



Managing interdependencies in Current Expected Credit Loss (CECL) implementations

Managing CECL interdependencies will be crucial to a successful implementation

Implementing most accounting standards is a finance-only effort. However, the Financial Accounting Standards Board's (FASB) new Current Expected Credit Loss (CECL) standard will be quite the opposite. CECL has many interdependencies across governance, modeling, credit analysis, production, and financial reporting. These interdependencies, combined with CECL being a principles-based standard, sets the stage for one of the most challenging accounting changes institutions have faced in decades. Institutions that prepare for and manage these interdependencies well will have more effective and cost-efficient CECL implementation programs.

Managing the interdependencies starts with defining the target operating model, or TOM. Defining the TOM early, and with specificity, provides the necessary framework for institutions to successfully implement CECL. Throughout the CECL

program, institutions should routinely review/challenge the TOM, which will identify issues early in the process and reduce the time and cost of TOM changes. This review/challenge effort can be effectively done in senior leadership workshops where the TOM is reviewed in detail from data management through disclosure.

Once you have the TOM in place—and have established the process by which you will review/challenge the TOM—you'll be prepared to tackle the four major implementation areas and the interdependencies associated with each:

- Governance and oversight
- Models and data
- Technology and production
- Controls, accounting, and reporting

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Managing interdependencies in CECL implementations

Governance and oversight

Governance and the role of the board

Audit and risk committee governance efforts over the new CECL allowance process will increase for most institutions. First, audit committee focus on financial statement internal controls will increase due to a more complicated operating environment of complex models, data, operations, and disclosures. Second, given that CECL estimates will now involve “reasonable and supportable” forecasts, significant coordination between the risk and audit committees will be necessary to review the analysis supporting the forecast selection and its financial statement impact. Third, with more robust models that include forecasts, the relationship between quantitative and qualitative reserves will need to be carefully reviewed by both committees to avoid including the same risk in both components and thus overstating the allowance. Finally, clearly and simply “telling the story” regarding the current allowance will be challenging. In the end, early board involvement will prove valuable.

Oversight: Management allowance committee

Often institutions review and approve the allowance amount and disclosures for financial reporting purposes through a management allowance committee (MAC). For many years, institutions have enhanced the MAC’s oversight of the allowance assumptions, measurement, and disclosure processes through more robust model analytics and validation, end-to-end (E2E) control effectiveness evaluations, more thorough disclosure reviews, and increased documentation. CECL will only increase the need for more critical challenge. Given that the MAC will sign off on the new CECL process and allowance each quarter, the MAC should be an integral part of the CECL program governance and should formally sign off on all crucial assumptions and decisions.

Oversight: The second line of defense

The adoption of CECL will require more extensive and frequent second line-of-defense reviews. However your institution performs and tests its internal control over financial reporting (ICFR) across the first and second lines of defense, ensuring effective coordination between the groups will be key. For this reason, institutions that adopt a “one-step-behind” review philosophy during the CECL design, build, and implement phases—and carry that cadence forward to the operating phase—will benefit from early detection of internal control gaps and deficiencies.

Using the one-step-behind approach, the second line of defense would review the initial internal control design in detail because the operating model will be more complicated under CECL. Furthermore, given that many legacy processes may not have been previously designed or tested at an ICFR level, these processes should receive additional attention during control design. Model validation should be completed with a one-step-behind approach as well to help avoid late-stage rework of model deficiencies.

Joint audit and risk committee meetings to review the CECL allowance will be the norm.

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Models and data

Developing expected credit loss models in an iterative manner will enable optimization of model-centric decisions regarding governance, technology, production, accounting, and disclosure requirements.

Rationalize CECL model “fit-for-use” analysis

CECL modeling decisions should align with model decisions used for other business purposes, and, importantly, institutions should expect questions from auditors and regulators about the consistency with other models used for stress testing, pricing, and forecasting. Making sure there is a formal, ongoing process to determine that initial model alignment remains intact will be a necessary element of the quarterly validation process.

