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Focus on the destination: Current Expected Credit Losses (CECL) implementation insights

Applying IFRS 9 lessons learned to a CECL implementation plan

The new CECL accounting standard, issued by the Financial Accounting Standards Board (FASB) under Accounting Standard Update (ASU) 2016-13 and codified within ASC 326,[1] is one of the most significant accounting projects for the next five years. Banks and other nondepository lending institutions need to think strategically about CECL's far-reaching implications and prepare for implementation as soon as possible, lest they fall behind on critical deadlines.

To help our clients get started, Deloitte[2] is sharing its CECL knowledge and insights through a series of topical perspectives and webcasts. The series will explore the many areas of your business that CECL is likely to impact and what you can do to ready your organization for complying on time and with efficiency and effectiveness. This first perspective covers lessons learned from International Financial Reporting Standards 9 (IFRS 9) implementations and how they can be applied to your CECL compliance planning. Future installments will discuss other CECL-related issues, from business implications, data management, and credit modeling to risk, governance, and technology. Each of our written insights is paired with a webcast to provide a deeper exploration of the issue with our subject matter specialists. The combined offerings are designed to help you form a strategic and comprehensive view of your CECL challenges and pave the way for an efficient and effective implementation.

Having an end-to-end perspective and a comprehensive approach to IFRS 9 and CECL can identify capabilities that institutions may leverage to create a more efficient program—and one that is more likely to be accepted by auditors and regulators.

[1] For titles of FASB Accounting Standards Codification (ASC) references, see Deloitte's "Titles of Topics and Subtopics in the FASB Accounting Standards Codification," https://www.iasplus.com/en-us/publications/us/other/codtopics/file.

[2] As used in this document, "Deloitte" means Deloitte & Touche LLP, a subsidiary of Deloitte LLP. Please see www.deloitte.com/us/about for a detailed description of our legal structure. Certain services may not be available to attest clients under the rules and regulations of public accounting.

IFRS 9 and CECL: Shared objectives, different approaches

Although both the IFRS 9 and CECL impairment models are based on expected credit losses, they take different approaches to measuring and recognizing those losses:

- IFRS 9 uses a three-stage model that classifies debt instruments as either performing assets, underperforming assets, or nonperforming assets with varying degrees of credit losses recognized for each category. This model requires institutions to recognize 12 months of expected losses for performing assets and lifetime expected losses for assets with increased credit risk.
- The CECL standard uses a life-of-loan methodology to determine expected credit losses. In addition, banks will be required to incorporate "reasonable and supportable forecasts" in their methodology, which will impact their reserve estimate and corresponding Allowance for Loan and Lease Losses (ALLL) processes. The life-of-loan approach is widely viewed as replacing the loss emergence period, creating the potential for estimates to cover a longer loss horizon. CECL also will have important effects on established reserves, recognized credit losses, and regulatory capital ratios.

Implementing IFRS 9 and CECL will be a major undertaking for banks and other nondepository lending institutions, with widespread impacts across operations, credit models, and IT systems. Institutions affected by IFRS 9 have been preparing for the new standard's adoption since it was finalized in July 2014. Through that long road of implementation, these institutions have gained experience and insights that can be helpful to US-based organizations that are now required to develop a credit loss model under CECL.

IFRS 9 experience can guide CECL modeling, governance, and more

Most of the largest players in the banking industry—including US banks with an international presence and international banks with US subsidiaries—will have to comply with both the IFRS 9 and CECL standards. Consequently, determining what IFRS 9 processes, if any, can be leveraged to meet CECL disclosure requirements is an important step in CECL planning. The following areas provide significant opportunities to apply IFRS 9 lessons learned to CECL.

Modeling decisions

Both the IFRS 9 and CECL impairment standards are based on an expected loss estimate. A key driver of this estimate is to include forward-looking indicators (FLI) for a reasonable and supportable period. The concept is similar for financial institutions applying both IFRS 9 and CECL standards, so learnings from organizations planning for and implementing IFRS 9 can aid those engaged in CECL compliance planning.

When financial institutions determine whether to select a simple (e.g., spreadsheet-based) or sophisticated (e.g., automated) estimation model, it is important to understand that there are clear trade-offs with either approach. A simple model may be easier to build, but is likely to require more management time and robust, continuous documentation to convince regulators of its accuracy. In contrast, a complex model may be more accurate, but it carries more knowledge transfer risk and processing changes (feeder models, inputs, etc.) as well. It is also more difficult for management to explain to company stakeholders and regulators.

