Palm Street Consulting LLC
CECL Implementation

5 Current Expected Credit Loss (CECL) Implementation Survival Tips

By Adrian Wong, CECL Survivor

Adrian Wong

Director, Credit Risk

Adrian Wong heads business development and client consulting engagements at Palm Street Consulting LLC.

Prior to his current role, he was Senior Credit Risk Manager (Financial Risk Director) at Brookline Bancorp and the architect of the bank's Current Expected Credit Loss (CECL) program leading several departments. His leadership helped the bank become part of the first wave of successful CECL implementations in the financial industry.

His previous industry experience includes

- Credit Risk Consulting at CoStar Risk Analytics
- Fixed Income Performance Attribution at Putnam Investments, State Street Global Advisors, and State Street Corporation
- Fixed Income Accounting at State Street Corporation

Email: awong@palmstreetconsulting.com

Phone: 857-302-5832

Fax: 617-958-2469

Address: 265 Franklin Street, Suite 1702, Boston, MA 02110

In May 2016, I began the first step of my CECL implementation journey. I sat in a conference room as an interviewee watching my future boss illustrate major principles of a new initiative called CECL on a large whiteboard. It didn't seem radically different from my existing job as a risk consultant, in which I helped large bank clients estimate commercial real estate losses for regulatory stress testing. Ready for a change, I accepted the job and started the following month.

On my first day, as a sign of a tough journey ahead, a fresh copy of FASB's 291-page Accounting Standards Update Topic 326 (CECL rule), a binder full of CECL articles, and other notes were neatly stacked on my desk. As a mid-size publicly traded bank, we had until Q1 2020 to publish a CECL estimate. After a three-and-a-half-year journey, I submitted the last batch of CECL documents to our auditors in March 2020; I felt relieved that my time with CECL was over. Rather than celebrate, I was ready to start something new. With the benefit of hindsight, I share my five survival tips.

This article is for general information purposes only, and should not be used as a substitute for consultation with professional advisers

DON'T DO EVERYTHING YOURSELF

Typically, large banks with dedicated personnel and teams to implement CECL had an advantage over smaller banks who usually leaned on existing staff. Fortunately for my bank, they hired me as a full-time resource for CECL. Known to others as "The CECL Guy" or "The Quant," I wore many hats: project manager, accounting specialist, statistical modeler, economist, data analyst, and communicator. Initially, I believed that my prior experience in risk consulting, statistical modeling, stress testing, and accounting gave me an advantage. Therefore, CECL implementation, despite its challenges, was doable with existing staff.

After a few months, the many experts working for the bank humbled me. I have experience with loan data but was inexperienced with navigating the loan system interface and did not know details of how the data is collected and validated. I understand accounting and financial reporting but have limited experience with internal controls and financial disclosures. Throughout my professional career, I'm used to being the go-to person, and I had to adapt to working with a team of experts. I found that it is crucial to utilize various departments in assembling your team.

