



# *ACUIA Region 6*

CECL Governance and Preparedness – It's more than just an estimate

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Carrie Kennedy, Partner

Dustin Birashk, Partner





## Carrie Kennedy

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Carrie has practiced public accounting since 1997. She provides financial auditing, operational auditing, and other consulting services for credit unions, community banks, SEC banks, and other financial services organizations. Her experience includes initial public offerings, SEC reporting, start-up institutions, mergers and acquisitions, HUD reporting, and Sarbanes-Oxley and FDICIA reporting. She is actively involved in the firm's Financial Services Group and is a frequent speaker at industry association events, Moss Adams' annual supervisory committee workshops and webcasts, and also authors articles for firm and industry publications.





# Dustin Birashk

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Dustin has been in public accounting since 1999 and specializes in serving financial institutions including credit unions, community banks, thrifts, mutual banks, SEC banks, mortgage banking companies, and other financial services organizations. He is proficient with opinion audits and Supervisory Committee agreed-upon procedures engagements.

Dustin is actively involved in the firm's Financial Services Group and is a frequent speaker at industry association events, Moss Adams' annual supervisory committee workshops and webcasts, and also authors articles for firm and industry publications.



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# Expertise

*Crater Lake—  
A monument to perseverance,  
North America's deepest lake filled  
to 1,949 feet over 720 years.*

D

106

years in business

E

3,000

professionals

E

P

30+

industries served



# Reach

*Grand Canyon—  
At 277 miles long and up to 18 miles  
wide, this icon serves as a testament  
to determination and time.*

# W I D E

30+

locations

100+

countries served  
through Praxity,  
AISBL

Top 4 in

credit unions  
served



# Agenda:

- Introductions
- CECL Overview
- CECL Implementation
- Data
- Modeling
- Macro Economic Input
- Impact on the Institution
- Validation
- Final Thoughts



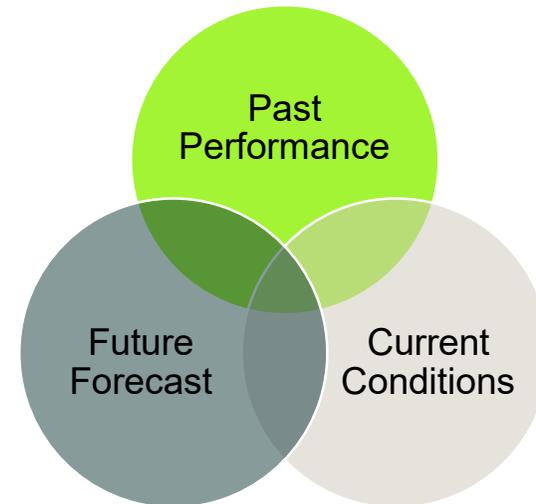
# Introduction

**CECL:** The Financial Accounting Standards Board (FASB) issued the final current expected credit loss (CECL) standard in June 2016. The new guidance particularly impacted community financial institutions by modifying or replacing existing impairment models for financial assets, such as trade receivables, loans, debt securities, and purchased credit-deteriorated assets.

## -Loss Estimates

Under the CECL model, a company's estimate of expected losses should represent all contractual cash flows that a company doesn't believe it will collect over the contractual life of the financial asset. This could be up to 30 years for certain types of loans, such as consumer mortgages. In practice, estimating credit losses over significant periods of time, as well as applying other aspects of the CECL model will be challenging.

