Defining the CECL parallel run

The CECL parallel run is critically important and should be well-defined now

There is universal agreement that implementing the Financial Accounting Standards Board's (FASB) new Current Expected Credit Loss (CECL) standard will be challenging. Therefore, virtually every institution we talk with plans to run a parallel CECL process in 2019. Understanding what is meant by a parallel CECL process is less clear.

The goal of an effective parallel run is simple: ensure your institution is ready to calculate, review and report on your CECL allowance for credit losses for the first quarter of 2020 in a manner that satisfies board, management, external auditor, and regulatory expectations.

Defining the parallel run objectives and, thus, its mechanical and business construct should be a priority early in your project planning and a collaborative effort among the current allowance for credit losses governance and project owners, while incorporating review by the board.

Consider three guiding principles for defining your 2019 parallel run: 1) make sure you thoughtfully plan for the resources to complete the parallel run in tandem with the business as usual (BAU) process, 2) make sure the "plumbing works" before 2019, and 3) make sure you have at least two "full parallel" cycles including governance, financial reporting, investor communications, and external auditor review.

An effective parallel run also has three distinct phases of work that can be thought of as building blocks: 1) testing the functionality of the production process in 2018, 2) running the operational and internal control portion of the end to end (E2E) process for four quarters in 2019, and 3) adding the approval, reporting, and investor communications components for the last two quarters of 2019. This approach will focus your institution on each critical phase and will keep you

Running "parallel" in 2019 is the right goal and detail planning now will provide much needed clarity ensuring an effective parallel run.

from suffering the consequences of "boiling the ocean" in the beginning of 2019. In addition, this cadence should prepare you to use the 2019 fourth quarter run as the basis of the banking regulators' proposed transition calculation with confidence.

While not ideal, running the first two phases by product type can work but adds a degree of complexity and might not identify issues that a parallel run across all product lines might identify.

Lastly, we have said before that using a "one step behind" cadence between the first, second, and third lines of defense pays big dividends during the build phase of CECL and the same holds true for the parallel run phase. Through all three phases of a parallel run, institutions should engage the entire team that will run CECL as BAU and, importantly, refrain from allowing "delegate" substitutions as this weakens the effectiveness of the parallel run.

For planning purposes, institutions should consider the parallel run process assuming five categories of work:

- Resource planning
- Technical functionality
- Operational — start to finish
- Allowance for credit losses approval processes
- Reporting and messaging

Resource planning

Currently, resource planning may be the biggest missing piece of planning a parallel run. Consider four factors in your resource planning:

- During the project build phase, consider reassigning existing BAU resources to work on the project, run parallel and then return to BAU. To address the gap created, borrowing team members from risk or internal audit to back fill current operations can be a rewarding special assignment and temporarily fill the gap during the CECL build phase.
- Prepare a detailed, step-by-step CECL operational cadence now to identify those hard-to-find resource needs. Given that a CECL process is likely more interdependent than the current process, only by doing this type of planning will you identify the new resource needs and avoid surprises later in 2019.
- Designate project resources to fill new and existing BAU roles as the best way to transfer knowledge from the build phase to the operate phase.
- If necessary, plan to use outside resources but do so deliberately with a clear transition plan and transfer of knowledge during the parallel run. Carrying over contract resources from the build phase to parallel run phase will enhance both efforts.

Finally, CECL resources are scarce and currently in demand. Unlike most transformation efforts, CECL is required by every bank, in every market, and everyone must implement on the same day. Your CECL skilled resources are being sought after by your competitors. Accordingly, consider stay bonuses or other retention benefits for specific team members.

Technical functionality

Conducting the system integration testing (SIT) and the user acceptance testing (UAT) in 2018 is critical to an effective parallel run in 2019. It goes without saying that having to fix the "plumbing" in 2019 will challenge the ability to achieve other parallel run goals effectively.

SIT and UAT can be done in pieces throughout 2018 with a final E2E test in late 2018 or early 2019. Additionally, when modeling approaches or "equations" are substantially completed yet still being refined, production platforms can be built and tested using "in sample" models and results. Finally, plan

Resource planning is often the biggest missing link in institutions' parallel run planning.

to run the quality assurance (QA) testing program throughout the parallel run.

