



Current Expected Credit Losses (CECL) — Focusing on the journey ahead

Now is the time to sharpen your focus on the CECL journey. With many banks planning to run parallel throughout 2019 in advance of a 1Q 2020 start, 2018 is the “build it time”.¹ While we discuss many specific aspects of the CECL change effort below, we believe there are **three** overarching aspects of any CECL change program that the board and C-Suite should keep top of mind.

First, and perhaps the most important element of CECL, is recognizing that the accounting rule is “principles-based” and not prescriptive. Thus, it is imperative that banks define their targeted operating model (TOM) early and with clarity AND test the TOM periodically throughout the program. Periodic workshops that include C-Suite leaders during the build phase will surface new integration challenges early, thus reducing time and cost of TOM changes.

Second, as with any End-to-End (E2E) process change effort, most of the topics that follow integrate with each other, thus requiring significant planning during the design phase. Performing E2E “table top” reviews with all constituents will help manage the integration risk. Key leaders from across finance, risk, technology, data, operations, model risk review, accounting policy, and internal audit need to participate in the E2E table top reviews to ensure maximum effectiveness.

Remember Basel II ?

Every bank must comply with CECL —
and CECL will be more challenging.

Like Basel II –

- ✓ Data and models are key and CECL requires the precision and controls to support a P/L charge.
- ✓ Investors are anxious given that they must forecast your loss model.
- ✓ Operationalizing is challenging and even more so because CECL must fit in the short quarterly financial close timeframe.
- ✓ CECL requires a significant effort with little guidance.

Third, institute and enforce a “one step behind” review philosophy during the build phase of CECL. Require that your second and third Lines of Defense conduct their respective reviews and sign off one step behind the first line. Equally important, request feedback from your external auditors on control design early in the build phase. While no doubt an investment of time and money, we are confident that adopting such a review philosophy will pay dividends in the end.

¹ For nonpublic banks and public banks that do not file with the SEC, the start date is 1Q2021, so those banks should learn from those going before them.

The following is a working outline of how to think about CECL in four simple buckets, along with specific questions and Deloitte's perspective.

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STRATEGY, GOVERNANCE, AND CONTROLS

Will CECL cause you to rethink any of your business or capital allocation strategies?

- Will CECL change product profitability and pricing or structure?
- What is CECL's impact for long-duration assets such as CRE and mortgage?
- What is CECL's impact on capital and CCAR/ DFAST? What are regulators saying?
- How will investors react to the capital charge, volatility, and earnings guidance?

How should allowance governance and oversight change?

- What are your board committees' independent and collective roles?
- What are the roles of finance, risk, and technology along 1/2/3 Lines of Defense?
- Will your external auditors provide feedback before or after earnings release?

Does your bank have an E2E view of the appropriate CECL controls?

- How will existing allowance "production" controls change?
- What is your ICFR/SOX control readiness today and will it be enough for CECL?
- Are your scenario testing processes adequately controlled?

Perspective

In theory, CECL is only about the timing of estimated lifetime losses, so there should be no reason to rethink product profitability. Practically, accounting for loss recognition sometimes drives decisions more acutely than economics. Focus on economics, not accounting, and educate investors. Right now, regulators are saying little about CECL. Notwithstanding, investors will focus on CECL transition and CCAR impact before regulators provide guidance. Phase-in relief may be a likely response by regulators, as has happened in the past. Formulating an early Investor Relations strategy proved valuable as international banks adopted IFRS 9, their version of CECL, this quarter, and that may begin investor questions in the U.S.

Oversight will change for sure. CECL's increased complexities require corresponding allowance oversight and control changes. Audit and risk committees should raise their level of oversight given CECL's complexity, while your management allowance approval committee should enhance its data, model, and control focus. Additionally, new oversight processes will have to be defined to oversee the "reasonable and supportable" economic forecasts. Role clarity around the 1/2/3 Lines of Defense should be established during the design phase of CECL. Engaging your external auditor around accounting is a must, but be sure to also discuss the timing of their work and the corresponding impact on your quarterly close process.

Banks should be investing in their CECL control environment. We believe one of the most significant CECL risks is the potential for internal control deficiencies. Given that the auditing standard considers whether a control weakness COULD result in a material error, should internal control deficiencies be noted, proving a material error could not have occurred may be difficult. Furthermore, we believe segregation of duties will be a risk point given the integrated nature of data, models, and production processes. Make sure these processes are adequately controlled.

ACCOUNTING POLICY, MODELS, AND DATA

Which accounting policy decisions are most impactful?

- Which accounting decisions impact modeling efforts vs. sideline issues like TDRs?
- Have your accounting decisions been operationalized appropriately?
- Have your auditors provided feedback at all necessary levels within their firm?

What are the tradeoffs between your existing DFAST/CCAR and allowance models?

- Are your DFAST models SOX-controlled and can they exclude new loan volumes?
- Can your allowance model incorporate required economic forecasts?
- How will you validate your models and their output every quarter?
- How will your current quantitative and qualitative components change?

How robust and well-managed is your current credit data? Where are your data gaps?

- Do you have the credit data you need or the time to get it?
- Have you defined your “reasonable and supportable” forecast data and timeframe?
- Are your data controls SOX-compliant?
- Do you need to change loan systems to gather new data going forward?

Perspective

Make accounting policy decisions early, especially those that impact modeling. Additionally, make sure your decisions align with the standard setters' review forums. Operationalizing your accounting decisions will be complicated, so strong, early review processes by your accounting, risk, and technology/operations groups will help avoid costly rework or workarounds. Additionally, real-time, robust documentation will be worth the investment and add needed clarity in communicating with your external auditors. Make sure you get your external auditor's feedback on policy decisions and the implementation of those policies. Given that most auditors use consulting model experts around modeling, make sure their experts provide feedback on model policy decisions as well.