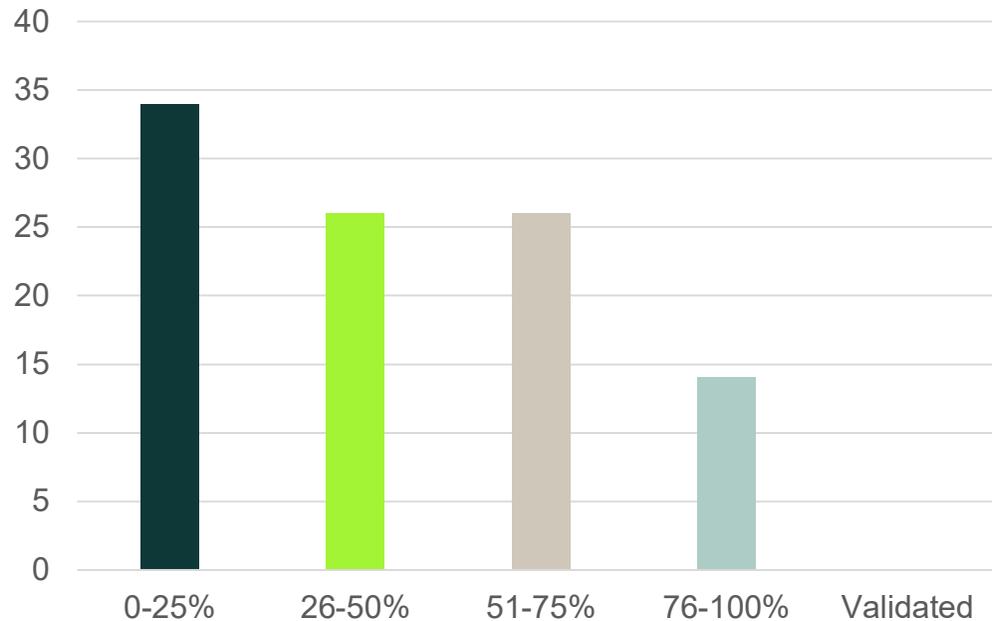
## Life of Loan Loss Forecast



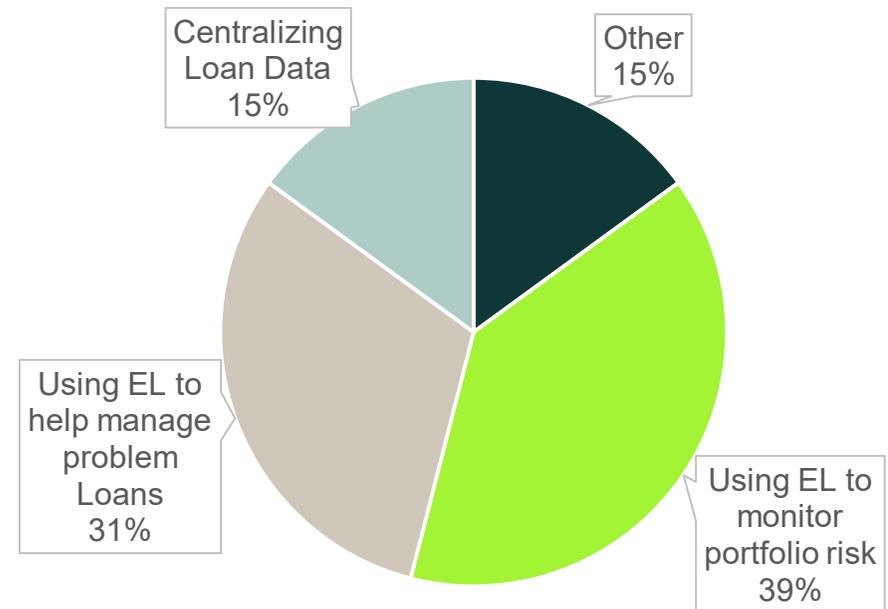
# Where we are at...

A recent survey conducted by DebtX – The Debt Exchange reported the following results...

## How far along are you in model development and validation?



## Do you see any additional uses for CECL?



# Revised Timeline

The old timeline...

## CECL implementation dates



# Revised Timeline CECL/Insurance/Leases/Hedging

On July 17, 2019, the FASB voted to propose a delay in the effective dates for certain companies for the credit losses, insurance, leases, and hedging standards. This month those proposals were approved.

The new timeline creates essentially two “buckets”: (1) SEC filers other than smaller reporting companies (SRCs, as defined by the SEC) and (2) all other entities, allowing at least a two year difference in the effective date between the buckets

	<b>SEC filers, excluding SRC's</b>	<b>All other entities</b>
CECL	Fiscal years beginning after December 15, 2019	Fiscal years beginning after December 15, 2022
Insurance	Fiscal years beginning after December 15, 2021	Fiscal years beginning after December 15, 2023



# Modern Portfolio Theory – How we got to now...



We don't  
make bad  
loans.



Okay Some  
loans might  
go bad.



Some loans  
will go bad.  
How do we  
find them  
early?



# What to focus on...

## **Step 1 – Define the goal**

Begin with the end in mind... Think about the goal and then work backwards. Think about the disclosures you will have to make, what the regulators and accountants are looking for, etc. A well defined goal will go a long way in keeping you on track.

## **Step 2 – Determine if your plan is reasonable**

Take a step back... Think about your institution, the risks you take, your size, complexity and develop a plan that matches your risk profile. Consider what you already have in place that can be leveraged and used in the new process.

## **Step 3 – Get the right people involved**

Is CECL Accounting, Credit, Systems / IT, Enterprise Risk??? It's all of these. Having the right people involved will be key in the success of any CECL implementation. Think about your goal and a reasonable plan... Then think about who needs to be at the table to carry out the necessary steps to achieve that goal.



# Differences between ALLL and CECL estimates

## ALLL

- Incurred loss was succinct, easy to explain
- Foundation was based on observable facts such as past due rates, balances, NPLs, net charge offs
- Variance from past trends provided the guidance
- Focus on understanding the portfolio quality in relationship to the past and to your peers
- Internal audit team had a defined process to validate ALLL estimates

## CECL

- CECL is an easy concept, but difficult to explain and justify
- “An entity must use judgment in determining the relevant information and estimation methods that are appropriate in its circumstances.” ASU 2016-13, page 2
- Variance and quality from peers in what – judgement, relevant, estimation, appropriate or circumstances
- Is your internal audit team even qualified to audit the new expectations

**What’s reasonable and supportable?**



Data is really about one thing... **Governance**.

You can debate how much and what kind but if quality isn't there then you are starting from zero.

### Questions:

- Who has a data initiative or data strategy at their institution?
- What data issues have you struggled with?
- Who is only using internal data?
- If you are supplementing, what are you using and for what purpose?