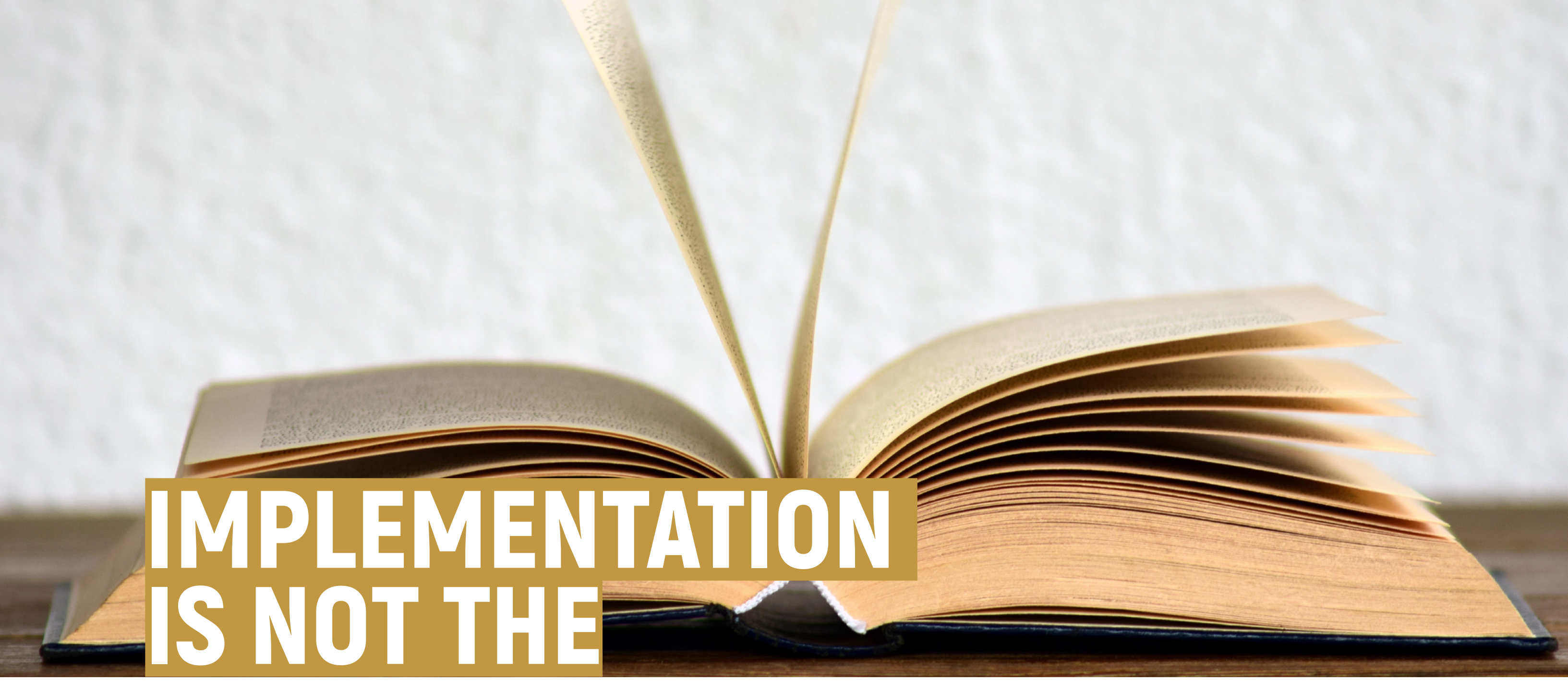
To help prepare your CECL team, please see the below list of suggested CECL implementation domain knowledge (not an exhaustive list):

1. **Loan Data & Operations**
   - » Data flow: timing, systems/ process linkages, procedures, key personnel, quality control standards
   - » Data dictionary/ definitions
   - » System navigation: input, configuration, settings, output, query
   - » Data analysis
2. **Treasury**
   - » Fair value, credit risk, impairment, other than temporary impairment (OTTI)
   - » Securities: held-to-maturity (HTM), available-for-sale (AFS)
3. **Program/Project Management**
   - » Experience: model development, platform/system implementation, vendor analysis
   - » Detailed orientated: excellent coordinator/tracker, documentation
   - » Soft skills: empathy, listening, negotiation, teamwork, leadership
4. **Information Technology**
   - » Data warehouse / structure
   - » Technical knowledge: information security, SQL, API
   - » Experience: quality control, interacting with auditors, documentation
5. **Accounting (U.S. GAAP)**
   - » Technical accounting: accounting rules, understand FASB literature, allowance for loan and lease losses (ALLL)
   - » Securities: held-to-maturity (HTM), available-for-sale (AFS)
   - » Financial reporting: ALLL, financial disclosures, U.S. GAAP, call report / SEC filing
   - » Internal/Sarbanes-Oxley Controls: data integrity, process and review, documentation
6. **Credit Risk Specialist**
   - » Statistical modeling: regression, PD/LGD, economic forecasting
   - » Allowance: impairment, quantitative/qualitative calculations, accounting rules
   - » Experience: credit analysis, portfolio risk, banking, financial services, dealing with auditors
7. **Executive Sponsor**
   - » Formal authority and budget
   - » Strong leadership: build coalitions, remove obstacles, negotiation skills, project management
   - » Functional experience: credit, risk, operations, or finance

My bank formed a CECL steering committee and assigned an executive sponsor in early 2016. The involvement of bank executives was crucial in keeping the CECL program visible and resourced. It also kept bank employees working on CECL aligned because they heard the same message from both the CECL program manager and their division executive.

