# CECL for Credit Unions: Ready or Not

We have been talking about the Current Expected Credit Loss (CECL) accounting standard for almost 10 years, and the adoption date is fast approaching. On January 1, 2023, many financial institutions will adopt this standard. As your institution fine tunes its model, we invite you to watch this complimentary webinar. We cover last-minute considerations and answer your questions regarding adoption.

**Find additional resources on our event page:** https://www.claconnect.com/en/events/2022/cecl-for-credit-unions-ready-or-not.com

**Here is a transcription of this session:**

Harrison Powers:

Good morning, or depending on which time zone you're in, good afternoon. My name is Harrison Powers. I'm one of today's presenters. And we want to welcome you to our webinar, CECL for Credit Unions, Ready or Not. We have a really exciting, informative presentation today. I'm excited for y'all to join us. We have three fantastic presenters. I'm going to go ahead and introduce them once we get through our disclaimers here.

Harrison Powers:

Y name's Harrison. I'm a principal base here in Dallas, Texas. I serve financial institutions here in the state and adjacent states. Steve, do you want to go ahead and introduce yourself? I'm sure a lot of our attendees have met you already.

Steve Schiltz:

Don't know about that. Yeah. I'm Steve Schiltz. I'm a principal based in Tucson, Arizona. So I got the Pacific time zone covered this time of year. I've been with the firm for 20 years, focusing on audit and consulting services to credit unions. Michele?

Michele Cinciripino:

Hey guys, I'm Michele Cinciripino. I'm a director. I live in the Philadelphia area, so I have the Eastern time zone covered. And I've been with the firm about six years. I serve banks and credit unions in the financial institution's industry.

Harrison Powers:

Thanks, guys. I want to start off today's presentation with some good news and some bad news. The bad news, I'm sure many of the attendees are aware of this, is that CECL is happening, whether we want it to or not. I know we hoped it would be delayed again, it would be canceled. I know a lot of the attendees hope they would retire. Had a lot of clients tell me that they hope they wouldn't be in the credit union space anymore. But unfortunately, we are at a spot where we are in the final stretches of getting ready for this. Probably the most important accounting standard in the last two decades.

Harrison Powers:

So we have some important learning objectives and a crack team to go through them. We're going to go over why we're doing CECL, why it's important for your institution, importantly, how to adopt the new standard, and the expectations from your regulators and auditors, what you need to have ready depending on when your adoption date is.

Harrison Powers:

And one of the more exciting things we're going to go through as we talk about adoption, we do have a client that has early adopted. And so we have some firsthand experience on what that's like in our experience as walking through that in the credit union space.

Harrison Powers:

Starting off, what is CECL? Most of you remember the initial information that came out. You may have been keeping up with all the changes and updates. You may have forgotten a little bit since the initial announcement. So I thought it'd be helpful to walk through what we're trying to accomplish and the history behind CECL. Thinking back, CECL came about, really, as a project from the 2008 financial crisis. That seems like a long time ago. I guess it is getting to be a while ago, but the regulators from that period felt that the banking system really hadn't adequately estimated the losses that they sustained as a result of the mortgage crisis.

Harrison Powers:

So the regulators came together and thought, "Well, what can we do to have our reporting agencies more accurately reflect the credit loss that they had." And they did sustain. And the result of that is CECL. Instead of looking at things in the past, as they had for many years, CECL introduced this idea of future risk and forecasting. So instead of forecasting or estimating what we're going to lose today based on what we've lost in the past, we use what we've lost in the past, along with other factors to estimate what we anticipate losing in the future. And that forward-thinking attribute is really what makes CECL special and a challenge.

Harrison Powers:

We have a chart here that lays out the big difference between what we do today and what we're going to be doing at adoption. We're still considering an average annual loss rate. We still consider what we have lost in the past, but we're converting that into a lifetime loss rate. We're factoring our losses over the entire portfolio. We've also retained the concept of qualitative factors, but we also have to consider what we're forecasting into the future.