## -Data: What You've got vs. What you need



# The more data the more options you have

Data will largely  
drive what  
methods and  
modeling you  
can use

- Historic loan loss
- Weighted average loss
- PD / LGD
- Cohort
- Vintage
- Migration
- Discounted cash flows
- A mixture of the above



# Reasonable and Supportable Forecast...

## Macro Economic Indicators

*In your opinion, which of the following do you think are the best predictor of credit quality or deterioration?*

**A) Unemployment Rate**

**B) Real GDP Growth**

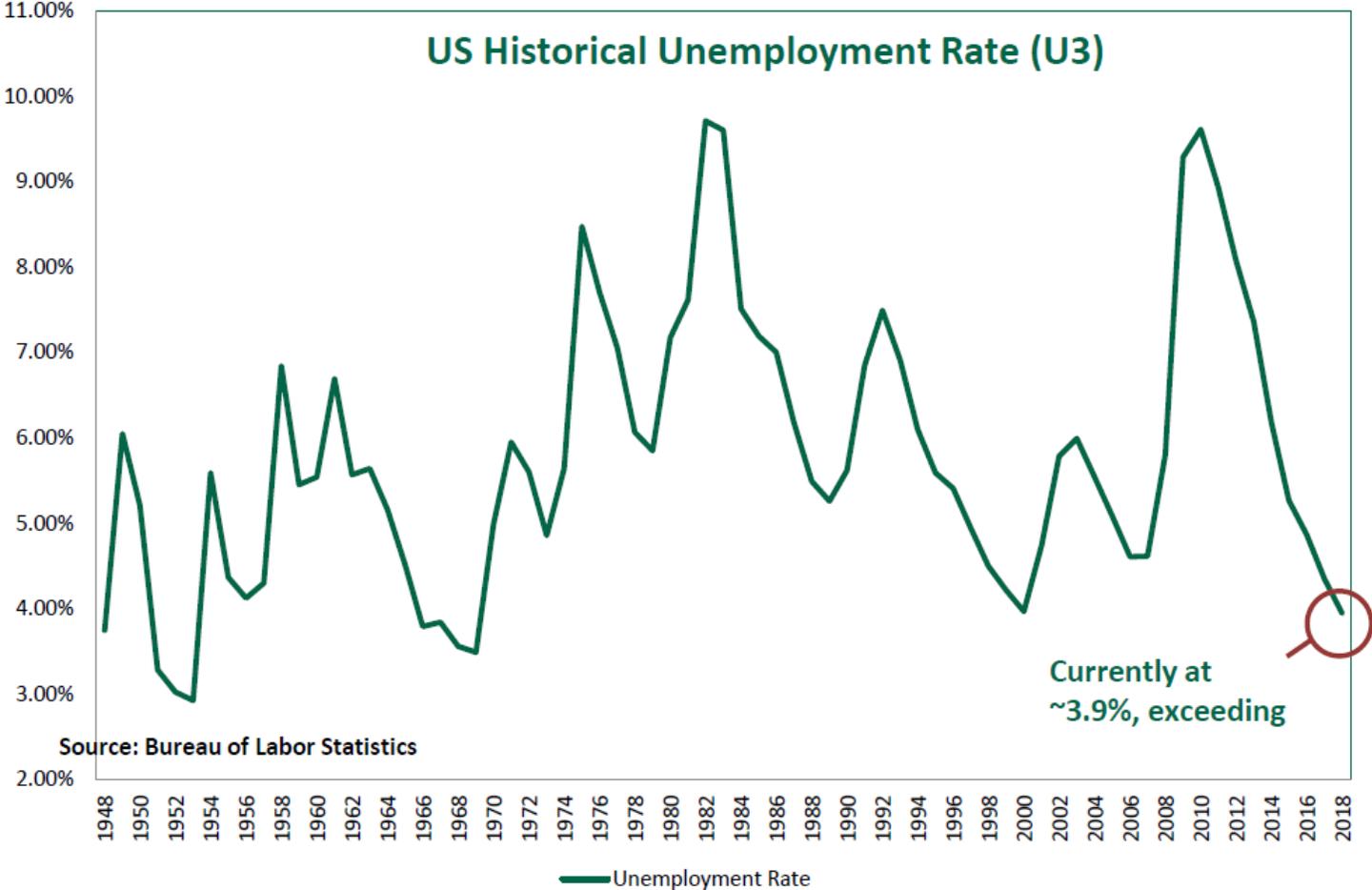
**C) House Price Index**

**D) Moon Phase**



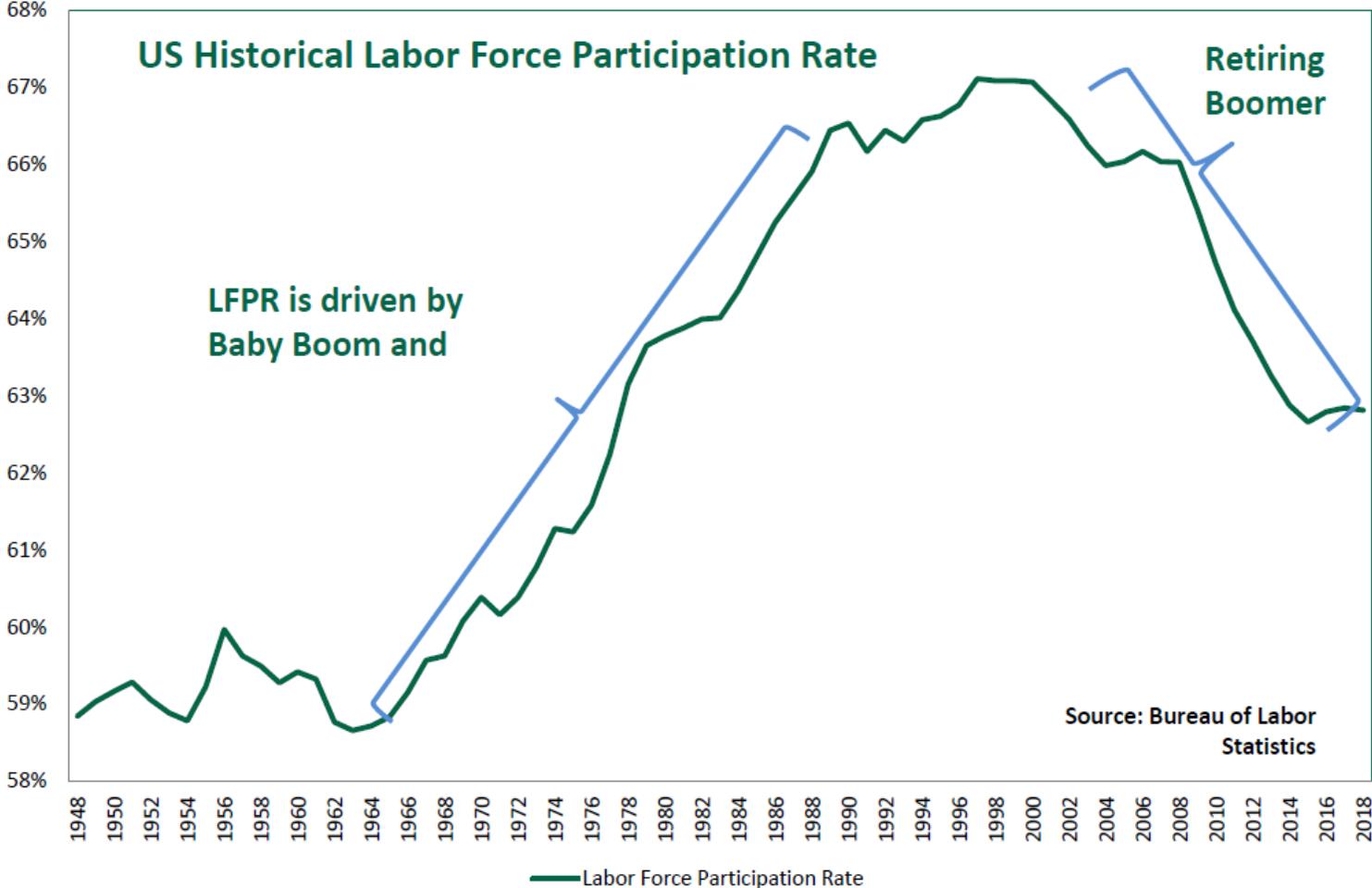
# Let's take a look at Unemployment...

...and now the key question is 'how low can it go?'



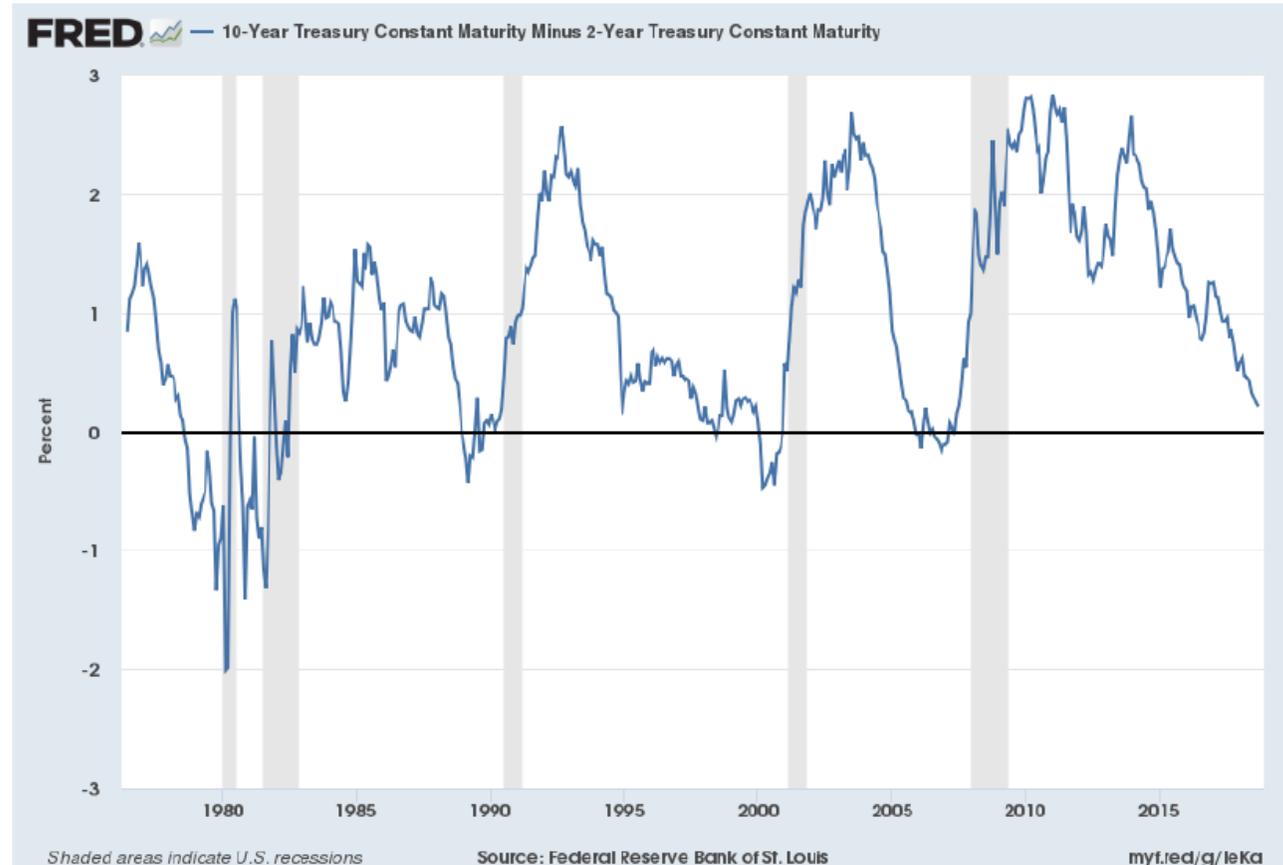
# Let's take a look at Unemployment...