Reasonable and supportable forecasts

For the first time, institutions are required to incorporate reasonable and supportable economic forecasts into the allowance models that estimate credit losses. This addition, coupled with the already complex credit quality indicators currently in today's models, results in multiple new modeling dimensions for many portfolios. Additionally, the required reversion period presents another layer of modeling complexity. For example, the model platform should be flexible enough to allow management to respond to economic changes or model ineffectiveness by adding new forecast elements or changing both the reversion period and quantitative method.

Understandability

To satisfy the required period-over-period and vintage disclosures, institutions need to understand model output and changes in the resultant allowance for credit losses at a more granular level than today. The impacts of changes to the various inputs need to be comprehensible and transparent to all users, not just those with knowledge of quantitative methods.

Understandability of model results will be of the utmost importance to the board, senior management, and analysts alike.

Efficient model production cycle

The timely production of expected credit loss estimates and the related disclosures could place a significant burden on an institution's computational infrastructure and staff. Institutions may be challenged to meet the timelines to comply with the requirements of CECL, as the demands of CECL compliance on resources will be more intensive relative to those of legacy requirements.

Grow into a robust data set

To help ensure timely CECL implementation, don't boil the ocean to obtain the best data. Use the data available and buy additional data until there is enough history you can leverage. Using external data to ensure a more robust data set will help model performance, but be sure to consider qualitative overlays for the model risks of using third-party data.

Models and data are at the core of CECL; connecting them in the right way with the E2E process will help minimize potential surprises.

Managing interdependencies in CECL implementations

Technology and production

Few institutions have sophisticated E2E technology platforms to process the current allowance methodology; rather, most have platforms built over decades, evolving in a piecemeal fashion to meet changing demands. Beyond improving the allowance technology platform itself, developing a new CECL production process will challenge all institutions. Defining the technology business requirements early, including the interdependency driven by modeling performance decisions and accounting and disclosure demands, will help minimize project rework.

Flexibility is the key business requirement

CECL requires a flexible, sustainable, and scalable technology and production platform to support the robust and complex requirements of CECL's lifetime loss estimates and be responsive to internal modifications, changes in the external economic environment, and the inevitable evolving accounting interpretations. Interrelated with the model build effort, the technology platform needs to support calculating period-over-period change attribution for the factors that drive allowance results.

Beyond the quarterly close process, risk and finance functions need the ability to perform periodic, real-time scenario analysis to support business demands. Specifically, the platform must support strategic and annual planning processes, as well as product pricing, stress testing, and other corporate requirements. The use of CECL credit metrics and loss estimates in other internal processes—for example, management accounting and compensation—will only increase over time.

Speed is the key production requirement

Consider the volume of information needed for CECL vs. what is used today. More complex models require more data and greater processing time for model execution. Additionally, adding CECL's reasonable and supportable forecast requires more data to be run faster. Faster model and production platforms also help minimize the need for costly and difficult upstream system process changes. Further, processing time likely should be shorter than it is today given that the allowance output will require more in-depth review by multiple functions before final approval by the MAC and the board.

Control is the key financial reporting requirement

Because the technology platform serves as part of the system of record for accounting recognition, controls must function and be tested at an appropriate ICFR level. Also, today many allowance processes have manual controls; but given the nature of CECL, technology controls or controls performed with artificial intelligence or robotics process automation, would be more efficient and effective. Extensive end-user computing controls and process logs to capture and document changes in model configuration settings, inputs, assumptions, and loan data must be in place and available for first-line assertion, second-line validation, and third-line review.

CECL technology and production business requirements demand flexibility, speed, and control.

Managing interdependencies in CECL implementations

Controls, accounting, and reporting

E2E controls: The CECL backbone

Internal controls are the backbone of CECL and should not be thought of as an after-the-fact compliance exercise. A solid ICFR environment will not only facilitate appropriate governance and oversight, but also will assist in achieving a more efficient closing and reporting process. During the build phase of CECL, the first line of defense should coordinate closely with risk, finance, technology, and other areas to build, document, and assess the effectiveness of internal controls. Given the complex nature of CECL model execution and the multiple hand-offs within and between functional groups during the production cycle, ensuring adequate segregation of duties is paramount.

