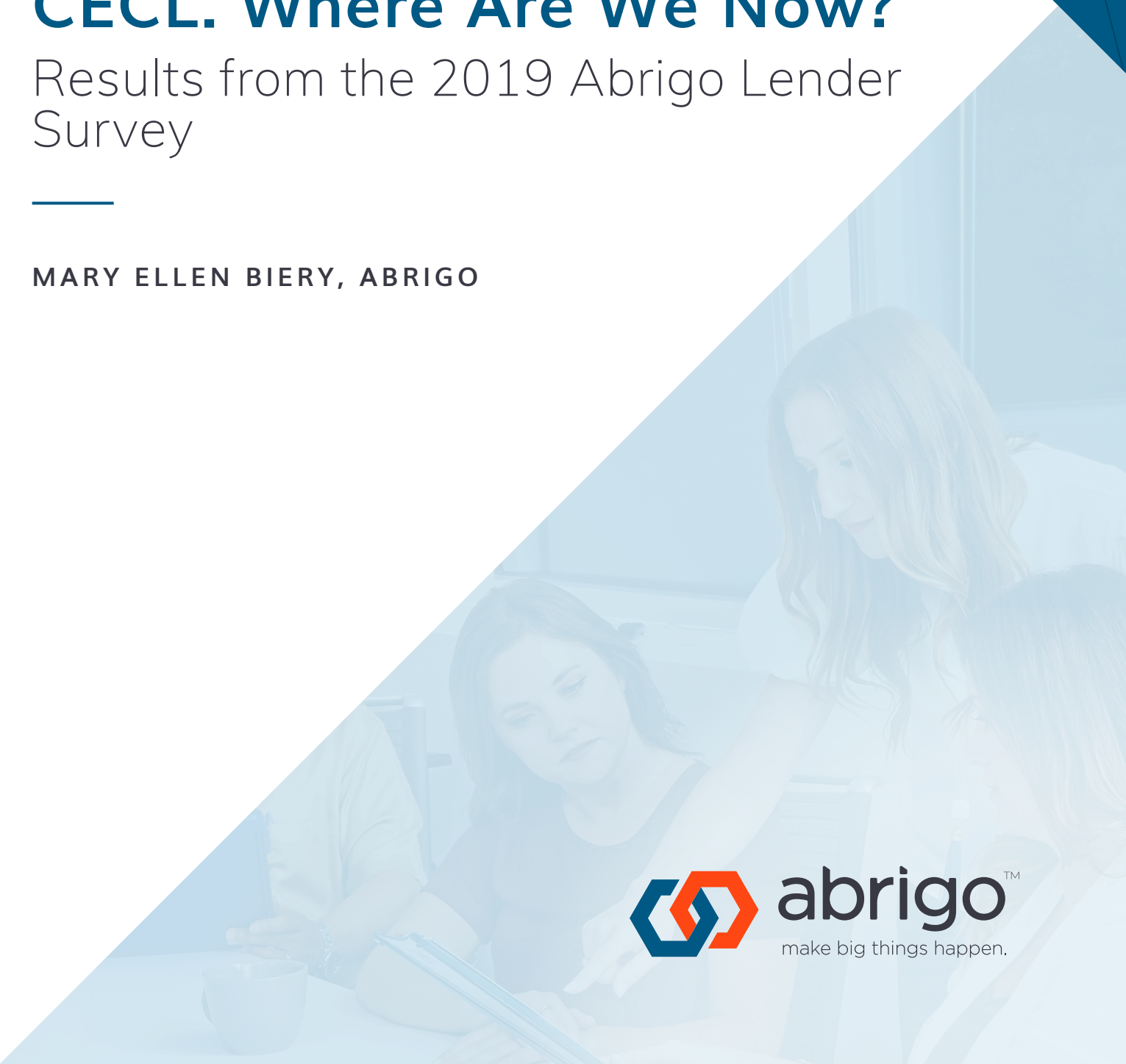
# CECL: Where Are We Now?

## Results from the 2019 Abrigo Lender Survey

MARY ELLEN BIERY, ABRIGO



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## INTRODUCTION

For the third year in a row, Abrigo (formerly MST, Sageworks, and Bankers Toolbox) surveyed a wide range of financial institutions to gauge CECL preparedness. The 2019 survey shows that as the Q1 2020 compliance date looms for SEC registrants, institutions of all types are making progress – but not enough, according to CECL experts.

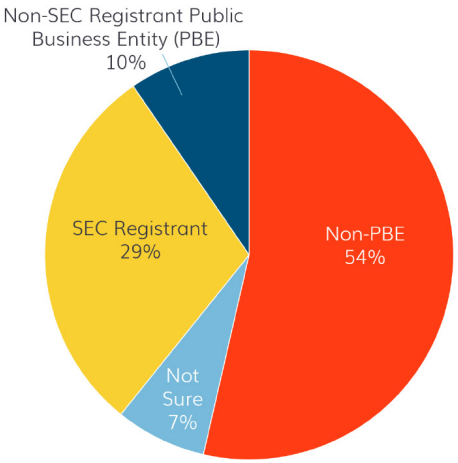
"The clock is ticking," said Abrigo Senior Director of Advisory Services Regan Camp. "While many financial institutions are taking the necessary steps to make sure they are prepared for this important change in accounting for credit losses, it's clear that others are falling behind their peers."

## SURVEY DEMOGRAPHICS

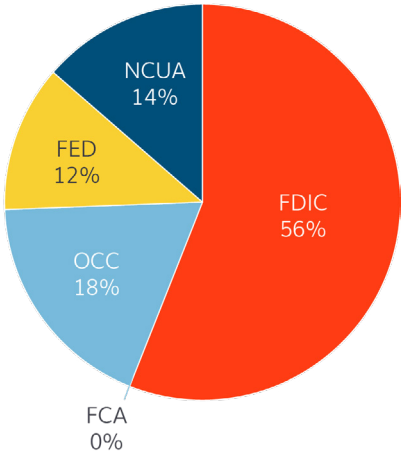
This survey included responses from institutions located or doing business in every state in the U.S. and from institutions representing a variety of asset sizes.

