If It's Broken, Let's Fix It

By William (Bill) J. Rossong, CPA, CBA

It's Broken

As you might imagine, much attention has been given lately to the Financial Accounting Standards Board (FASB) Current Expected Credit Loss (CECL) Model and rightfully so. It will certainly have a significant impact on the largest and smallest of banks in the system. However, as I listened to a recent public meeting with various stakeholders ranging from the FASB to the various regulatory bodies to lobbyists and then ultimately to the banks being impacted, I thought to myself this is a meeting that is too late and yet too early. One takeaway many had from the February 4th meeting was that the incurred loss model is certainly broken and it certainly needs to be fixed. It does not take one long to reach this conclusion if you sampled ten bank’s incurred loss models today. In fact, nearly 60 – 85 % of ALLL models today are primarily made up of qualitative factors as their loss history ranges generally between 10 – 30 basis points. While most banks are utilizing the eight qualitative factors recommended in the interagency statement, many banks continue to have an increased amount of unallocated reserves. A recipe for disaster exists as it relates to directional consistency in the components of the ALLL if banks do not employ more complex methodologies to increase the quantitative component such as loss emergence period (LEP) – thus the inherent flaw in the incurred loss model.

Let's Fix It

Since I started my career more than 10 years ago, there have been a couple of themes that surround the current ALLL model I have picked up on while talking to bankers:

• Our current model does not allow us to support higher reserves, and if we do provide for higher reserves, they are very difficult to substantiate.
• We need a standard that allows us to reserve in good times for when times are bad and vice versa.

The proposed CECL Standard will likely be released during the second quarter of 2016. Could this Standard be the solution to these concerns? Perhaps. The proposed Standard certainly introduces more complexities; however, it also establishes new concepts such as life of loan, reasonable and supportable forecasts and reversions to the mean as well as how these concepts might impact loss analyses over a more extended period of time. As we prepare for the final standard release, I believe there are three key elements we can use to sharpen the saw and build a roadmap.

1. Know your Data: A detailed plan around gathering, storing and analyzing historical data will benefit you significantly as you prepare for CECL. The following are a couple of examples:

   a. Net Charge-Off history for loss modeling: Understanding the various components of your losses, such as the probability of default (PD) and loss given default (LGD) related to your portfolio cohorts can provide you with benefits in other areas of your bank such as loan pricing. Given the unique nature of many community bank portfolios, having this level of granularity will not only allow you to more accurately project losses, but will also give you the tools to more effectively price loans.
b. Transactional data for Prepayment Speeds: The life of loan concept will certainly become one of the more challenging yet beneficial components of the Standard. As you think about the weighted average life of your portfolio cohorts, prepayment speeds and in turn duration will become very meaningful to the overall calculation. Having this granularity on your actual loan portfolio will benefit you in other areas as well, including your ALCO and pricing models.

2. Know the Standard: There will be plenty of opportunities to get up to speed on the new standard once it is issued if you have not already been staying abreast. In addition, the FASB has developed a transition resource group (TRG) that will address implementation issues related to the standard. Rest assured, although there will be kinks to work out during implementation, there will certainly be tools available to assist.

3. Know the Impact: There have been many speeches and high level analyses to gather data on what the average impact for the transition to CECL might be. Some were performed two to three years ago when the standard was first drafted. These are certainly helpful data points; however, what is critical to know is what your impact will be so you can properly plan in advance of the implementation date.

The Challenge – Let’s Make it our Standard

It is my opinion that CECL at a minimum allows bankers the flexibility to build adjustments and forecasts that are reasonable and supportable to more fully address their concerns related to events impacting their portfolio, while at the same time addressing many of the themes outlined above. There is a unique opportunity to maximize the benefit of one of the most impactful standards the banking industry has seen in quite some time. Let’s make it our standard and help write the script.

With more than 10 years of experience servicing financial institutions, William (Bill) J. Bossong, CPA, CBA has developed a great deal of expertise regarding the standards and operations of banks of all sizes. As a shareholder at Elliott Davis Decosimo, Bill leads the firm’s Financial Institutions Consulting Practice. His team specializes in mergers and acquisitions, including due diligence, valuations and tools for data analytics used by banks. Bill’s team developed ValuCasTM, a proprietary solution designed to assist banks with Day 1 and 2 accounting. To learn more about Bill’s team and how they can help you with the upcoming CECL Model, call 803-255-1497, visit www.elliottdavis.com or email Bill at bill.bossong@elliottdavis.com.

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our workplace challenges must not be neglected. The challenges highlighted by the Chairman above are ever-present and deserve our utmost engagement. VACB provides two crucial avenues of engagement for Virginia’s community bankers. To navigate through the ever-increasing web of laws and regulations, we provide top-notch training and numerous opportunities for peer exchange with other community bankers. And to reduce the weight of those burdensome laws and regulations, we provide outlets like the upcoming ICBA Washington Policy Summit for VACB bankers to advocate for right-sized regulation that will allow our banks to build our communities and our economy.

Thank you for your continuing support of our education programs and our efforts in the nation’s capital. If you haven’t been taking part in our educational seminars and webinars, I hope you will. And it would be great to have you join our delegation to Washington in April. These are investments that will pay dividends. The challenges persist. Let your response to them be bold!