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Client Alert: Getting Ready for CECL

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Financial Institutions

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On June 17, 2016, the four federal financial institution regulatory agencies issued a joint statement on the long-awaited and controversial new accounting standards issued by FASB implementing the "current expected credit loss" model for financial reporting, commonly referred to as "CECL." The agency issuance applies CECL to all banks, thrifts and their holding companies, regardless of size, and involves a sea change in the method of establishing reserves that will be reflected in new disclosure, accounting and examination requirements. Importantly, CECL will have a major impact on establishing an appropriate allowance for loan and lease losses (ALLL) for all financial institutions. CECL takes the estimated credit loss analysis used for establishing the ALLL from that of an "incurred" or **current loss** model, to one that requires predictions as to "**expected" losses** over the life of the credit, instituting a major change in approach to the reserving mechanism and a potential source of significant liability for institutions and their boards.

In 2020, CECL will apply to SEC filers (as well as banks and thrifts that file with their own regulators under applicable federal securities laws), and will apply to all others in 2021. The precise effective date varies depending on a number of factors, and institutions should determine the effective date that applies to their particular type of financial statement reporting.

The Board and Establishing the ALLL

One of the most important roles of management and the board is to ascertain that appropriate systems are in place to adequately identify and reserve for potential losses in the credit portfolios of their institution. Ascertaining that the underlying system and controls are appropriate to cause the institution to identify potential losses and establish and maintain an adequate ALLL is a key obligation and part of the risk management function. As a result, ALLL establishment and disclosure issues are two of the most common bases for financial institution exposure and liability. While the board can and should rely on management to recommend an appropriate CECL process and ALLL for the institution, the board should, in fact, also be taking time right now to understand CECL. Boards should also work with management, accountants, legal counsel, auditors and regulators to ascertain that the controls, systems, programs and disclosures utilized by their institutions are being readied for CECL. In addition, boards should ensure that the other aspects of the institution's financial strategies are also being developed and readied. The delayed implementation dates recognize the importance and complexity of this new reporting structure and the need to enable institutions to transition. However, delaying demonstrable efforts to understand CECL and the impact of the transition will be risky at best, and agencies will likely be watching transition efforts closely as part of the examination process.

The CECL process is complicated and fraught with potential for issues arising from the subjective analysis utilized in measuring impairment and establishing the ALLL that, with 20-20 hindsight, may be subject to second-guessing by third parties. CECL does not specify appropriate estimation methods or formulas or provide any "safe harbor" in that respect. Recognition of judgment and scalability in CECL programs should be helpful, but provides further potential for second-guessing and potential issues with what may be established as "best practices." The industry has seen a number of programs in the recent past that, while intended for large complex organizations, in the end wind up being unofficially subject to "trickle-down" regulation or "regulatory creep" through "best practices" and the nature of the regulatory process. While different assets are treated differently by CECL, the entire concept of estimating potential "expected" losses in advance, and based at least partially on subjective criteria, calls into question the basics of credit analysis. The potential for second-guessing on credit decisions is exacerbated by the notion of "expected" losses to a point where the historic protections for director liability under the "business judgment rule" may be subject to additional attack from the inception of the credit. CECL requires a crystal ball with objective and subjective analysis that management and boards of institutions do not currently utilize on a regular basis, and will impose significant new staff and IT requirements (and expense) on an already-stretched industry.

It will be critical for management and boards of financial institutions to begin immediately to position themselves for the accounting, compliance, disclosure and potential capital issues that CECL will entail, and to document their efforts in that regard. Regulators will be watching, starting now, to make sure that steps are being taken by institutions to:

- familiarize management and the board with the requirements and impact of CECL
- prepare for transition to, and implementation of, CECL as appropriate including preparation to collect and analyze appropriate data to support the subjective loss analysis and projections required by CECL
- ascertain that appropriate methodology and controls are being established to undertake and report the loss "predictions" required by CECL
- ascertain that appropriate disclosures are being provided to investors and agencies as to the potential impact of CECL on the institution
- adopt strategies for implementing and addressing the requirements of CECL including the impact of CECL on capital
- ascertain that vendors are making appropriate changes for CECL and to coordinate with vendors in transitioning to the CECL model
- prepare and provide progress updates on implementation of CECL and transitional activities

- generally be in a position to adopt the important changes required by CECL before the actual trigger dates

Plaintiff’s lawyers and securities regulators may well see CECL as an important new tool to question the adequacy and accuracy of securities disclosures in light of the predictive requirements of CECL and the ability of the board to subjectively predict losses and make appropriate changes throughout the life of the credit. Hence, documenting the steps taken to implement controls and systems to establish appropriate ALLL reserves as a result of CECL will be critical in defending the actions taken.

Conclusions

Management and boards need to take appropriate steps now to become familiar with the impact of CECL on their particular institution, and to discuss the impact internally as well as with their auditors, accountants, legal counsel and regulators. CECL is likely the most complex and most significant financial reporting change for financial institutions in decades, and will have a major impact on institution credit and accounting controls, establishment of ALLL, credit reporting and capital adequacy. Bank and securities regulatory authorities will be watching, as will plaintiff’s lawyers – who will see this as another opportunity for second-guessing good faith decisions by management and boards. Preparing for CECL should be a major focus for institutions right now. The impact of CECL on institutions and their accounting, credit, lending, reporting requirements, as well as potentially capital, will be significant.