Survey participants include presidents, CEOs, CFOs, Chief Risk Officers and Chief Credit Officers, Senior Vice Presidents, Controllers, various vice presidents, credit or loan executives, as well as numerous risk and financial analysts.

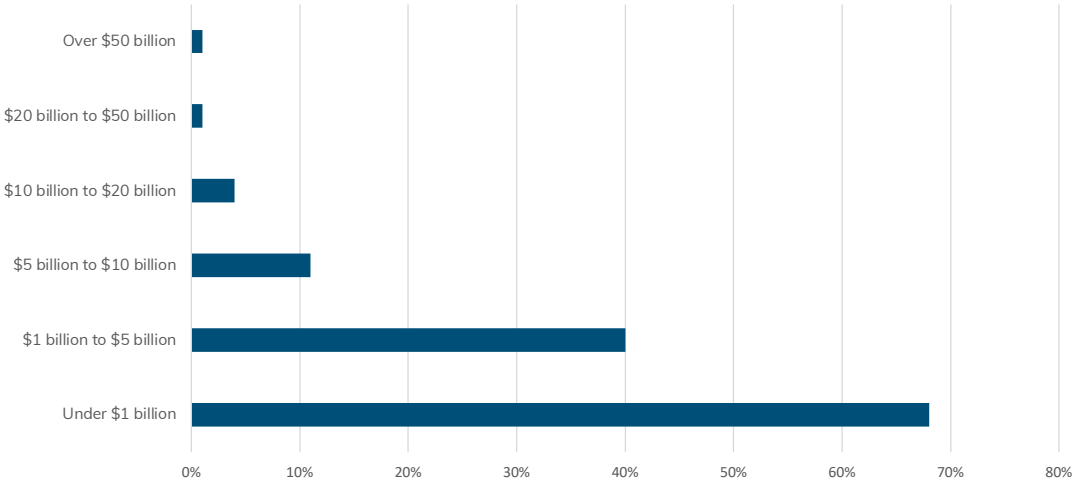
How is your institution classified as a business entity




Who is your primary regulator?




What is the total asset size of your financial institution?



## PROGRESS TOWARD CECL

Unsurprisingly, none of those surveyed said their financial institutions has adopted CECL early and begun incorporating the standard into financial statements. "This is consistent with our experience, as financial institutions have their plates full with basic CECL implementation issues," noted Garry Rank, Senior Advisor with Abrigo's Advisory Services.

And whether it is due to "CECL paralysis" or to hopes that the FASB will delay implementation deadlines, a small share of respondents (6 percent) admit their institutions have yet to begin preparations.

The good news is that nearly half of survey participants (and a majority of SEC filers) have already collected and validated data, which is typically one of the more significant bottlenecks and challenges in CECL implementation. More than a third (and at least half of SEC filers) are testing potential CECL-compliant methodologies.

"The glaring concern in these SEC-filers' responses is the seemingly limited number of institutions that have actually produced meaningful results and are already running parallel in preparation for a 2020 adoption," notes Camp. Institutions have been broadly encouraged to plan for at least four quarters of parallel execution in order to offer enough time to observe a series of results and appropriately calibrate their models, but only 14 percent of SEC registrants surveyed are running parallel allowances, and 3 percent acknowledged having yet to begin CECL preparations.

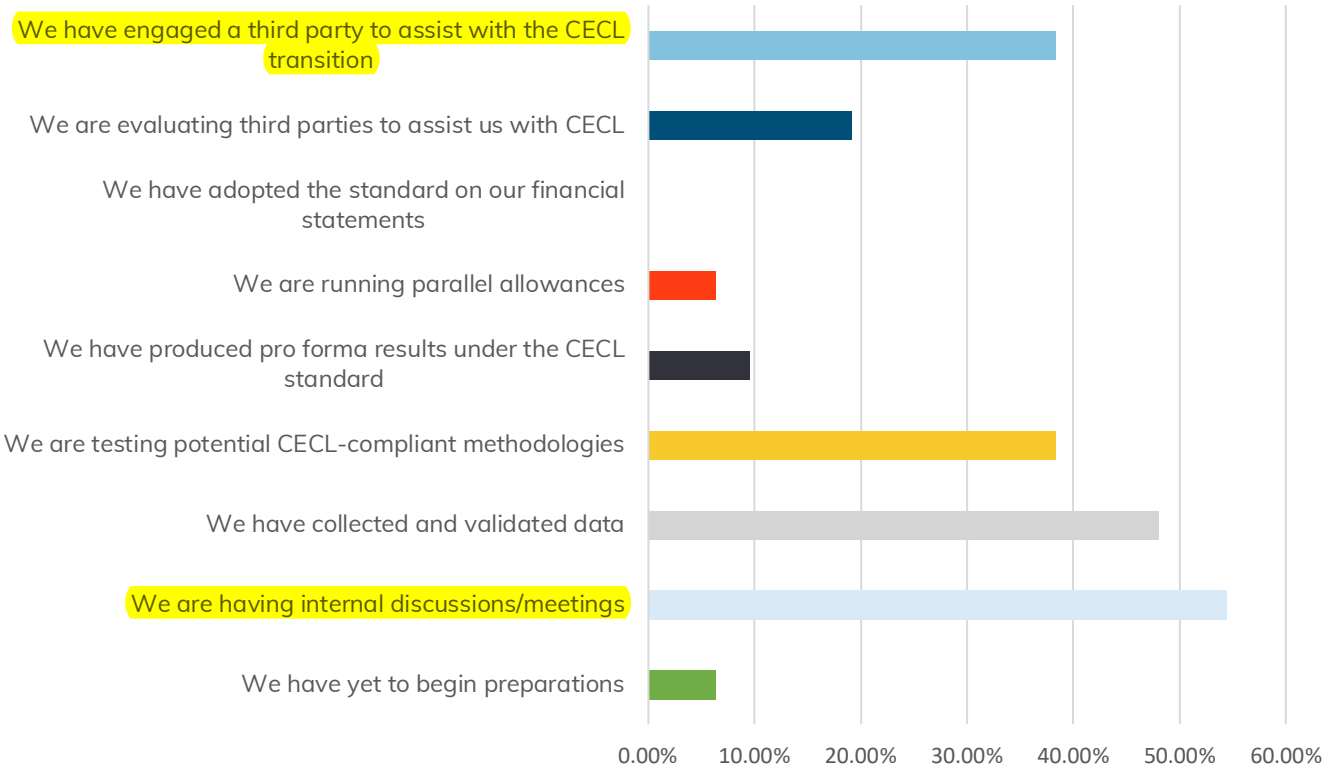
"Allowing enough time to do a walk-through of your models will point to areas that may need to be adjusted and give the institution the opportunity to make those adjustments prior to their CECL compliance date," noted Abrigo Senior Advisor Paula King, a former bank CFO and co-founder. Loan segments and methodologies may need to be adjusted based on testing results. In addition, the walk-through provides time to prepare for loan loss reserve levels and to create supporting documentation, she noted.