Harrison Powers:

The way I try to explain CECL to our clients is it's a lot of the things that you're doing today with the added twist of adding future considerations, whether it's to the loss rate, the qualitative factors, or the overall calculation.

Harrison Powers:

There are also some small differences that are important to be aware of that may not necessarily impact your institution directly. One of them is impaired loans in TDRs. There are still loans considered to be non-performing under CECL, but the standard way of accounting for impairment has been eliminated with the exception of one small change. You can still use fair value of collateral, but the other methods that we used to estimate losses for impaired loans have disappeared and been replaced with the CECL methodology. We've also removed the accounting for purchase credit and paired loans. These are now included in normal reserves. Not every institution may have these, but it's important to be aware there is an accounting change should you find your institution in a position to have these in the future.

Harrison Powers:

That's where we are today. We're trying to get from where we are, an incurred loss model, working forward to a CECL estimate. We're moving from an incurred lifetime loss rate to a historical lifetime loss rate, or moving from qualitative factors that may consider the condition of the institution today to qualitative factors that consider what's going to impact the institution in the future. We also have considerations for forecast adjustments. How do we think things are going to change over the next period these loans that we have today are going to be on the books?

Harrison Powers:

All of these things sound really, really technical and complicated. I think what you'll find, especially as we work through adoption and what we see in the marketplace and with our clients, it doesn't need to be a big lift to get ready for CECL as long as we understand the fundamental changes that we need to see with the new calculation. But before we get to that, let's talk about when this becomes effective.

Harrison Powers:

Oops, sorry. Extra click there.

Harrison Powers:

The main adoption date for most institutions is going to be January 1st, 2023. And this is if you're on a calendar year. Steve and I were joking before the presentation that there's been official, well, unofficial official guidance if you follow a fiscal year from the NCUA, and that's you could follow your fiscal year. I don't know, Steve, if you have any other guidance on that one, or if we expect to see a change there, but I think our clients could probably work for the expectation they can follow their fiscal year.

Steve Schiltz:

Yeah. I think that's what's going to come out from all this. But right now, based on NCUA guidance that's in place, the standard has to be adopted for pretty much everyone in the first quarter of 2023. So the first quarter 2023 call report, they expect everyone to post their CECL adoption adjustment. The issue is the gap is different than that. It's for fiscal years beginning after December 15th of this year. So the first fiscal year for 1231 year ends is going to start January 1st, which most credit unions fall into that category. But then we have some audits, some fiscal years that start on April 1st for March 31st audit. We have some fiscal years that start on July 1st for a June 30 year-end audit. And then some that start on October 1st for September 30th year-end audit.

Steve Schiltz:

And the challenge there is what, what do we do in that case? If gap is requiring those credit unions to adopt at the beginning of the fiscal year, but the regulators have indicated that you need to adopt in the first quarter call report, that's going to create a challenge, come time for the audit.

Steve Schiltz:

Now, we've heard unofficially that NCUA is evaluating that, and should have some updated guidance about changing that guidance to basically coincide with gap so that all credit unions will adopt in accordance with gap at the beginning of their fiscal year. And the call report will be updated accordingly. So I'm hoping that we get some official guidance, not unofficial official as you mentioned, Harrison, but have not seen that yet.

Harrison Powers:

Well, we'll certainly keep everyone on this call up to date once that information is available. We're hoping it will come out here in the next few months. But that question around adoption certainly plays a big role when we talk about capital relief. So when we adopt CECL, the initial entry is posted against undivided earnings. And for a lot of institutions, they can expect CECL will require an increased allowance. And we'll talk more about that here on the next few slides, but that increase in the allowance can reduce your current capital.