TIPS

- Assemble a steering committee.
- Build a team before you start.
- Have the right experts



IMPLEMENTATION IS NOT THE HARDEST PART

Our auditors have recommended that we produce documentation hand-in-hand with implementation. We prioritized high-usage documents such as the project plan and data dictionary. Our data dictionary included more than simple definitions. For each data field, we provided a detailed description, the SQL code, a range of potential values, an assessment of data quality, and data dependencies/connections. Our comprehensive data dictionary provided a strong audit trail that kept our auditors happy.

Like many public financial institutions required to complete CECL implementation by Q1 2020, we relied on vendor models. I finished half of our documentation before our vendor models were ready in summer 2019. Because the model, methodology, and process were in a constant flux, we deferred the remaining work. Although my rationale was reasonable, my logic was flawed. As we resumed documentation during the second half of 2019, we identified data, process, and methodology gaps that could have been identified earlier. Specifically, we thought that our internal controls were strong until we began drawing flowcharts and penning our checks and balances. We thought the data dictionary was solid until we discovered a significant batch of changes was not included. This is when we learned that writing documentation hand-in-hand with implementation forces continuous self-review and validation. From an implementation perspective, documentation may seem auxiliary to building models and processes. A successful implementation isn't simply checking off a task list but also completing documentation that is signed-off and reviewed by relevant parties: senior management, auditors, model validators, and the board.

Another challenge is that information is harder to retrieve post-implementation. First, finding old documentation related to CECL (vendor evaluation, proof-of-concept modeling exercises, detailed rationale on our CECL implementation discussions/decisions, and evidence of senior management approval) can be tough and specific details can get lost. Although we saved our presentations, emails, and related documents throughout implementation, we could have collected them more consistently. Second, our technology worked against us. The company's email mailboxes had limited storage capacity and emails over 18 months old were automatically deleted. We were forced to search solely through saved emails and shared working folders.

Third, we could have been better organized by having a dedicated documentation leader who can help the team with the following tasks:

» Determine shared folders and organize files.
» Enforce good team documentation habits: saving emails, plans, work, and notes.
» Maintain documentation quality by making sure relevant information has been saved.

Having existing documentation on the Incurred Loss methodology can also satisfy certain CECL requirements, saving additional work. For example, CECL requires an institution to segment a portfolio by "similar risk characteristics" in section (326-20-55-5). A document listing your institution's existing segmentation and specific risk characteristics by each segment may satisfy CECL's requirement for grouping financial assets by similar risk characteristics.

Documentation is the hardest part of CECL implementation. In the end, our team collected and completed about 50 documents, with some files larger than 20MB. Having a CECL vendor who handled a sizeable chunk of technical documents sped up our documentation efforts.

TIPS

» Have a comprehensive data dictionary. It should go beyond simple definitions, serving as a detailed guide.

» Pen documents hand-in-hand with implementation. Completing tasks gives an illusion of progression. The genuine work is documentation and its validation.

» Save email correspondences, presentations, and other evidence of work in an organized fashion regularly.

» Assign a dedicated documentation leader. This person will help the CECL task force by organizing a central repository of work, reviewing files, and enforcing documentation standards.

» Auditors and model validators don't sign off the process; they sign off on evidence of work: process documentation, signs of review/approval, etc.

FOCUS ON THE PROCESS NOT THE RESULT

In 2016, when I began working on CECL, the banking industry relied on expert opinions and research papers to understand CECL's potential impact. Three years later, among large publicly traded banks who had disclosed their CECL estimates, the majority reported higher credit losses than under their Incurred Loss methodology. With the economic impact from the coronavirus still uncertain, the gap between CECL and Incurred Loss methodologies will probably be wide.

Knowing publicly reported CECL estimates, it is tempting to anchor your credit loss estimate "with the herd." Equally tempting is to target a reserve based on the bank's historical experience or recently reported Incurred Loss. The purpose of CECL is to develop an expected loss over the life of a loan based on "historical experience, current conditions, and reasonable and supportable forecasts." CECL's principle-based approach allows a wider flexibility for management judgement than the Incurred Loss methodology, but it requires robust documentation to support management's rationale. Auditors will heavily scrutinize the bank's CECL documentation (data, controls, methodology, rationale, and reports) rather than the credit loss estimate. Let the estimate be the result of and not the start of the process.