More than half of the respondents from SEC-filer institutions indicated they have engaged a third party to assist with implementation, and another 19 percent are evaluating third parties to assist with CECL implementation. "This is consistent with our experience that the internal lack of experience with the CECL standard, the lack of available time, and the simple recognition of the increased efficiencies and enhanced controls offered are the core reasons for reaching out to third parties," Rank said.

"Among banks with assets below $1 billion, it looks like most are still in the discussion, planning, and data gathering phases," said Chris Emery, Director of Strategy and Engagement for Abrigo. Indeed, 56 percent of the smallest institutions surveyed are having internal discussions and 43 percent have collected and validated data. Just over one quarter are testing potential methodologies, and 36 percent have engaged a third party to assist with the CECL transition.

"Very few [4 percent] have actually completed a true parallel run," Emery noted. "The majority of the banks of this size are going to fall into the private or non-SEC PBE categories, so they are naturally a little farther behind the larger SEC filers. Because the non-SEC PBEs don't have to adopt until 2021 and the private institutions don't have to adopt until 2022, these banks are understandably behind, but they need to stay focused in order to be prepared to make parallel runs in 2020."

## How would you describe your progress in preparation for and transition to CECL? (Check all that apply.)




Abrigo's 2019 survey does indicate financial institutions are making progress, at least compared with institutions surveyed in previous years. Thirty-eight percent said they are testing potential CECL-compliant methodologies, up from 27 percent last year, and 15 percent in 2017. Others are moving forward by securing help from outside the institution: Nearly 39 percent have hired a third party to assist with the CECL transition, compared with 32 percent in 2018.

| Survey Responses | 2017 | 2018 | 2019 |
|---|---|---|---|
| We have yet to begin preparations | 5.1% | 4.5% | 6.5% |
| We are having internal discussions/meetings | 86.7% | 55.1% | 54.0% |
| We are testing potential CECL-compliant methodologies | 15.3% | 27.0% | 37.9% |
| We are evaluating third parties to assist us with CECL | 36.7% | 28.1% | 19.4% |
| We have engaged a third party to assist us with our CECL transition | — | 31.5% | 38.7% |
| We have completed the transition process (2018, 2017) / We have adopted the standard on our financial statements (2019) | 1.0% | 2.3% | 0.0% |

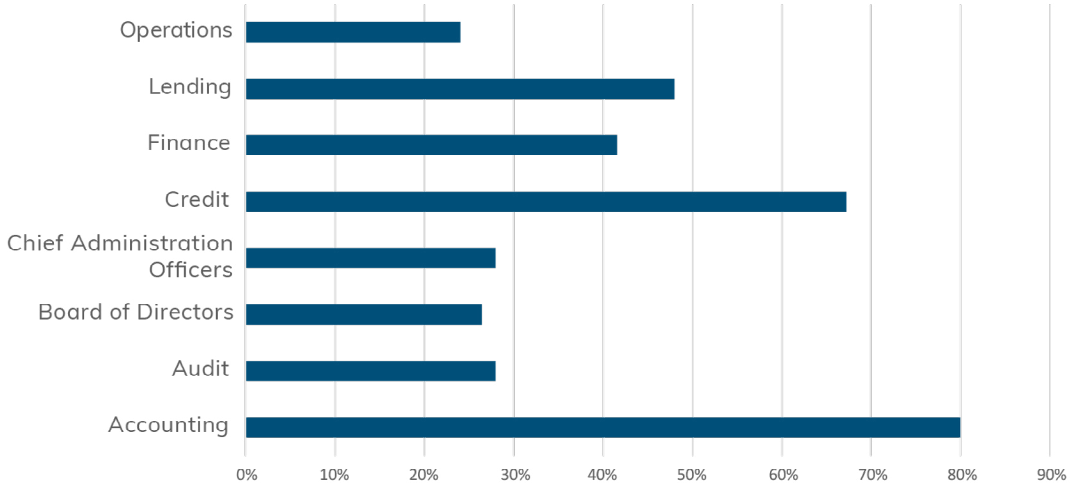
## WHO'S INVOLVED IN CECL

The "usual suspects" involved in preparing the allowance for loan and lease losses (accounting and credit departments) are most often cited by survey respondents as being involved in CECL preparations. However, one interesting survey result is that the lending department was the third-most highly represented group behind accounting and credit. Lending certainly is a group that may be impacted by CECL, noted Emery. "However, given that just over half of those surveyed represented institutions with less than $1 billion in assets, I suspect the representation here is more indicative of smaller institutions having employees that are more likely to wear several 'hats' than they might at a larger institution," he said.