Harrison Powers:

And the regulators across the board, banking, credit union have recognized that can reduce the capital ratios that the institution has, and have proposed capital relief. Under the current rules, if you adopt January 1st, there's a three-year phase in for the CECL transition adjustment to impact regulatory capital. It's important to clarify, this doesn't change the entry you make when you adopt. It does change how it is reported on the call report. And I know there's a lot of confusion around that, but what this effectively does, it gives you an add back over three years within your net worth calculation.

Harrison Powers:

And, Steve, and just as you were talking about, this is part of that confusion we see that we're hoping will be clarified this fall because if you're adopting later, they haven't quite said that you still get that transition relief. Right now it's tied to January 1. So we're hoping that when the new guidance comes out, they'll also bring with that transition adjustment relief if you choose to adopt on a fiscal year to follow your audit.

Steve Schiltz:

Yeah, I think that's one of the challenges too, Harrison, is that if you have credit unions adopting in different quarters, how is this call report system going to do this through this phase in approach? I think that's one of the challenges that NCUA's facing right now.

Harrison Powers:

Yeah, no, I think it's going to lead to a lot of confusion. And I think that it's understandable. It's going to take a little bit of time for them to sort out. But when we talk about what adoption looks like, let's walk through some examples. And I know that Michele and I are working with some clients that have early adopted, and we want to talk about that experience. But before we get there, want to talk about some of the data that's come out from larger institutions that have reported an adoption of CECL.

Harrison Powers:

There are some patterns here to be aware of. Now, keep in mind, public companies, public banks have had to follow CECL for several years now. And so a lot of this data is for larger institutions, public institutions. And it may not be directly applicable to your organization, but I think there's some trends that we can all take away from the data that has come out.

Harrison Powers:

The first is that generally across the board, there is an increase in the reserve required on your CECL. And I know that when I talk to our clients, there's some pushback on this. And I know, Steve, you're going to go into this in more detail in your section around what you see from software and things like that. But when you think about the fundamental principles of CECL or going from estimating essentially one year of losses to losses for the life of your portfolio, within that understanding is that you're going to have more losses. I mean, that's effectively what we're doing. Most of the attendees on this call have a large retail portfolio. The loans on your books are on the books for longer than one year. Even if you have a low loss rate, if you're adequately funded right now, you're going to end up with a little bit more going forward to cover those extra years.

Harrison Powers:

One question on probably jumping back a little bit here is, can you prefund CECL? I know, Steve, you got that question. Michele, I got a lot of those questions. Can you prefund it? I've got a lot of my allowance right now. Can I put more in there, and just call it good when I adopt? The answer is, really, you can't. You can't follow a new standard while also following an old standard. And when we talk about that capital relief, if you overfund your allowance thinking that it's going to reduce the impact of CECL, you're going to miss out on that transition benefit. You're going to end up running that through your allowance, and hitting capital and not getting that three year phase in that everyone else is going to enjoy from their adoption period.

Steve Schiltz:

Yeah, recognizing higher provision expense too. Keep in mind that initial adjustment is to undivide earnings. It doesn't impact the provision expense, but if credits start increasing the allowances beyond what gap is accepts today, not only is that not in compliance with gap, but it's penalizing you on the income statement side as well.

Harrison Powers:

Exactly. The next slide- I'm sorry, Michele. Go ahead.

Michele Cinciripino:

I'm sorry about that. Yeah. One of the questions we got in the chat here was, is the injury to undivided earnings comparing the current incurred loss calculation to the CECL calculation? So I think that we touched on that.

Harrison Powers:

Yeah, that's exactly right. And when we look at how much you need to book to undivided earnings, it really is what you consider adequate under current gap versus what that estimated allowance is going to be under the new standard. That difference is the amount that's going into undivided earnings. And so knowing the transition adjustment, knowing that you have some time for net worth, knowing exactly what Steve said, any future adjustments go through the income statement, there's a big incentive to make sure you have a funded balance when you adopt versus being a little bit skinny because you get a lot of help on that day you go live with the new calculation in terms of making sure it's sufficient.

