Point of View

CECL: Current Expected Credit Loss – The Need for Data and a Proactive Preparation Plan

One of the most significant changes affecting financial institutions in recent years is the Financial Accounting Standards Board pronouncement regarding evaluation of credit risk. CECL: Current Expected Credit Loss requires not only banks and credit unions but any firm with instruments exposed to potential credit loss to estimate what those future losses may be. While some regulations impacting financial institutions may change or be eliminated as political winds change, CECL is a FASB pronouncement, not regulatory legislation. While changes are always possible, it is unlikely to be altered for political reasons.

With potential increases in economic volatility, understanding credit exposure will be critically important in order to remain competitive and profitable. The process of preparing, understanding and analyzing the data needed should not be taken lightly; that endeavor should be undertaken thoroughly, thoughtfully and immediately. In the first of a three-part series we will discuss setting up teams and identifying data needs.

Create a Team

Understanding the process and identifying the data needs is not something that should be done by one person in a small room in the basement of the institution. It should involve stakeholders from across the institution and be visible and transparent.

Start by creating a team and identifying who should participate on that team. Many, if not all, of the potential participants may already be members of the asset/liability committee (ALCO). However, this work should not be part of the regular ALCO meetings. It should belong to a subcommittee from that group. The group can consist of current members of the committee or individuals from across the institution not already part of the ALCO. In the end, however, the team needs to be made up of representatives from various functional areas.

Areas to consider recruiting participants from include accounting, finance, IT, risk, credit and treasury. In some institutions, some of these areas may be combined. Risk may be part of treasury, and accounting and finance may be one department. In others, each is a distinct functional area. The important thing is to have representatives from each discipline.

Identify the Data

Each of the team members in the groups above will have a unique perspective and understanding of data within the organization. Begin by identifying internal data components. What are the aspects allowing you to aggregate types of loans and investments? Then within each category, what additional elements allow for subpools?

For example, start by organizing loans by collateral or loan type, i.e., mortgages, home equity lines of credit, autos and credit cards. Then create subgroups based on if fixed or adjustable, followed by term. This is information that should already be in use today. The risk and treasury departments should already be conducting analysis at these levels; therefore, getting this level of data should not involve additional work other than formally identifying the groups for CECL.

When segmenting each of the categories, institutions may want to see if they have or should begin to collect other instrument-specific data such as original and current credit scores, and original loan to value, geographic information, employer base, etc. Between loan type, geographic and employer information, as well as others, institutions will be able to monitor concentration risk. The question can be asked and answered: "Do we have a disproportionate amount of credit exposure in a particular area?" The original and current credit scores will show migration or deterioration of credit quality for a particular group.

These additional data points will allow you to further refine the pools, tracking credit loss at a much more detailed level. With this information you will be able to see what the cost to your capital is with a given strategy due to credit exposure. This will enable stronger strategic planning, increasing profitability and competitiveness.

The team should also evaluate the types of loans and investments for any other data points that might be of use. Each institution is different and there may be data associated with loans at one institution that are key indicators of credit quality but less so at other institutions. This may be a subjective evaluation but an important exercise nonetheless. There is no one exhaustive list of data that fits all institutions.

Next the team should identify external data. Which economic factors are indicative of credit changes and quality? There are many common factors easily obtained. Historical unemployment rates, GDP, CPI and housing values, among others, are easily obtained online. Forecasts for those same values can be found as easily. When gathering this external data the team should determine if national economic values are sufficient or is the customer base concentrated in a way that regional metrics will be of use.

When identifying external data it is important to try to determine which factors can indicate credit changes and which ones might not. A key component of CECL is ensuring assumptions are reasonable and supportable; therefore, it is important to find which historical internal factors correlate with which historical external factors, as well as which ones do not correlate. When asked why you didn't use a specific factor in the Allowance for Loan and Lease Losses calculation, you'll want to be able to show and prove there was no correlation.

As the data points are identified, the team will need to ask where and how they can consistently and reliably obtain the data. As stated above, much of the data may already be in the process of being gathered on a regular basis. Since the team is made up of representatives from various groups, it will be easy to see who already owns which pieces. The IT representative should be able to provide insight as to how all the data can be organized and centralized for reliable use. The team should be able to create a plan to consistently gather additional data identified as needed but not currently captured.

Summary

With CECL, the most significant and hardest part will be preparation. Identifying, gathering, analyzing and understanding the data and their relationships will be the most arduous and time-consuming part for complying. It should not be taken lightly or delayed. Creating a plan involving a team to identify data and how to get it will help meet the goal in an organized and timely manner.

After gathering the data, choosing the appropriate method of analyzing and forecasting losses is essential. We will discuss the various methods that can be used in part two of this series.

Connect With Us

For more information about CECL preparations, call 800-872-7882, email getsolutions@fiserv.com or visit www.fiserv.com.

fiserv.

Fiserv, Inc.
255 Fiserv Drive
Brookfield, WI 53045

800-872-7882
262-879-5322
getsolutions@fiserv.com
www.fiserv.com

630-16-32665-COL 01/17