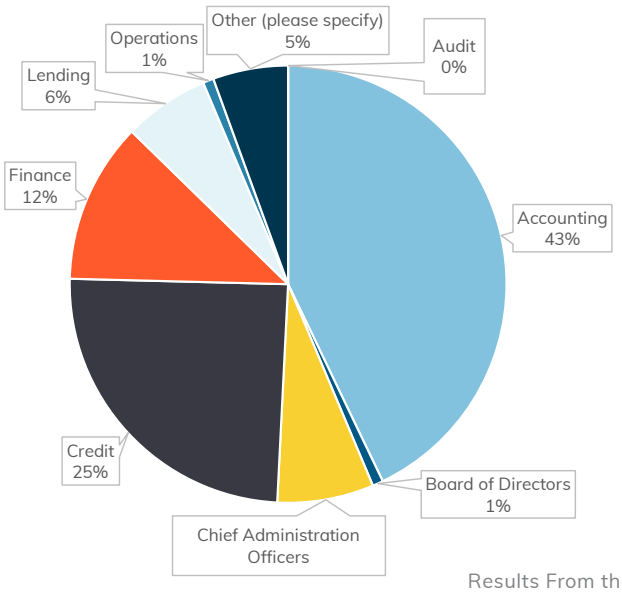
Another interesting finding related to CECL preparation is consistent with trends Abrigo has seen in the marketplace. "While historically the allowance has been a responsibility mostly shouldered by the credit department at smaller institutions, many of these institutions are using CECL as an opportunity to re-evaluate where this responsibility lives," Emery said. "In many cases, the result has been a transitioning from Credit to Accounting or Finance, due to viewing CECL as ultimately an accounting standard."

Twenty-seven percent of those surveyed included their board of directors among those involved in CECL preparations, but very few said the board is driving the process.

Which departments of the financial institution are involved in your CECL preparations?




What department is the primary driver of your CECL preparations?



## DATA REQUIREMENTS

Several factors, including the methodology or methodologies selected and the composition of the financial institution's portfolio, are important to consider when determining requirements for data tied to expected loss calculations.

"Gathering the required historical data has been a challenge for many institutions due to core conversions, incomplete or missing data fields required to run a particular CECL model, and/or lack of historical losses in an institution's data for the model to produce a meaningful result." King said.

Not surprisingly, the results of the survey seem to support this, in that only about 43 percent of the respondents reported that they have sufficient data, while 27 percent are confident that they will have to incorporate external data. Thirty percent of SEC registrants are confident they will incorporate external data.

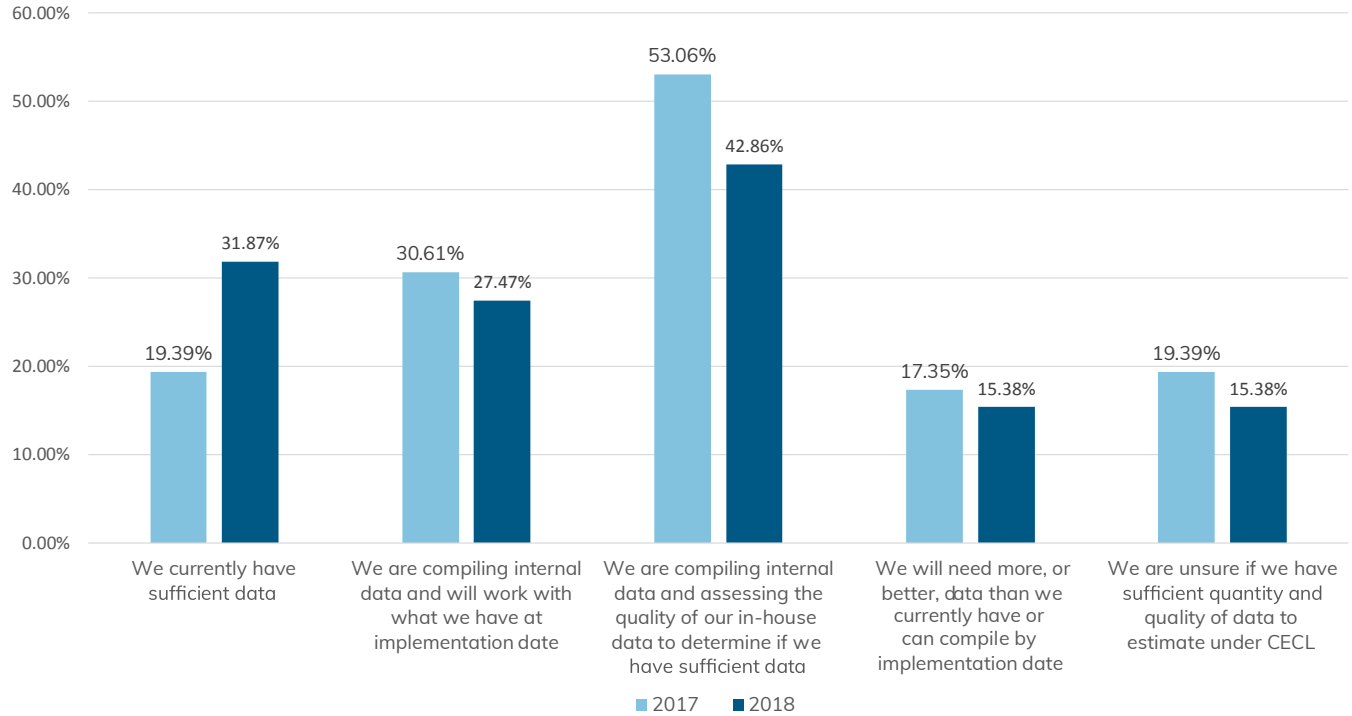
"Commonly in our field work, we see institutions chasing quantities and qualities of data that are not realistically achievable and may not even be necessary due to some generally preconceived notion regarding how much will be required," said Garver Moore, Managing Director of Abrigo's Advisory Services group. "The amount and the quality of information that you need depends on the story within that information, which is going to be institution-specific."