**Below the surface, structural drivers are at play**

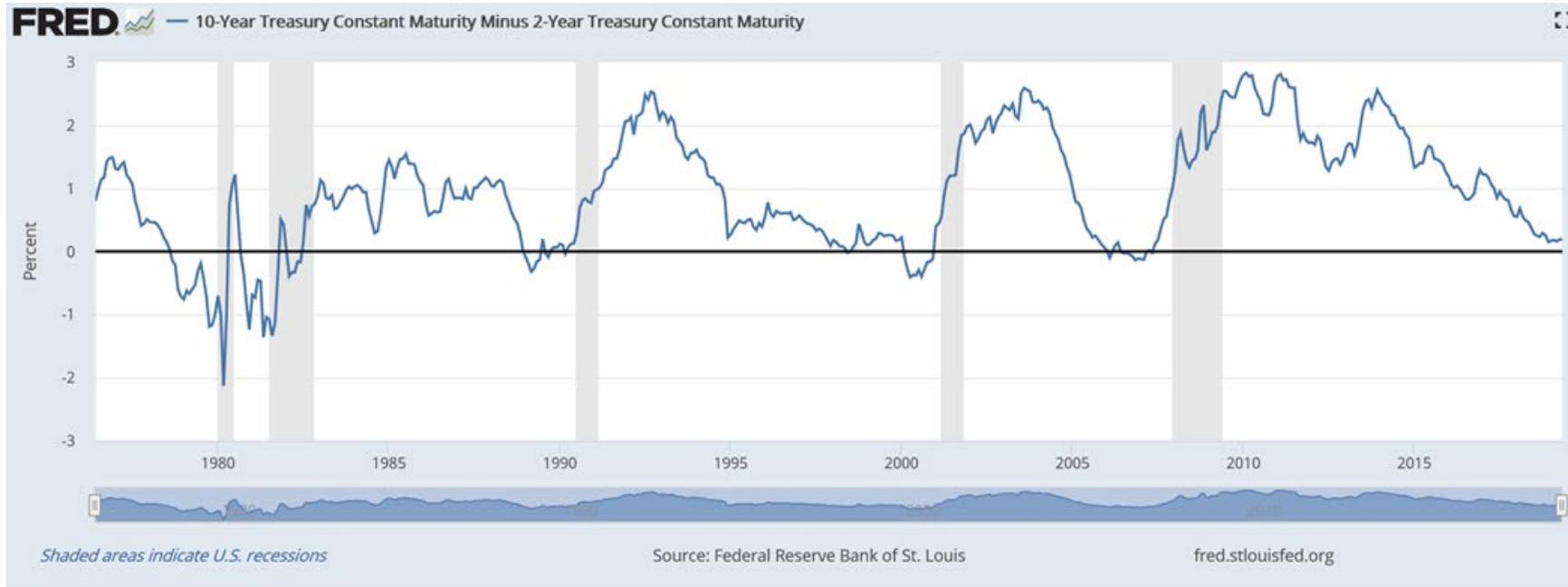


# Let's take a look at Real GDP Growth...

- Every Recession since 1980 has been preceded by an inverted yield curve.
- Inversion happens, on average, ~17 months prior to recession.
- Example: Inversion first seen in December 2005 leading into The Financial Crisis of 2007-2008.