Steve Schiltz:

And one of the takeaways I had from this slide, Harrison, was, in all cases, the pre-CECL allowance and... The post-CECL allowance is going to be higher than the pre-CECL allowance in all asset ranges that we see here for the early adopters. However, the increase isn't as much as we might have thought several years ago. I know there was talk about potentially doubling the allowance. And I think that could have a dramatic impact on capital. But if you look at just visually the bars, the orange bars showing post adoption are not double the blue bars that are showing pre-adoption. So that at least gives me some level of comfort, and hopefully, some of the participants today, some comfort as far as what the adoption looks like and what the impact to capital may be.

Harrison Powers:

No, that's a really good point, Steve. And I think it definitely illustrates how much our understanding of the standard has evolved because I remember when it first came out, that was the gloom and doom that all of our credit unions are going to be out of business because their allowance will be three times the size it used to be, and everyone would be under capitalized. And by the way, you need to hire an actuary to calculate this. And I think a lot of that stress is subsided once the practical application has come out.

Harrison Powers:

The next slide covers where we see the biggest increase. And I think that this slide's really important because it speaks to the nature of the credit union market, and it also talks about how CECL impacts different types of portfolios. Our experience, walking through the calculation, seeing it live, is that the retail portfolio, we're talking autos, RVs, toy loans, typically have the biggest impact from CECL. And the reason for that versus a commercial portfolio is a couple of reasons. One, the retail portfolio generally has a more substantial loss history. When you're making car loans, when you're making RV loans, ATV loans, charging those loans off as part of business, and that's priced into the interest rate versus a commercial loan, you may not have a loss in that portfolio for a long time. And the collateral is a little bit more saleable than a used car, at least historically.

Harrison Powers:

The life of those loans, the retail portfolio is also a lot longer now than it used to be. And when we think about CECL and the way it functions, we're estimating losses over the life of a portfolio, over the life of a loan, the longer that loans on the books, by definition, you're going to have a longer, a bigger reserve. When you think about the commercial portfolio, a lot of those loans are a one-year renewal, 18 month renewal, two-year renewal. And then we have some credit unions giving auto loans at seven, eight years. And so that changes how much you have to reserve for those types of loans. And that's not surprising. What we see here is a big increase in other consumer, and a big increase in credit cards. So credit cards has a significant impact from CECL because you're having to consider not only the unfunded balance of those cards, but also whether they pay down, how quickly they pay down, if they carry a balance. It's a lot more evaluation of the risk for those types of products.

Steve Schiltz:

Yeah, And one concept that's been discussed, Harrison, is breaking out the credit card portfolio by transactors versus revolvers. Transactors being your members that just charge their credit card to earn the points, the rewards. They pay it off every month. They don't carry a balance. There probably isn't much risk associated with those loans, those credit card loans. Versus revolvers, you have your members that carry a balance every month and could be close to the available credit limit. These are unsecured loans, generally. The losses are probably going to be much higher on those. So not only is segmentation important from a collateral perspective or a product type perspective, but this concept of maybe even breaking apart transactors versus revolvers, looking at two different types of behavior when you look at the credit card portfolio, I think could come in handy as well.

Harrison Powers:

Yeah. And that's a really good point, Steve. And I think... I know on your slides, you're going to talk a little bit about this. Understanding whether to make that decision to segment that portfolio depends a lot on your portfolio and the institution's risk. If you have a small credit card portfolio, it may not really be worth spending the time and energy to segment that between transactors and revolvers because you're not really going to see the benefit. But if you have a massive credit card portfolio, well, that's probably something that your team wants to drill into because it's going to have a big impact. We have some clients we work with that their credit card organizations, that's primarily what they sell, are credit cards. Well, that's a different question. They're going to spend some time figuring that out versus some of our members have that some don't.