However, progress in data collection has been made from previous years. In 2018, only 32 percent reported having sufficient data, and in 2017, that share was 19 percent.

A larger share of respondents this year also said they "are compiling internal data and will work with what we have at implementation date," compared to previous years: 44 percent vs. 27 percent last year and 31 percent in 2017. Perhaps due to the lack of loss data history, there is greater recognition this year than in previous years that institutions may require external data in order to produce meaningful results.

"In an ideal world, we would all have our own internal, historical data with sufficient depth and breadth to support all our analytical and modeling needs," Camp said. "The reality, however, is that most institutions fall short of this ideal and thus, external data is needed to strengthen or augment the picture painted by internal data."

Estimating CECL will require more historical data than required by the incurred loss standard. Check all that apply, relative to your institution and the required data.



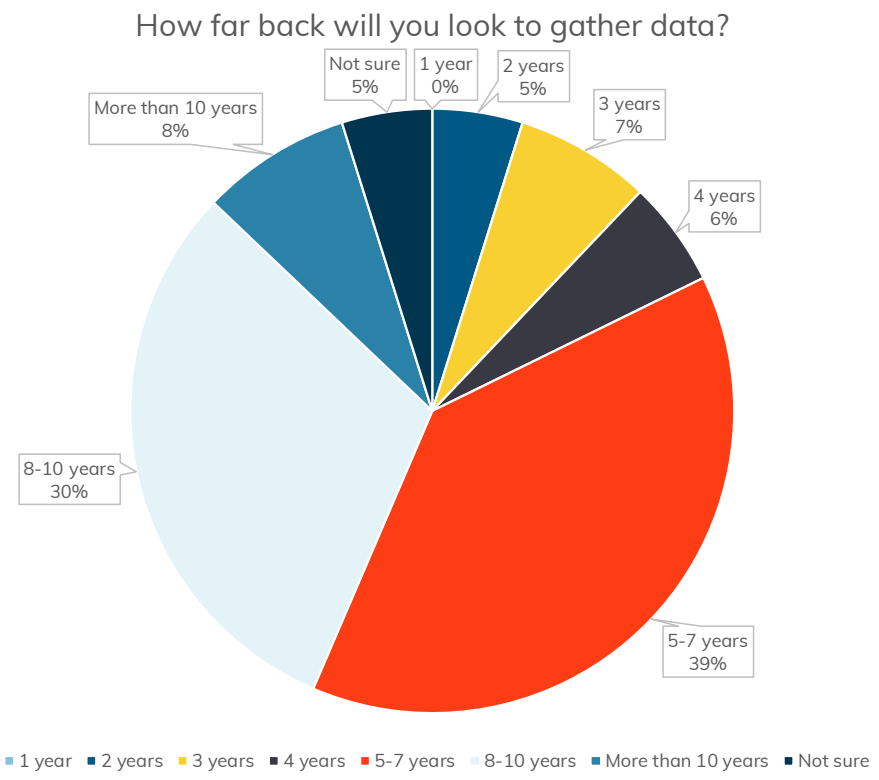
## HOW FAR BACK IS FAR ENOUGH?

Generally speaking, institutions are encouraged to gather and validate as much data history as is reasonably available, and they are particularly encouraged to look to secure data that spans periods of economic fluctuation, Camp noted. Thirty-nine percent of those surveyed by Abrigo said their institutions plan to look back five to seven years to gather data, while another 30 percent will look back eight to 10 years. Twelve percent of respondents from institutions of all sizes said they would look back three years or less.

"Initially, for most institutions, the depth to which they'll gather data will be less driven by subjective strategy and more by the objective reality of whatever history is available to them," Camp said.

Two-thirds of survey participants representing banks with assets below $1 billion plan to look back seven years or less for their CECL estimation process. "Given the extended economic expansionary period, we find that most banks do not have enough loss or default experience in the last seven years to calculate a meaningful CECL result using their own bottom-up data," Emery said. "This can certainly lead to challenges for these institutions, and may result in having to rely on primarily external rather than internal information to substantiate their CECL result." Twenty-two percent of respondents from banks with less than $1 billion in assets expect to look back eight to 10 years to gather data.

Relative to smaller community banks, credit unions seem to be either more willing or more able to look back farther to gather data, with nearly a majority planning to gather eight or more years of data, Emery said. "This could be due to credit unions typically being more consumer-loan focused, as longer-term consumer loans may require more data to substantiate a meaningful CECL reserve estimate," he said.



## CECL DATA USEFUL FOR OTHER APPLICATIONS?

The focus on data in the transition to the new accounting standard for the measurement of credit losses on financial instruments has meant a substantial investment of time and effort for financial institutions. Given that data is key across many facets of the organization, Camp said, "Any efforts undertaken to increase the depth and/or improve the quality of dynamic data will undoubtedly prove advantageous in other applications."

Survey participants seemed to agree. By a 3-to-1 margin, they said the data they are gathering for CECL would be useful for other applications.