# Let's take a look at Real GDP Growth...

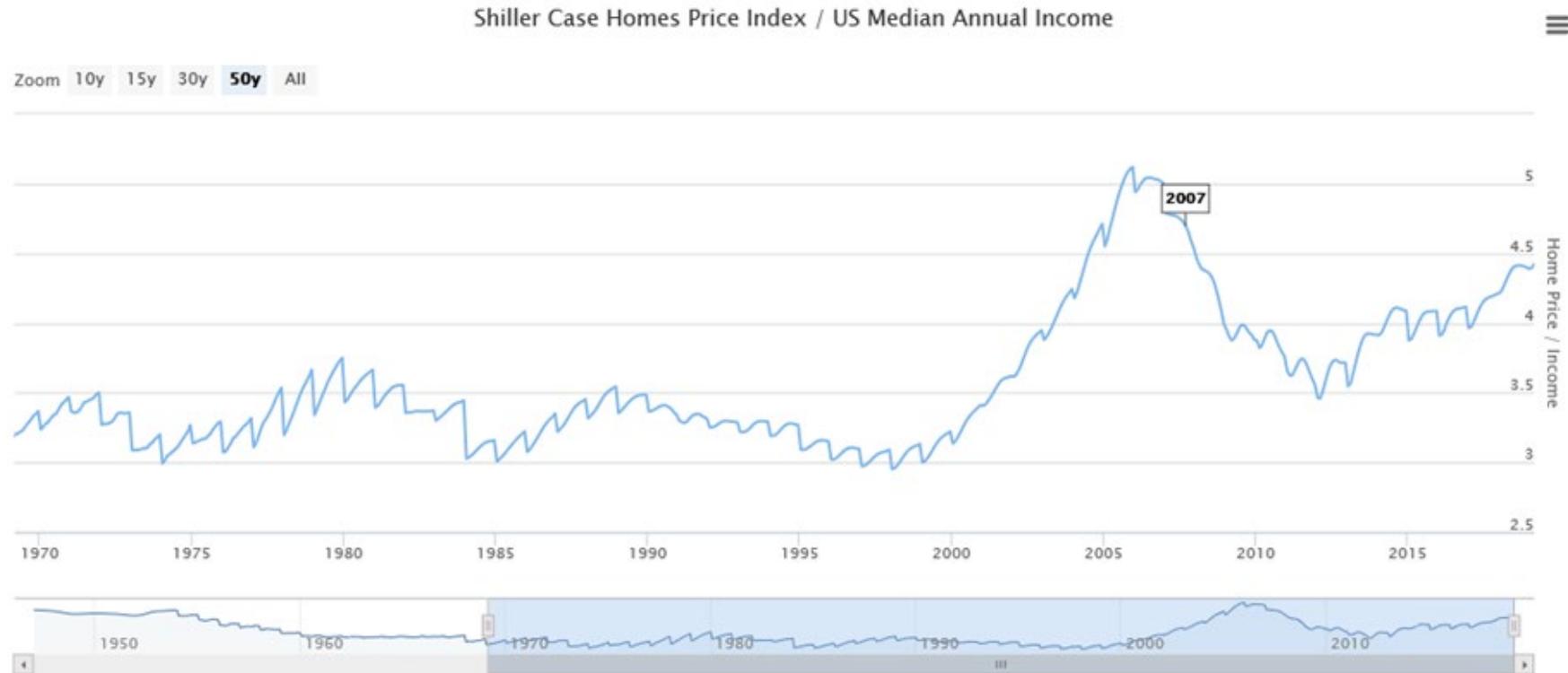


Date	1 Mo	2 Mo	3 Mo	6 Mo	1 Yr	2 Yr	3 Yr	5 Yr	7 Yr	10 Yr	20 Yr	30 Yr
09/03/19	2.06	2.01	1.98	1.88	1.72	1.47	1.38	1.35	1.42	1.47	1.77	1.95
09/04/19	2.05	2.02	1.97	1.87	1.69	1.43	1.36	1.32	1.40	1.47	1.77	1.97
09/05/19	2.05	2.01	1.97	1.88	1.73	1.55	1.47	1.43	1.51	1.57	1.86	2.06
09/06/19	2.05	2.00	1.96	1.88	1.73	1.53	1.46	1.42	1.50	1.55	1.83	2.02
09/09/19	2.04	1.99	1.96	1.87	1.74	1.58	1.52	1.49	1.57	1.63	1.91	2.11
09/10/19	2.04	1.99	1.95	1.89	1.81	1.67	1.61	1.58	1.66	1.72	2.00	2.19
09/11/19	2.01	1.97	1.96	1.88	1.79	1.68	1.62	1.60	1.68	1.75	2.02	2.22
09/12/19	1.99	1.97	1.95	1.90	1.82	1.72	1.67	1.65	1.72	1.79	2.06	2.22



# Let's take a look at housing Prices....

## Home Price to Income Ratio



# How do you apply macro economic variables?

- A) Build it into your models
  - A) Add it as a variable in your PD's / use stressed LGD's
  - B) Use Scenario Analysis – have a base case, adverse scenario, stressed scenario
- B) Apply it as a qualitative factor
  - A) Management judgement
  - B) Use an external resources (i.e. consensus forecast, etc.)
- C) Maybe something in the middle of the above two options
  - A) Build an index to support your adjustments
- D) Importance of regional vs. national economic data
- E) What are the key risk drivers for your portfolio?