Harrison Powers:

Before we jump into your slides, we were talking before the presentation on what adoption looks like in real time, and we're going to spend more time at the end talking about what regulators expect to see, auditors expect to see. And so we'll definitely get that content in.

Harrison Powers:

I know, Michele, you have worked through some adoptions. I mean, is this consistent with what you're seeing, or are you seeing something different when you look at the calculation that's gone live for our credit union clients?

Michele Cinciripino:

Yeah. I agree with what was said. I think, just with the early adopters and those thinking through that transition, thinking through the impact that it's going to have on your undivided earnings account and what that entry will look like, also thinking through how that's going to impact your call report based on the effective date. So I know that's a big one. If you decide to early implement, or depending on when you implement that, making sure that your call report reflects those injuries, making sure it reflects the new guidance that the new standard will have on the calculation as well. So I think those are some of the high level things. Also, just making sure that, and as Harrison mentioned, we'll cover this later, but making sure that the reports that are feeding into the allowance calculation are complete and accurate, and that you have the support for the different metrics and criteria that you're using.

Harrison Powers:

Yeah, no, exactly. I know, Steve, that's where we're heading next. Right?

Steve Schiltz:

That's right.

Harrison Powers:

There's too much to do, and too little time.

Steve Schiltz:

Yeah. Too little time. For a lot of credit unions, probably most of the participants today, we're less than six months out. Can you believe that?

Harrison Powers:

Yeah, that's crazy. It snuck up on me. So do you want to go ahead and take us through what they need to be doing now at least to get ready?

Steve Schiltz:

Sure. Yeah. Different things to put CECL into perspective, we're going to talk about understanding your credit union's risk, and determining the evaluation between if you're a complex credit union or maybe non-complex and trying to make that distinction. Although, there isn't clear cut guidance as to what is considered complex and what's not. I know Michele and I have some ideas on that we can share with you.

Steve Schiltz:

Also, knowing the data that you have. I think the data really impacts the methods available to you. And there is no one specific method that you have to use. You have options, and it doesn't have to be the same method for the entire portfolio either. You could choose to use different methods for different segments within your portfolio. So we'll go over that.

Steve Schiltz:

Selecting a model that fits based on your complexity based on the data that you have available to you is really important. And then, making sure that you document your approach for your board, for your examiners, for your auditors. We're going to be looking for that as well.

Steve Schiltz:

So understanding your risk. Really, we tried to create two separate buckets, looking at high risk on the left hand side, low risk on the right hand side. One of the keys is, do you have significant losses? That might put you in the high risk category. Or infrequent losses might be more the low risk category. And, Michele, I was thinking about this, and I think a lot of the industry has infrequent losses. They don't have losses all the time. Actually, I think I've seen the charge-offs and delinquencies, or at a decade low. They have been through the pandemic. Any thoughts on that first category there?

Michele Cinciripino:

Yeah, I would agree. It seems like most clients that we work with have some of the smaller infrequent losses. I guess something to consider would be if you have a large commercial real estate portfolio or some other commercial portfolio that might drive some of the more material losses or more frequent losses in that case.

Steve Schiltz:

Yeah. And that ties into the second bullet point, is it difficult to measure impairment that might be high risk? Whereas, low risk might be more your residential real estate and common collateral consumer loans might go on the low risk bucket. But I know it can be challenging to evaluate impairment, measure impairment for a commercial portfolio because all those loans are unique and different. They're non-homogenous. Any thoughts on that one?

Michele Cinciripino:

Yeah. I mean, speaking of difficult to measure impairment, we've seen collateral everything from livestock, to raw earth material, like rocks and soil, art pieces. So, I mean, some collateral can be very difficult to measure, versus, like you mentioned, the routine real estate loans might be a little bit easier and more concrete.