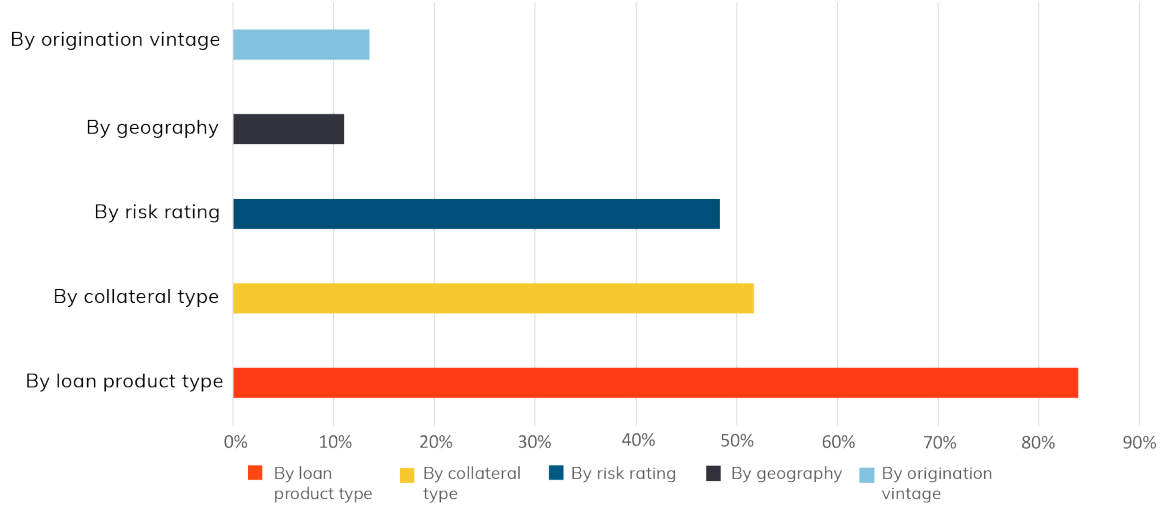
"This is consistent with the design of ASU 2016-13," Rank said. "Standard setters want lenders to gather more information and perform more ongoing analysis relative to portfolio risk and potential losses. Therefore, if CECL models are designed correctly, they will provide greater information to all parties at the table: Credit Risk Managers, Loan Officers, Executive Officers, Board of Directors, Financial and Internal Auditors, Regulators, etc."

## POOLING & SEGMENTATION

Financial institutions are already directed to segment financial assets on the basis of similar risk characteristics for the purposes of estimating losses under the incurred loss model used today, Camp noted. Therefore, it is no surprise that a fair number of respondents are expecting to stick with similar segments to those leveraged today.

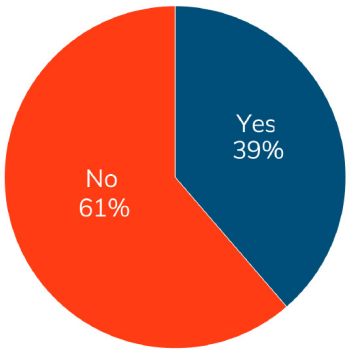
Asked how they are segmenting loans for purposes of estimating losses, a majority of respondents named loan product type (84 percent), followed closely by collateral type (52 percent), then risk rating (47 percent).

For purposes of estimating, how are your loans segmented? (Check all that apply)




Survey respondents are split on whether CECL will cause them to change how they pool or segment loans:

Will CECL cause you to change how you pool or segment your loans?

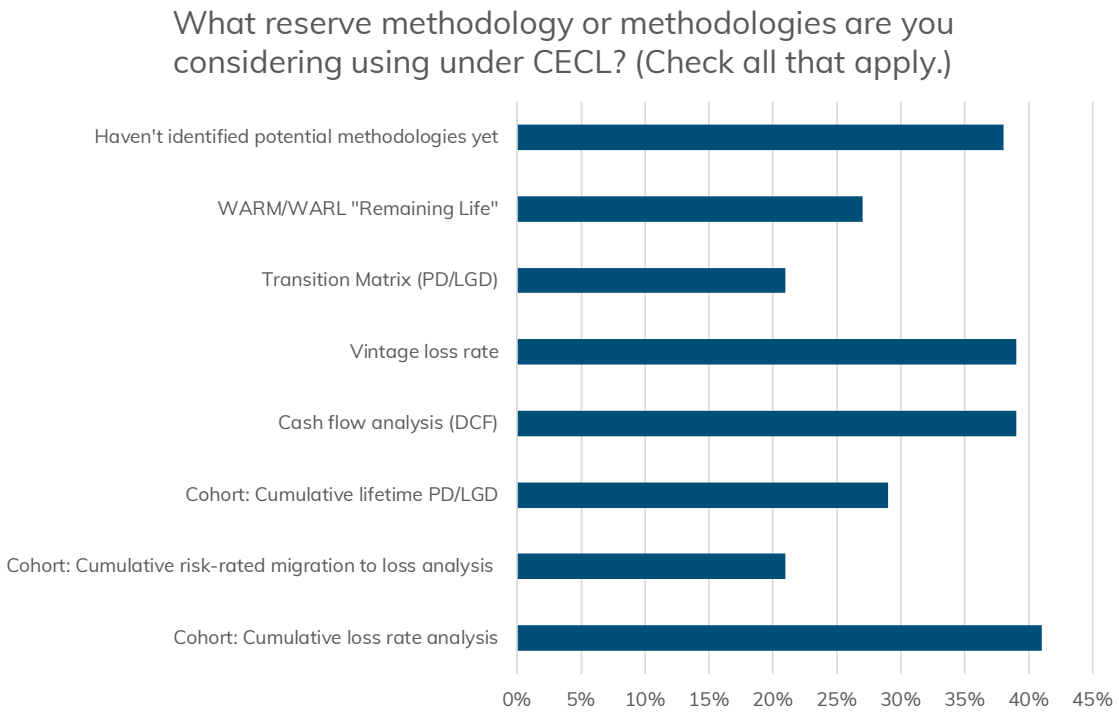


King believes that it is more likely than not that loan pools, or segments, will change under CECL. "While we want to avoid being too granular in terms of loan pool balances and counts, many institutions currently have broad segments for their incurred loss model," she said. "CECL mandates segmenting loan pools in terms of similarity of credit risk. In addition, an institution wants to ensure they are pooling loans that behave in similar fashion to external events such as changing economic conditions (e.g., collateral types and value deterioration patterns or specific industry borrowers and how they react to conditions and trends). Segments such as Commercial Real Estate may need to be sub-segmented into, for example, Owner-occupied versus Non-owner occupied or Multifamily sub-segmented from other CRE, etc. For larger institutions, further segments by collateral or industry may be prudent."