In addition to testing the functionality required for processing the allowance for credit losses and related financial disclosures, consider SIT and UAT for all the supporting technology processes, including regulatory reporting, ad hoc reporting, annual planning and forecasting, and scenario testing capabilities.

Operational – start to finish

Once you are confident the plumbing works, focus can turn to the E2E operational processes for all of 2019. The new BAU E2E process owner should run the four-quarter operational parallel run. Ideally, this owner was named at the beginning of the project and has been involved throughout the build phase and is ready to oversee the new operational cadence.

During the operational phase of the parallel run, the goal is to produce the allowance for credit losses amount and required external quantitative reporting disclosures. This phase of the parallel run will follow the target operating model design sequence, including all first and second lines of defense internal control procedures and, importantly, documentation requirements. During this phase of the parallel run, you should consider scheduling real time, cross-functional team debriefs. Also, regularly incorporating feedback from the third line of defense and external auditors will ensure timely consideration of their advice in the next parallel run cycle.

Within the operational parallel run phase, the control environment and processes should be fully tested and documented. Ensuring these efforts are done conscientiously, in a "live" environment for all four quarters will provide assurances that control deficiencies that could be "material weaknesses" are discovered. Considering the role of the external auditor in assessing control deficiencies once an institution goes "live" with CECL, gaining their insights and feedback during this part of the parallel run is important.

Allowance for credit losses approval processes

Consider running the complete E2E allowance for credit losses process, which includes the governance/oversight committee construct, for two quarters. Additionally, some institutions may choose to have the allowance for credit losses approval committee review results for all parallel process testing but not necessarily in the normal cadence nor as completely as the full BAU process.

There are two specific aspects of the allowance for credit losses review scope that should receive extra attention during the parallel run. First is the approval committee's analysis of the drivers of the period over period change in the allowance for credit losses. There are multiple factors at play here, including the impact of the changes in the reasonable and supportable forecast components and time horizon as well as the changes in portfolio vintage composition and risk attributes. Second is the qualitative overlays included in the allowance for credit losses. Given that many qualitative overlays will address portfolio uncertainties, model imprecision, and other hard to predict risk attributes, additional focus will provide useful information regarding the overall allowance for credit losses. Together, these two analyses will provide management important insights regarding allowance for credit losses' volatility and possible future changes in the allowance for credit losses balance that will be valuable when developing external disclosures.

Finally, institutions may not deem the overall conclusion memorandum a high priority during the parallel run. Institutions should consider that, initially, the memorandum might serve as the

In the end, an effective CECL program will drive information that is useful to both management and financial statement users.

best roadmap for executive management, external auditors, and regulators to view your CECL allowance for credit losses. Fully preparing and reviewing this memorandum will lend clarity to all parties in their review of your parallel run results and during the early years of adoption.

Reporting and Messaging

This is where the rubber meets the road. Thus far, the parallel run design categories have been internally focused. The clarity and effectiveness of an institution's external reporting and messaging and the comparability to its peers' disclosures will set the stage for investor evaluation.

Like the allowance for credit losses approval process, consider running the complete financial reporting and messaging process for two quarters. Complete production, drafting, and review of the quantitative and narrative disclosures, including earnings release call script, is the best way to drive the entire team to a level of execution and understanding that will prepare you to go live with confidence in 2020. Audit committee review also will add valuable oversight and insights.

Key players in this process are your SEC reporting and investor relations (IR) teams. Getting these groups involved in the CECL program early, especially IR, will ensure their insights are incorporated in key elements of the reporting philosophy. Additionally, IR's early involvement will allow them to start compiling their investor "tough questions list" and possible answers.

To gain useful insight, you may consider bringing a sell-side analyst that does not personally cover your institution "over the wall" to provide feedback on your disclosures, earnings release information, and earnings release script.

Finally, including the entire cross-functional CECL team, along with executive management, in the design and sign off of your parallel plan will bring all the right players together as the team builds its new CECL process. Given the visibility and lack of comparability of expected CECL results, being over prepared by executing a robust parallel run process in 2019 will be well worth it.

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