Steve Schiltz:

Wow. Art pieces. Yeah. That would be very challenging to come up with evaluation there. I mean, you could get an appraisal, but what it's worth is what someone's willing to pay you for it, and, who knows what that could be. And then, the third category, really, is the lending, is it complex lending or routine loan structure? Really, when I think of complex lending, I think of commercial lending. I know credit unions are relatively new to that space in relation to banks. Although, there are some credit unions out there that have been doing commercial lending for quite some time, but what do you think about that one?

Michele Cinciripino:

Yeah. So I think when thinking through some more complex lending that we've seen, that would be, as you mentioned, the commercial relationships that have multiple guarantors that might be involved with other relationships. Another thing that might impact the lending is if you have loans based on grants, like a CDFI loan or something that has other criteria that the borrowers or guarantors might have to meet.

Steve Schiltz:

Makes sense. Going into knowing your data, what degree of data do you have? Are you data rich? Do you have loan dashboards, data pools, complex risk modeling already in place? If you do, that might be conducive to using a more complex methodology under CECL. Whereas, if your data limited, maybe some of our smaller credit unions out there that are more Excel-based, informations retained on paper and data silos, particularly if maybe use different third-parties to assist you with some of your loan servicing. I know that can be challenging. A lot of credit unions might contract with a mortgage loan servicer, a credit card servicer, a student loan servicer. You might have participations that are serviced by other credit unions. It can be challenging to get all that data in the same format that you need to calculate the allowance under CECL, and then less complex risk modeling as well.

Harrison Powers:

Yeah, Steven, and Michele too. I'm curious to know your experience. I feel like this is where I sense the most anxiety from clients, is, where do I get the information? Can I get the information? Is it too late to obtain the information? And I don't know if y'all have any practical guidance that's going to put you on the spot here. I mean, obviously, if you're an organization that you've been using a loan dashboard for a while, you're probably very familiar with your pay down rate, and your interest rate for your portfolio, and how complex your lending is. I mean, can you do CECL in Excel? I mean, I feel like most institutions could, but I didn't know if you had any guidance on that.

Steve Schiltz:

Yeah, absolutely. You can use Excel to do CECL. And I know we've worked with many of our clients to help them develop their methodologies and calculations in Excel. So it's definitely possible. It doesn't have to be a complex exercise. I think the challenge is that if you are involved in complex operations, such as commercial lending, maybe that Excel model isn't going to cut it for you. I think it'd be more challenging to calculate reserves for commercial loan portfolio in Excel. But normal, typical credit union loan portfolios of residential real estate and consumer loans, Excel is absolutely an option for them.

Steve Schiltz:

Then talking about selecting a model, and there's more complex models, there's simpler models. And you really have the choice to choose which model you want to use here. I mentioned with the complex modeling, that's probably a better fit for a commercial portfolio, but the simple models are probably a good fit for your consumer portfolios. More complex, more challenging to do in Excel. All three on the left hand side, I would not recommend in Excel. I think it would be very difficult to do that. A vintage where you're tracking loans by year of origination and calculating loss rates by each year and applying those based on where they are and the life of the loan, that would be very challenging to do in Excel, as well as discounted cash flows.

Steve Schiltz:

I think David Henneke one of, one of the people that develops a lot of our own Excel modeling that we share with our credit unions and helps them develop their models in Excel, try to discount cash flow. And I think he said it crashed because it was just so many calculations, it couldn't handle it for a large portfolio. And then, probability of loss, given default, a lot of assumptions built into that. You're probably going to need the assistance of a third-party to assist with that calculation.

Steve Schiltz:

But then simpler models, weighted average remaining maturity. You might have heard of the WARM Method. That's something we've presented on in the past. It's fairly simple to do in Excel. And it might be something where you can enhance or modify your existing allowance calculation to incorporate some of the lifetime loss rate information that Harrison was talking about at the beginning of the presentation.