"Look at your current loan segments, which should be pooled by risk indicators (e.g., Call Codes) and determine how you can make adjustments to those current loan pools," she said. "It is true that smaller institutions will not be able to sub-segment as much as the larger ones, due to their inherent smaller loan pool balances and loan counts. You want to maintain a meaningful and statistically relevant output from the model and in order to do so, you need sufficient segment size. We find that institutions want to segment in a very granular fashion on the front-end, until we explain the impact on the model output. For example, if a sub-$1 billion bank decides that they would like to segment based upon NAICS codes or regions, in most cases, resulting loan pools will become statistically irrelevant."

## WHICH METHODOLOGY

Abrigo's survey has several interesting findings regarding methodology selection. First, financial institutions in general and banks that are the closest to the CECL deadline (i.e., SEC registrants) are "clearly buying into what the FASB and regulators alike have repeatedly emphasized in asserting that there is no 'one size fits all' approach to CECL," Camp said. "There appears to be a well-distributed spread across the more prominent methodologies being considered for CECL." This implies institutions are applying judgment in developing estimation methods that are appropriate and practical for their own respective circumstances.



Notably, 17 percent of SEC registrants haven't yet identified potential methodologies. With a compliance date of Q1 2020, these institutions ideally need to have preliminarily selected their methodologies and loan segments so that they can begin testing them in the software system, King noted. A plurality of banks with assets below $1 billion are unsure what methodology they will be utilizing, but that isn't a big surprise, given the stage of preparation for most institutions in this asset range, Emery noted.

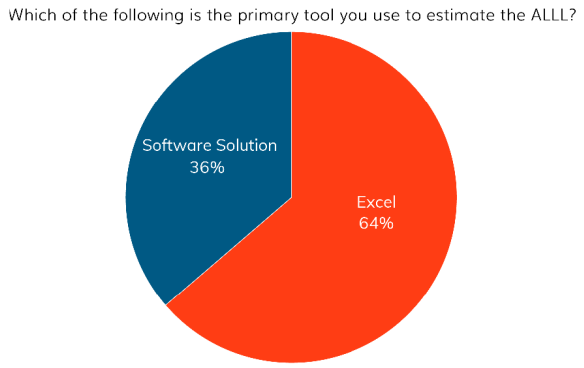
"Among the ones who have made a determination, it looks like the most common overall approach is the cohort or cumulative loss method, followed closely by the WARM or remaining life method and the vintage loss rate approach," Emery said. "The inclusion of vintage here is a little surprising, as our experience at Abrigo has indicated that smaller banks have a difficult time utilizing the vintage method for a variety of reasons, most notably the lack of the volume necessary in most segments in order to fully inform vintage curves. It may be that these institutions are still in the exploratory phases of methodology selection, or it may be that they are only using this method on segments that may have higher than average volumes like auto loans. Also included as a significant factor is the DCF method, which has gained some traction among smaller banks, in addition to larger institutions."

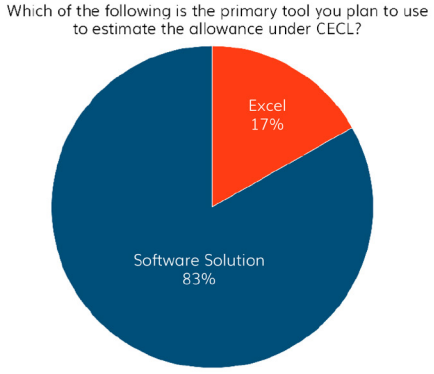
As is with their data collection efforts, credit unions' focus on consumer portfolios may be showing up in the types of calculation methods these institutions seem to be focused on, Emery said. Vintage loss analysis, which tends to work best with higher-volume consumer portfolios, shows as the majority choice among credit unions in this survey.

## TOOLS FOR THE JOB

Due to the higher levels of historical information needed as well as the increased complexity in many of the calculation methods in CECL, many banks are seeing software solutions as more necessary than ever before. The shift to using a software solution is the largest in smaller banks, the vast majority of which have historically used manual Excel spreadsheets as their incurred loss estimation tool.

"The widely-considered methodologies would be time consuming and difficult to run in an Excel environment, given the large amount of historical data necessary as well as the formulas used in the models," King said. "Setting up the models will require someone who is not only proficient in Excel but also in understanding the model sufficiently enough to set up the logic – translating it from theoretical to building the model in the spreadsheet." In addition, even with current incurred loss models, which have been relatively easy to perform in Excel, there is the propensity for human errors, such as in setting up formulas incorrectly, inadvertently overriding formulas, etc. With a tested and proven software solution, security controls, and the validation process of the model, the potential for errors will be significantly reduced and the institution can ensure that the model logic has been appropriately interpreted. This will also encourage time spent more efficiently in analyzing results as opposed to inputting assumptions.

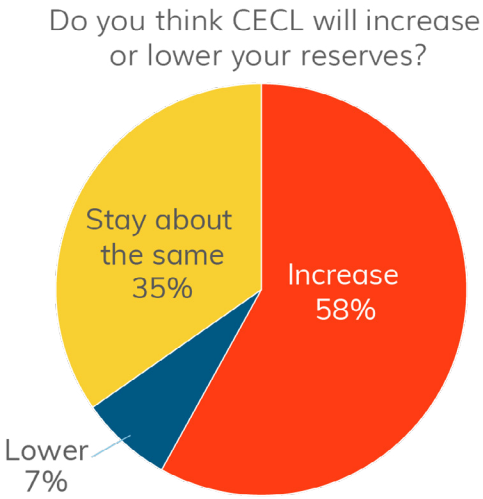


## CECL'S IMPACT

As CECL's deadlines have neared, some financial institutions have called for delays and additional studies of the financial impacts. According to Abrigo's survey, 58 percent of respondents believe CECL will increase their institution's reserves. That's more pessimistic than the 45 percent who predicted higher reserves in 2018 but more optimistic than those surveyed in 2017 and in 2016.