After calculating an initial estimate, take the following steps:

1. Review the entire process focusing on the rationale behind management judgements, methodology selections, and other critical choices. If there are several choices, list and detail their pros and cons. Last, state how the best choice helps determine the "expected" or "most likely to occur" loss.
2. Is your final estimate reasonable - neither overly conservative nor optimistic? Use the bank's historical experience, peer, and industry data to justify your response.
3. Have a third-party review.

TIPS

- CECL is a major methodology change; prepare for intense auditor scrutiny.
- Your CECL loss estimate is what you would "expect" or is "most likely to occur."
- Resist the temptation to work back from a predetermined estimate; start with the process then calculate the estimate.

EXPECT DELAYS, EXPECT MORE DELAYS, EXPECT ADDITIONAL DELAYS

From my hire date, I had three-and-a-half years to prepare. Accounting for delays, I budgeted 12 to 18 months of implementation followed by another 12 to 18 months of parallel testing. It seemed like a brilliant plan.

Members of the bank's CECL implementation team had regular full-time responsibilities besides their work on the CECL task force. I constantly jostled for help. Our loan data and reporting specialist always had a full plate of tasks and projects. The loan operations department was perennially understaffed. The finance team was unavailable for several weeks each reporting cycle. Resource constraints haunt many financial institutions, especially smaller ones. To adapt to this situation, simplify your CECL methodology and process. Use existing capabilities: data points, sign-offs, methodologies, and processes. Satisfy CECL requirements in broad strokes instead of accounting for the minute.

Senior management and the Board of Directors prioritize initiatives that generate revenues or reduce costs. Accounting and regulatory compliance implementation satisfies neither points. Through my time at the bank many multi-department projects were introduced that slowed CECL implementation progression. To increase implementation success, champion your project and its impact when your institution's priorities shift. Provide a detailed impact assessment on CECL's implementation timeline and areas of increased risk to your executive sponsor and steering committee.

Outside of staffing issues, there are always methodology, data, and process complications. Intuitively, it makes sense to inventory loan data and determine which ones are critical to credit modeling. But this approach depends on your model selection. So, it is important to develop a comprehensive blueprint first by evaluating available data (not just credit data directly) and potential model choices simultaneously. Although finalizing methodology can be an iterative process, this will reduce second thoughts on model selection and data requirements further into implementation.

Model Development is another source of potential delays. Early in the CECL program, I spent three months developing a rudimentary PD/LGD model using "R" for a small segment of my bank's loan portfolio. After presenting preliminary model outputs and discussing the economics of build versus buy with senior management, we hired a CECL vendor rather than develop an in-house model for two reasons:

- Outsourcing: We didn't have modeling experts, and it would be costly to start a team. A CECL vendor would own the bulk of model responsibilities including development, implementation, enhancements, and documentation.
- Business continuity risk: I was the only person dedicated to CECL implementation. Having a vendor offered another resource.

No longer a major factor, CECL vendors prior to 2020 struggled to deliver their platforms and models for last year's first CECL implementation wave. Platform and model changes occurred quarterly (many times, monthly), forcing us to revisit our data, processes, and methodology. We hired a vendor in 2017, but a year-and-a-half later switched to a second vendor that was a better fit. The new vendor had pre-built models (credit risk and economic forecast) rather than solely a calculation platform, which saved us model development, documentation, and testing time.

After FASB unveiled ASC Topic 326, financial institutions and industry associations continued lobbying to delay CECL through a variety of channels. The initiative paid off in October 2019 when FASB delayed CECL for non-public and small public financial institutions to 2023. However, the next delay from the CARES Act was too late for most publicly traded financial institutions who adopted CECL in early 2020. The Consolidated Appropriations Act in late 2020 delayed CECL for large publicly traded financial institutions a second time. The new deadline is January 1, 2022 or the termination of the COVID-19 national emergency declaration, whichever occurs earlier. Some large banks, despite having years to prepare and the resources to accomplish this, didn't make the 2020 deadline. Therefore, it is important to continue implementation rather than defer and discover obstacles later.

Almost out of time, we completed implementation early March 2020. Revisiting the original plan, we targeted a 2018 completion date followed by 12 to 18 months of true parallel testing. After our CECL vendor released their models in summer 2019, we tested three prior quarters and two upcoming quarters. Despite other delays I previously described in this section, we were fortunate to experience low employee turnover and have outsourced our model development responsibilities to a CECL vendor.