Steve Schiltz:

Snapshot cumulative loss rate, that can be done in Excel as well. Migration analysis is a interesting concept. We actually have a craving client that uses migration analysis today, delinquency migration analysis, where you look at what's the movement of loans to delinquent categories, to aging within delinquency to eventually become a loss. So moving from the current portfolio to two to six months, to six to 12 months, to greater than 12 months, and eventually charge off in tracking that movement and estimating loan losses based on that movement. You could also utilize migration analysis potentially with risk ratings, looking at what's the chances of a past credit moving to special mention, moving to substandard doubtful loss, and eventually charge off.

Steve Schiltz:

And then SCALE is a newer concept. I believe that was developed by the Federal Reserve, where you're actually using pure loss rates to calculate the allowance under CECL. I think there's some pros and cons to that. Definitely probably simpler methodology, less volatility by utilizing something like that because you don't have the infrequent charge-offs that we were talking about before. It's spread out over the entire peer group. But you could be penalized potentially. What if your peers have a higher loss rate than you do? What if you have a higher loss rate than the peer group? Then you could be underfunded in your allowance calculation.

Steve Schiltz:

Harrison, not sure if you have experience with any client selecting SCALE or not, or any thoughts on that one?

Harrison Powers:

Yeah, no. I think you had a great summary. I think SCALE is very attractive because there's a lot of information about it. There's a very nice spreadsheet you can download for free from the Federal Reserve. I've had a lot of clients present it to me and say, "I've downloaded this, and I've put my stuff into it. I'm done." And I'm like, "Well, I think there's more to it than that." What Stevie mentioned is you're relying so much on peer data, you still have to explain and justify why that peer data's relevant to you. And you have to explain, I mean, we're dealing with, especially from the credit union world, I mean, all the data's coming from the bank world, and it's all banks over $1 billion in assets. So if you are a 200 million credit union in a rural area, you're going to spend a lot of time explaining why peer group $5 billion banks is at all relevant for your consumer portfolio when most of that bank's portfolio's commercial.

Harrison Powers:

And so it's really attractive. It seems very, very simple, but there's a lot of heavy lifting that has to be done on the back end to get your auditor and examine or happy with the result. And even if you do end up convincing them that it's relevant, I think Stevie make a great point, you're going to be penalized by their lending, not yours. And so you're really tied to their peer group.

Harrison Powers:

To me, the clear winner that I see, I don't know if y'all see differently and with your clients, is the WARM Method. I would say that's 95% of my clients that I work with. I really love the WARM Method. It's easy to explain. And I think, of the other models, is the most similar to what we do today.

Steve Schiltz:

I agree.

Harrison Powers:

This is a historical loss rate. It uses the same pools, and you're just multiplying it by a lifetime loss factor. And so if you're evaluating, if you're a little bit behind adoption, if you're getting ready a little bit late, that may be where we would recommend you start, is with that model.

Steve Schiltz:

Yeah. I agree with that. Yeah. Easier to audit too, probably because we're already pretty comfortable with the allowance methodologies today. This, as I mentioned, you can modify your existing calculation probably to incorporate a weighted average remaining maturity component into it. Agree with you, everything you said on that, Harrison.

Harrison Powers:

Yeah. And an important thing too, if you struggle to explain you're model to your management team, you probably should not pick the model. I mean, you're going to have to explain where all the stuff's coming from to your auditor and to your examiner. And I've had a lot of clients I've worked with that have purchased the software, and I have nothing against the software selection, but they looked at it, I looked at it, I had someone else look at it, we had David look at it. We couldn't figure out the math. And I mean, I had it penciled out. I had it on paper. I tried to recalculate it. I could not figure out how it was working. And the software did not come with the support to really educate the management team on how it came together.

Harrison Powers:

That's not a great conversation to have with your examiner to say, "Hey, I bought this. It's got all my data. Here's my number, but I don't really understand what's happening in the back side of it." So I think under... And if you have a really complex institution that requires that analysis, okay, that's great. But if you have a simpler portfolio, more routine portfolio, picking the simple model. There's no bonus for going hard. I mean, you don't get extra auditor points. Right, Steve? I don't give them.