When choosing which model to build upon or whether to build a new model, make sure your analysis considers long-term goals, timeline risk, validation considerations, and ease of production and control. Determine your validation approach early and make sure that your model validation can be completed in a timely manner given your close calendar. Many qualitative components today address future expectations that CECL includes in the model, thus eliminating or significantly reducing current qualitative overlays and components. Combine the assessment of the model's design strengths and weaknesses and qualitative overlays early and be mindful that an existing qualitative reserve may now be covered in your model. Your qualitative reserve assessment will likely decrease the number, size, and percentage coverage of qualitative components.

Strategically, your data requirements should be built off your model decision, not the reverse. Make sure your CECL model decision is based on your long-term data strategy. Grow into a robust data model; don't boil the ocean within your CECL effort and seek alternative data sources until you have enough history. Buy data until you have enough history, it will be worth the investment because your models will perform better. There are many sources for data. All your data needs to be controlled at a SOX level. Updating the data set each quarter as data is dropped and added will be an area ripe for control breakdowns.

TECHNOLOGY AND PRODUCTON

Will your technology platform be able to support CECL, or do you need enhancements?

- Will your platform enable quick fixes and “what ifs” in a timely manner?
- Do you have appropriate technology controls for the required CECL functionality?
- What are the upstream and downstream technology dependencies and changes?
- Is CECL dependent on other projects?

How will your E2E production process be executed and controlled at a SOX level?

- Will there be an impact to your quarter end production processes?
- How are the models SOX-controlled in development and production?
- How is production controlled/assessed by the 1/2/3 Lines of Defense?
- Is there appropriate, documented segregation of duties?

Perspective

A flexible, end-user-driven technology platform will facilitate the necessary production and review processes CECL requires. Further, a technology platform’s flexibility and the ability to do “what if” analysis will be important for disclosures and corporate-wide strategic planning. Ensure controls are built into your technology solution up front. Perform an early, detailed systems processing sequence review to thoroughly understand interdependences with your processing cycles, as late system processing changes will threaten your implementation calendar. If building a new platform for CECL, be sure to have adequate contingencies built into your program calendar as there will undoubtedly be hiccups.

Defining the integrated production cycle for your new CECL process will require the greatest E2E coordination. Monthly closing cadence should be an early area of focus. Functional hand-offs between 1/2/3 Lines of Defense will need to be thoroughly understood and documented. Creating real-time documentation and conducting “dry run” exercises during the build process will highlight weaknesses prior to parallel processing in 2019, enabling more timely and less expensive rework. Engaging your SOX controls group early and incorporating their insights will save time and money. Ensure your control approach addresses segregation-of-duties aspects each quarter.



REVIEW AND REPORTING

Will the approval process change because of CECL?

- Does the CECL modeling approach require a different review process?
- What are your 1/2/3 Lines of Defense accountabilities?
- How will your management allowance committee's focus and composition change?
- Will your external auditor provide feedback before your earnings release or prior to your SEC filing?

Given CECL is a principles-based standard, what is your disclosure philosophy?

- Is a "less is more" or a "more is more" disclosure approach better for CECL? Has your audit committee reviewed the proposed disclosure strategy?
- Do your model analytics clearly support your draft disclosures?
- Will your planned new credit guidance be valuable to your investors?
- Where will the SEC focus its review?

Perspective

Approval and review processes will need to be more robust given a more complex methodology and required forecasts of economic variables. Your management allowance committee likely will need to be more model-focused and have model experts that are voting members. Clearly defining production and control roles will pay dividends in both your build and operate phases of CECL. Define the scope of Internal Audit's review early; clarity around their expected process and model review scope is important. Your external auditor should provide feedback on allowance amount and controls prior to earnings release. Pay to have your external auditors run their own parallel review process in 2019, in the same time cadence. This will be a worthwhile investment.

Disclosure using a "less is more" philosophy, with the actual disclosures having strong predictive value, may provide investors with better insights. Draft your disclosures very early in your project to help define the end game. As part of the project design, ensure you will have the analytics to understand and disclose the changes and components of your allowance. Providing guidance on future provision expense will challenge companies and analysts alike. Analysts may focus on your future economic indicators to draw comparisons period-over-period and across the industry. The SEC's focus may very well be on the forward-looking nature of the disclosures. Remember the SEC's "through the eyes of management" perspective for MD&A disclosures, as well.





CECL will be a challenging, but not insurmountable, change effort. Because you must first define your end-state or model, the CECL change will be more difficult than normal product enhancements where the final product is defined for you by the vendor. Early, granular model and data definition work will pay large dividends.

Models and data will be a challenge, but both areas have defined options in the marketplace. We think the most successful CECL projects will be those that deliver the best E2E processes with strong controls using models and data that enhance and are aligned with your long-term credit risk strategies.

To define a better path forward for your CECL journey, organize your C-Suite leadership team around CECL and set a timeline to keep the organization focused on delivering. Schedule frequent board check-ins to stay abreast of the biggest change in banking in years.

To lay the foundation for your journey, providing the board and management appropriate training regarding CECL and its wide-ranging, E2E impacts will provide the basis for better oversight and decisioning.

Deloitte has significant experience in all of the necessary CECL components. Our approach is focused on providing an E2E perspective, building upon your bank's current capabilities.

Please reach out to **Greg Norwood, Troy Vollertsen, Jonathan Prejean, or Peter Wilm** to further discuss CECL or to schedule a meeting with your board or management team to explore what CECL will look like in your organization.

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