"It's good news to see that the majority of respondents are preparing for an increase in their reserves under CECL," King said. "It makes sense logically, that adding the life-of-loan concept and the forecasting component would cause an increase in the reserve; however, the increase may not be as substantial as predicted when the Update was first released. The level will depend upon, among other things, the impact of historical losses that might have occurred over the expanded historical timeframe of the institution's data as well as how management adjusts the reserve for the forecasting component. Most critically, if reserves are wildly overstated under an incurred notion, it will be difficult if not impossible to produce an increase if stating an accurate lifetime expectation." Answers didn't vary dramatically by size of the respondents' institutions.




Similarly, most respondents, regardless of institution size, expect CECL will "somewhat" impact capital requirements. A third of respondents from banks with less than $1 billion in assets (and 27 percent from SEC registrant banks) said CECL will have no impact on capital requirements.

Camp noted that regulators recently revised captial rules in anticipation of CECL adoption, with the aim of softening any potential blow. "The sooner an institution can begin calculating CECL's impact the better, even in a rough approximation, to verify whether or not they may have and need to prepare for a capital shortfall."

## PRICING AND UNDERWRITING

Asked if CECL will result in changes to how they price loan products, 59 percent of respondents (including 51 percent of SEC registrants) said it would not. However, that share rose to 70 percent among respondents from financial institutions with less than $1 billion in assets. This, Emery says, suggests loan pricing for these smaller institutions is driven by local competition, internal strategy on Asset Liability Management, and periodic offering of certain products and rates to stimulate customer growth and market share.

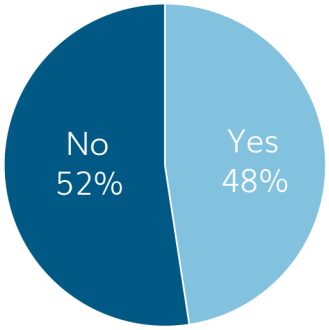
Seventy-seven percent of respondents said they do not think CECL will result in changes to their institutions' underwriting standards, and more than half also don't think CECL will result in changes to loan administration practices. "My opinion, here, is that loan operations should be in the loop on your CECL decisions," King said. "They are the front-line when it comes to booking your loans in the core system and need to understand the importance of completing all required data fields as well as how you ultimately decide upon loan segments. My recommendation is that once you determine your new loan segments, if any, have them check their mapping guides for loan type codes, collateral codes, etc. and spend time educating the department on the importance of proper coding on the front-end. You may want to tighten up review processes in this area as well."

It is widely acknowledged that CECL introduces additional rigor into the allowance process. Will that necessarily introduce complexity into justifying the allowance to external auditors and regulators? "Institutions that are meticulous

in their preparation and documentation substantiating their methodology should find themselves in a comfortable position when it comes to justifying their conclusions," Camp said.

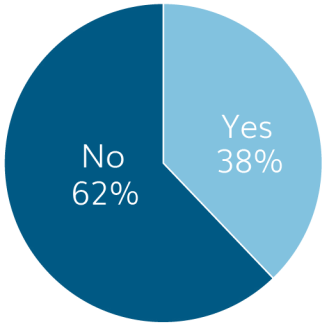
Respondents in Abrigo's survey were split on whether CECL will make it more difficult to justify the allowance to external auditors and regulators.

Do you think CECL will make it more difficult to justify your allowance to your external auditors and regulators?




SEC registrants were less concerned, with only 38 percent expecting more difficulty.

Do you think CECL will make it more difficult to justify your allowance to your external auditors and regulators?




King said that the many modeling options available under CECL bring a couple of requirements related to the audit and examination processes. "First, regulators and auditors will need to understand a variety of methodologies, whether based upon the concept of "perfect knowledge" (e.g. the Cohort method) or estimating expected cash flows through a DCF model," she said. "Second, the institution will need to be well-versed on their chosen model, understanding the premise and all of the inputs and outputs in order to explain the concept as well as the reason it makes sense for their institution based upon their loan pool attributes and available data."

## OTHER IMPACTS OF CECL

Not surprisingly, the most popular answers of additional impacts of CECL include increased demand on internal resources and increased cost and complexity of compliance. While most respondents believe CECL will have negative impacts in terms of increased costs, complexity, and burden on staff, very few seem to believe it will truly impact the fundamentals of the business of banking, including the types of loans made or profitability. Less than 1 percent of respondents answered that CECL would ultimately reduce loan losses experienced by their bank.

## CONCLUSION

CECL represents one of the, if not **the**, biggest banking accounting changes ever. The good news is that the vast majority of financial institutions are taking the standard seriously and making significant progress in their transitions to CECL. But is it fast enough? While nearly half of survey participants (and a majority of SEC filers) have collected and validated data, which is one of the more significant bottlenecks and challenges in CECL implementation, very few SEC-filing institutions have produced meaningful results and are running parallel calculations in preparation for a 2020 adoption. Gathering enough data has been a top concern among financial institutions, and this survey suggests that many institutions feel like they are still falling short on having the right amount of information.

The array of methodologies selected by financial institutions suggests that there really is no "one-size-fits-all" approach to achieve CECL compliance. Indeed, there seems to be a well-distributed spread across the available methodologies being chosen, which suggests that institutions are carefully assessing what estimation method is most appropriate for their own circumstances.

Overall, financial institutions have shown greater preparation for CECL than in the past three years. But as CECL experts warn, the implementation clock is ticking. This year's survey has brought to light that while many financial institutions are taking the necessary steps to make sure they are prepared for this important change in accounting for credit losses, it's clear that there are many others that are falling behind their peers.

## ABOUT THE AUTHOR

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## ABOUT ABRIGO

Abrigo provides technology that community financial institutions use to manage risk and drive growth. Our solutions automate key processes – from anti-money laundering to fraud detection to lending solutions – empowering our customers by addressing their Enterprise Risk Management needs.

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## ADDITIONAL RESOURCES

ALLL.com – a website for information about the allowance and the transition to CECL

Whitepaper: Practical CECL Transition Guide

CECL Transition Workshop Series

Webinar: Key Decisions and Steps in the CECL Transition

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