# The importance of a strong validation...

- A guiding principle for managing model risk is “**effective challenge**” of models.
- OCC 2011-12 framework can be used for managing CECL model risk
  - Sound model risk management including strong governance framework around model development, implementation, and use.
  - Outcome analysis, benchmarking, “**fit for purpose**” review
  - Evaluation of conceptual soundness
  - Testing and sensitivity analysis
  - Back testing when performance data are available
  - Loss estimates in aggregate may be validated as well
- All components of validation activities can be applied
  - For example, models such as PD, LGD, EAD, prepayment, recoveries, macro economic variable forecasts may be separately validated and evaluated for CECL use
- **Vendor model** risk management - similar to other third party models – OCC 2011-12 provides guidance on third party model risk management



# The Role of Audit in CECL Adoption

## Large Scale Project

For most institutions CECL represents a large multi-step project. Anytime projects like this are undertaken Audit can play a big role by being involved early, asking questions up front, making sure the project is on track, and helping the team stay focused on the big picture.

## Data and Systems

Given the data and system requirements around CECL, Audit can play an important role with testing controls and governance around these items on the front end. Identifying problems up front can save time and money in the end. You may have an awesome model but garbage in garbage out as they say.

## Challenging Assumptions

Audit can be key in challenging assumptions up front and making sure management can defend their decisions. Especially in the area of the forecast... Why did you choose to look at unemployment? Why did you segment the portfolio that way? Why is that the right model for that portfolio?

## Documentation

Lastly, documentation, documentation, documentation... All of this will have to be written up for outside auditors and regulators. Having an objective group to review the documentation supporting this overall process will be key. Many times the working group putting this together will be so close to it that a fresh perspective will add a lot of value.



# Again - What to focus on...

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**Thank you for  
your time and  
participation.**

**Any questions?**



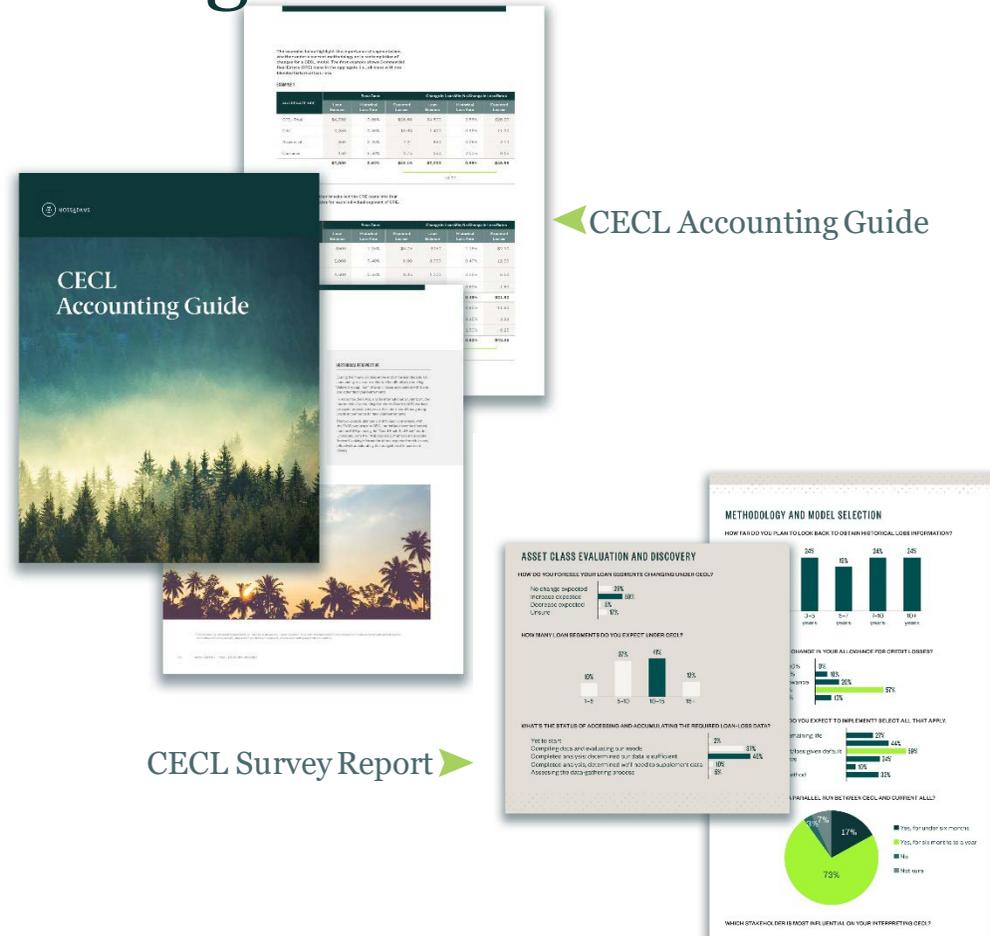
# Moss Adams CECL Accounting Guide

The adoption of the Current Expected Credit Loss standard (ASC 326) will be one of the most significant changes to accounting in the banking industry in the last 30 years.

We have the resources and flexibility needed to define, scope, plan, and deliver a custom solution that fits your organization—whether you need a full CECL implementation project or help crossing the finish line.