TIPS

- Start as early as possible; expect many delays.
- When time and resources are a constraint, satisfy CECL requirements by simplifying methodologies/processes and using existing capabilities.
- When your institution shifts priorities, provide executives with an impact analysis detailing the project's timeline and quantify areas of risk.
- Communicate frequently and proactively.

CECL IMPLEMENTATION IS ALSO A PERSONAL CHALLENGE

The Current Expected Credit Loss standard attempts to improve visibility on a financial institution's credit risk; however, many financial industry insiders disagree. To many, CECL is a complex and time-consuming project that checks the regulatory compliance box, produces no revenues, and adds another operational burden. I felt frustrated championing a project that is not always a priority for others.

CECL covers several specialty areas—technical accounting, credit risk modeling, allowance for loan and lease losses (ALLL), and financial reporting. Few in the industry are familiar enough with all aspects of FASB's ASC Topic 326 to implement it without a team. Affordable specialists can also be difficult to hire. I constantly felt the stress of handling multiple skill sets and providing tough answers. I have always wondered, can colleagues and senior management without specialized knowledge fully understand the scope and risks of CECL implementation and value my contributions? The answer to this question remains elusive.

Serving as the bank's CECL program lead, I lacked direct authority and financial resources. Most bank employees focus on work that is profitable, career building, and a priority for their boss. In most cases, CECL work is another responsibility on top of their regular full-time tasks. Gaining support of others was a test of patience, empathy, interpersonal skills/relationships, and sometimes meeting others more than halfway.

Our perspective determines what we gain or lose from our experiences. Reluctant at first, only after I embraced my work did I gain a new perspective. I became a better program/project manager, improved my communication skills, and further developed my technical skills in many areas: credit risk, banking, loan operations, finance, databases, and statistics. However, there is a limit. The work can overwhelm (shifting firm priorities, management challenges, and long hours) and divert desired careers. My peers working at other banks have experienced similar challenges, and some have resigned. I thought of leaving and working on something else. I don't know if I made the right decision by not doing so, but I maximized my professional growth from my choice to stay.

TIPS

- Remember that it is okay to feel challenged and frustrated.
- Remember that it is hard for outsiders to relate.
- Monitor your feelings; take action before it gets unmanageable.
- Keep growing; make the best of the situation.

FINAL THOUGHTS

I salute everyone who is working on CECL. This complex responsibility requires a diverse team of experts. Don't be so wrapped up in building models and processes to forget that others outside the implementation team measure success based on formal documentation and paper trail. Stay aligned with CECL's tenants and its processes rather than work backwards from a predetermined estimate. The only certainty about CECL is to expect delays. Focus your efforts on planning, developing contingencies, and communicating the program status. Be prepared to have your physical and mental limits tested. Pay attention to your feelings and take action before it becomes unmanageable. I wish you good luck and a successful CECL implementation.

CONTACT US

Email: contactus@palmstreetconsulting.com

Phone: 617-958-2468

Fax: 617-958-2469

Address: 265 Franklin Street, Suite 1702, Boston, MA 02110

Follow Palm Street Consulting LLC on LinkedIn

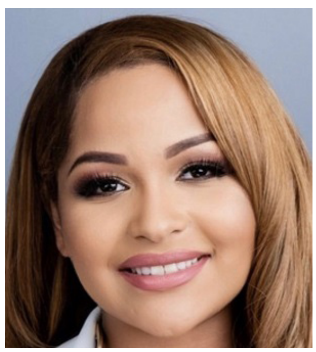
WHAT WE DO

We help thrifts, credit unions, and banks implement the Current Expected Credit Loss (CECL or ASC 326) Standard issued by the Financial Accounting Standard Board (FASB) in June 2016. We are empathetic towards CECL's impact on financial institutions and specialize in providing affordable, client-centered, and ethical consulting services.

Special Thanks to Our Advisory Board

Stephen Miller

Managing Director, Consulting Services



Jessica Polanco

Director, Credit Risk & Business Operations

Ilya Fishman

Director, Credit Risk

This article is for general information purposes only, and should not be used as a substitute for consultation with professional advisers