The Securities and Exchange Commission's (SEC) quarterly certification regarding ICFR effectiveness is the ultimate score card for internal controls over the allowance for credit losses. The SEC's internal control evaluation model requires that institutions assess whether an identified control weakness *could* result in a material error, not whether it *did* result in a material error. Thus, if internal control deficiencies are identified in the allowance process, proving a material error could not have occurred is difficult given the magnitude of the allowance estimate and its importance to financial statement users. This risk may be CECL's biggest risk, and, in the end, adequately investing in the CECL control environment will pay dividends.

Controls: Model validation

The increased complexity associated with the implementation of the life-of-loan loss models will place increased stress on model

governance controls at many institutions. First, the adoption of the standard will typically increase the total number of models subject to model validation. Second, for existing models that may have previously been used only for stress testing or risk analytics, the decision to use those models for financial statement measurement could require more frequent and/or extensive validation. Additionally, back testing the life-of-loan models will be more complex and time consuming than the back testing of existing allowance models with set loss emergence periods. To address these increased model validation demands, institutions should ensure that adequate resources are available for validation.

Controls: Data management

For most institutions, the adoption of CECL will require data that have not been utilized for financial reporting purposes—including historical, forward-looking, and third-party data. While portions of the data already may be subject to some validation, all data now used in the allowance process will need to be controlled and tested at a more rigorous ICFR level. The use of additional data elements also is likely to result in the utilization of data from applications and data warehouses that are not currently subject to the level of IT controls expected of financial reporting systems. As institutions identify these data elements, they should consider whether the same data are also available in systems that are already subject to ICFR IT controls, and leverage the data from those sources where practicable. Where new data sources are required, the first-line technology organization should proactively identify and document the additional ICFR IT controls.

Accounting: The policy starting point

Given that CECL is principles-based and not prescriptive, it is imperative that institutions establish their accounting policy decisions early, which may be the easy part. Operationalizing the accounting decisions will be complicated, so thorough and timely review processes by accounting, risk, technology, operations, and internal audit will help avoid costly rework or workarounds. Early external auditor feedback on accounting policy decisions, and operationalizing those policies, will avoid costly rework. Additionally, real-time, robust accounting policy documentation will be worth the investment and add clarity in communications internally and with external auditors and regulators.

Establishing a one-step-behind control review philosophy between the first/second/third lines of defense will prove a worthwhile investment.

Reporting: A lens into the allowance estimation process

Establishing an external disclosure philosophy and approach early will provide institutions a framework to evaluate project decisions such as model design and processing capabilities, data quality levels, production cycle time, scope of data analytics, and reporting. In addition, early external disclosure decisions will enable more frequent and in-depth dialogue among executive management and with the board that will help improve disclosure quality. Further, institutions also should design internal information requirements that will ensure management, including the MAC, is provided sufficient, accurate information appropriate for effective oversight of the allowance amount and process.

CECL requires quantitative and narrative disclosures designed to enable a user of the financial statements to understand: 1) inherent credit risk, 2) management's estimate of expected credit losses, and 3) changes in such estimates that have taken place within the financial reporting period. Within this context, institutions' disclosures are likely to vary widely, minimizing comparability and, in turn, increasing the focus on each institution's disclosure quality.

External disclosures using a less-is-more philosophy, with the disclosures having strong predictive value, may provide investors with the best insights. The nature of disclosures regarding the reasonable and supportable forecasts about the future will likely be a focus of financial statement users. Lacking other options, analysts may focus on institutions' reasonable and supportable forecast disclosures to draw period-over-period comparisons for the institution and all institutions across the industry.

Developing disclosures that help investors predict future credit losses under CECL will be a daunting challenge for institutions.

CECL is sure to be a challenging—though not insurmountable—change effort. Because institutions will need to first define the target operating model and then manage multiple and complex interdependencies, implementing CECL will be more difficult than normal product enhancements change efforts. Further, the importance of measuring the adequacy of the allowance for credit losses to financial statements users suggests there will be a high degree of scrutiny on the CECL change effort and its ongoing measurement under the new lifetime loss paradigm. Institutions that invest time and resources early and adequately across the organization will reap the rewards in the end.

Developing and implementing CECL estimation models

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