We can address your implementation challenges, not only the accounting and regulatory expectations around CECL, but also the more technical aspects of model development, validation and data integration with systems. Here are the steps we take to assist clients through the entire implementation process:

- Asset Class Evaluation and Discovery
- Methodology and Model Selection
- Model Development and Implementation
- Internal Controls, Policies, and Procedures

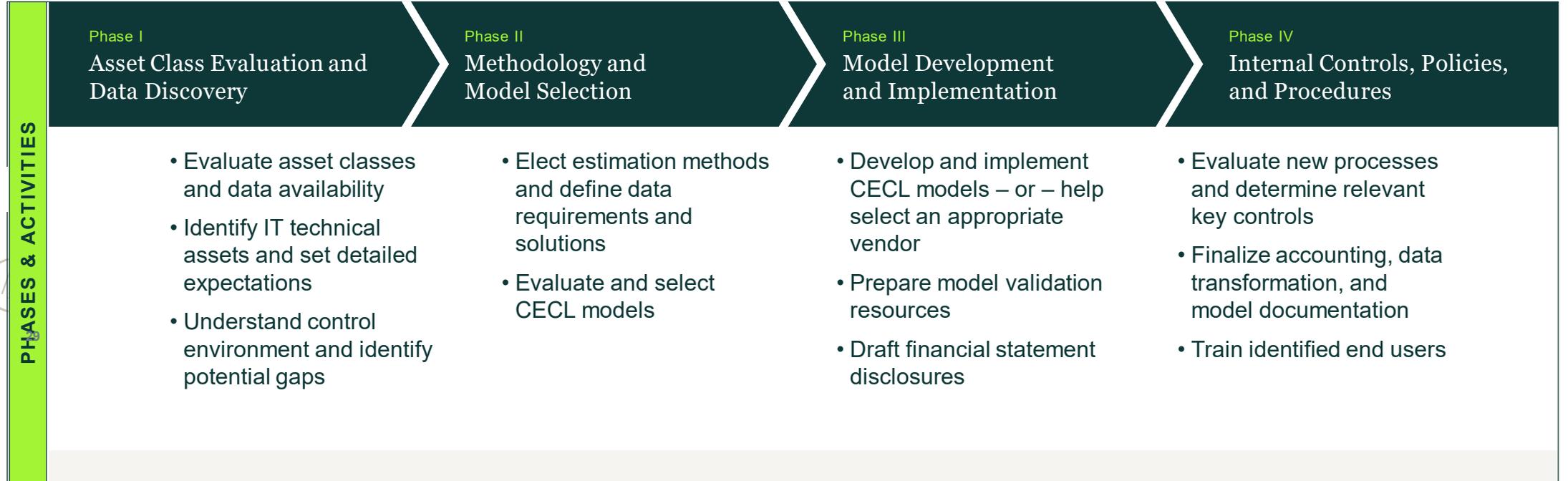


# Appendix A

## **The Moss Adams CECL Solution**



# CECL Implementation Process



# Our Solution

**Financial services and CECL consulting expertise.** We're immersed in the financial services industry, including experts who served on the AICPA's Depository Institutions Experts Panel (DIEP) and serve publicly held companies, giving us deep insight into CECL requirements. We can help you understand how CECL will impact you and create practical approaches you can take to implement CECL.

**Depth of resources.** As the largest accounting firm headquartered in the West and one of the largest accounting and consulting firms in the nation, we have extensive technical resources, including subject matter experts in credit risk modeling, data analytics and information systems, accounting implementations, valuation of financial instruments, and internal control over financial reporting.

**Quick, nimble, and responsive client service.** Given the compressed implementation timeline that many institutions are facing, having an agile team of professionals like ours provides a real, distinct advantage as your business continues to evolve. We'll be ready to start immediately and meet you wherever you are at in the implementation process. By selecting Moss Adams, you'll get the responsive partner attention you deserve.

**Ability to scale projects as needed.** Whether you are looking at a full CECL implementation project or just need some fill in resources the help you get across the finish line, Moss Adams has the resources and flexibility needed to define, scope, plan, and deliver a custom solution that is just right for you.



# Model Risk Management Services Beyond CECL

With advances in technology and the rise of ‘Big Data’, organizations have dramatically increased their reliance on computational models for making business decisions. Whether for CECL or beyond, Moss Adams provides a comprehensive suite of model risk governance and validation services that include:

## **Data Management:**

- Data sourcing, data integration from multiple systems, storage and management
- Full control testing and risk assessment of your data process

## **Model Design and Build:**

- Custom model design, build, and implementation
- Consultation on selecting the appropriate vendor model given your needs both today and into the future

## **Validation and Control Testing:**

- Output analysis, custom reporting, and dashboard creation around your business’s key performance indicators and risk profile
- Independent validation of your models, testing the conceptual soundness, process verification and benchmarking, as well as outcomes analysis to ensure proper implementation and use
- Assurance work around model controls, documentation / support, policies and procedures, as well as reporting and disclosures



# Attuned to Opportunity



32

With an abiding sense of responsibility for our clients, our colleagues, and the future, we're committed to delivering the highest level of professional integrity. Blending pragmatism with optimism, we help middle-market companies and individuals embrace emerging opportunity.

# MAKE A MOVE



◀ 105  
years in  
business



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YOU