Navigating a sea change: Results from Deloitte's US CECL survey

Deloitte's 2017 US CECL survey[3] polled senior executives at 31 US banks (covering a diverse range of institutions, different total asset volumes, loan book sizes, business types, and primary regulators) to identify how they are planning to implement CECL and the operational and financial impacts they expect. The survey also explored how banks are planning to execute CECL in conjunction with the IFRS 9 impairment model. Among the related findings:

- Forty-seven percent of the banks surveyed are required to adopt IFRS 9, and 86 percent of these banks say they will apply consistent methodologies when implementing CECL and IFRS 9 across portfolios, legal entities, and geographies.
- Reflecting IFRS 9's earlier implementation date (2018, compared with 2020 or 2021 for CECL, depending on institution type), 86 percent of the banks subject to IFRS 9 say this standard will be implemented before CECL in some or all of the geographies where they conduct business.[4]

[3] Navigating a sea change: US Current Expected Credit Losses (CECL) survey: https://www2.deloitte.com/us/en/pages/financial-services/articles/us-current-expected-credit-losses-cecl-survey.html Deloitte Development LLC, 2017.

[4] Ibid.

Institutions should link their choice of estimation model to design principles. We have found in our IFRS 9 work that some banks did not spend enough time communicating with their teams (e.g., modeling, operating model, financial accounting) about the various options. For example, prototyping models early in the design stage can be beneficial in the long run, as banks are already moving or planning to move to second-generation models and may be duplicating costs.

Program governance

One important learning that financial institutions have gleaned from IFRS 9 implementations is that an expected loss estimate impacts the entire organization—accounting, finance, risk, compliance, legal, and other functions. Unfortunately, as some institutions began encountering issues during their IFRS 9 rollout, program managers realized that they had failed to invite all relevant parties to the planning table or keep them effectively engaged.

Similar to preparing for IFRS 9 implementations, financial institutions planning their CECL strategy will need to identify and understand the secondary impacts of changes to credit loss estimates on capital, revenue, pricing, and other financial metrics. Doing so can help the project team identify which business functions should be asked to contribute to the work plan, timeline, and employee education process. This transfer of knowledge from CECL project team to Business as Usual (BaU) teams is a critical part of an effective implementation program.

Resources

Part of the argument for increased use of technology and automation in both IFRS 9 and CECL modeling is that numerous financial institutions which have undergone IFRS 9 implementation discovered that they lacked the necessary staff or technology capabilities to build and execute their chosen approach (e.g., model type). In response, increasing numbers of institutions have been turning to third-party resources to help design, build, and implement their IFRS and/or CECL programs. External advisors can use their market and regulatory compliance knowledge to evaluate model options, help choose a technology vendor, manage technical risks, and guide implementation. They can provide end-to-end or ad hoc support, which allows bank personnel to focus on other responsibilities.

Technology

One of our learnings from IFRS 9 is that some banks took a tactical, rather than a strategic, technology approach to compliance. They tried to layer a new estimating model on top of existing systems, which resulted in unintended data delivery and security risks. Many banks are now spending additional budget on system enhancements to more effectively satisfy the requirements and address the unintended risks created by the layering approach.

Operations

We have found that to build and execute IFRS 9 and CECL loss estimation models, and to fully understand how they are evaluating the lifetime of a loan, financial institutions need to go back as far as possible in their data history to know its base limitations. Data should be structured for flexible applications (e.g., to enable multiple model types) while championing improved quality and accuracy.

How can banks get started?

The IFRS 9 and CECL standards mark a fundamental shift in the accounting for credit impairment and require the expected loss modeling process to be grounded by the accounting standards. From a prudent regulator's perspective, determining if a bank or other lending institution is solvent begins with examining its balance sheet reserves. Therefore, accountants will be evaluating the expected loss modeling process to the appropriateness of the IFRS 9 and CECL accounting standards.

Deloitte is assisting a wide range of clients with their IFRS 9 transition. Based on our experience, financial institutions can consider applying the following IFRS 9 learnings to support their CECL planning and implementation:

1. Face the challenge as a team. IFRS 9 and CECL represent the biggest change in accounting standards since standards were established. An organization's finance and risk functions should work collaboratively to develop and implement new loss estimation models. In addition, they should ensure that other parts of the organization (information technology, lines of business, etc.) are involved as appropriate.

2. Ring-fence resources. Project leaders should engage early and frequently with business and function heads during the planning, development, and implementation process. And be sure to set specific, clear objectives: Selecting a "simple" estimation model likely means different things to different people.

3. Learn early, fail fast, and do both transparently. The modeling team should test multiple models and validation techniques and run them through the organization's existing technology to understand its potential limitations.

Learn early, fail fast, and do both transparently

Contact us

Tom Clifford
Director | Risk Advisory
Deloitte UK
+44 20 7303 6378
tclifford@deloitte.co.uk

Jonathan Prejean
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 703 885 6266
jprejean@deloitte.com

Troy Vollertsen
Partner | Deloitte Audit & Assurance
Deloitte & Touche LLP
+1 703 885 6356
tvollertsen@deloitte.com

Peter Wilm
Managing Director | Deloitte Risk and Financial Advisory
Deloitte & Touche LLP
+1 215 246 2446
pwilm@deloitte.com

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