL now, you can be too!

Contact your FIS representative today about Ethos™ CECL View for more details.

About FIS

FIS is a global leader in technology, solutions and services for merchants, banks and capital markets that helps businesses and communities thrive by advancing commerce and the financial world. For over 50 years, FIS has continued to drive growth for clients around the world by creating tomorrow's technology, solutions and services to modernize today's businesses and customer experiences. By connecting merchants, banks and capital markets, we use our scale, apply our deep expertise and data-driven insights, innovate with purpose to solve for our clients' future, and deliver experiences that are more simple, seamless and secure to advance the way the world pays, banks and invests. Headquartered in Jacksonville, Florida, FIS employs about 55,000 people worldwide dedicated to helping our clients solve for the future. FIS is a Fortune 500® company and is a member of Standard & Poor's 500® Index.

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