Steve Schiltz:

No trophies or anything like that?

Harrison Powers:

No trophies. There's no adoption trophy.

Steve Schiltz:

And then, documenting your approach and being able to explain that. I think Harrison made a good point about that. Make sure that you understand what you're doing and be able to explain that to auditors and regulators, the why behind the model, which model you selected. And as I mentioned, it could be a different model for different segments of the portfolio, the data that you're relying and utilizing for that model, the assumptions that you're using. And then the big one I really think is the qualitative environmental factors.

Steve Schiltz:

The industry has come a long way. I think, since the Great Recession in developing what we call Q&E Factors. And Harrison mentioned the stimulus for CECL, why this is coming about, because we really missed the boat as an industry during the Great Recession in determining those loan losses. And we were playing catch-up through the recession, and even afterwards, trying to increase our allowances for Q&E Factors.

Steve Schiltz:

So if you think Q&E Factors have been challenging and difficult to come up with, and we're looking out 12 months currently, imagine what that might look like moving to CECL, where we have to at least consider the bare minimum benchmark is 12 months out. We have to consider information past that time if we can reasonably determine that. And these are some different examples of Q&E Factors that you're probably looking at and evaluating today that you'll continue to think about and consider under CECL as well. So changes in lending policies and procedures don't generally see a lot of changes there.

Steve Schiltz:

I mean, one example I could think of, Michele, was maybe moving to risk based pricing. I know some smaller credit unions might be new to that area. So changing that from where you have the same pricing for all members to more risk-based pricing approach, and maybe you have a different composition of the loan portfolio, that potentially could have an impact on your Q&E and the allowance computation.

Michele Cinciripino:

Yeah. Another one I've seen is changing charge-off or recovery practices. So that could have a huge impact, or maybe changing a metric, like the allowable debt-to-income, credit scores, things like that.

Steve Schiltz:

Absolutely. And then changes in the experience ability in depth of lending management. I know probably everybody's heard about the great resignation. There's been lots of movement and changes of people from within our industry, within the credit union industry. That can impact that can have an impact on the allowance. Would you agree with that one?

Michele Cinciripino:

Definitely. I mean, I know even on our team alone, we've seen turnover. So I think, just in general, everyone's seeing that.

Steve Schiltz:

And then the one on the middle left, that's really, I think, where most credit unions are incorporating Q&E today, changes in the economy, particularly during the COVID pandemic. I think that was probably the risk that was identified where lots of reserves were incorporated into the allowance.

Michele Cinciripino:

Yeah. Another one that we've seen is, if there's a significant business, and that might impact the local economy or might impact a lot of the members that you have.

Steve Schiltz:

Absolutely. And then existence in effective, any concentrations of credit. I think credit unions have really done a good job overall, getting more diversified in their loan portfolios, but we still have some credit unions that are very concentrated in indirect lending. We have some clients that are very concentrated in commercial lending. Those can pose different risks to the credit union as well.

Michele Cinciripino:

Along those lines, also, if there's a concentration in an area, a geographic area, that might have an impact.

Steve Schiltz:

Absolutely. We saw that during the Great Recession. I mean, just based on real estate values, like in California, for example, that declines substantially. Whereas, maybe towards the center of the country, like Texas, where you're from Harrison, didn't see as much changes in real estate values. And then changes in the nature and volume of the portfolio, so how the portfolio is changing over time. And then, the catchall, the effect of other external factors, any thoughts on what those might be, Michele?

Michele Cinciripino:

Yeah. So you mentioned one of them. If there's a big change in the value of collateral in different places, that might impact it. Also, possibly what your competitors are doing, that could have an impact as well.

Steve Schiltz:

Absolutely.

Steve Schiltz:

All right. So we're wrapping up the presentation. We're going to try to leave a little room for some Q&A at the end, but really want to get our perspectives on working with examiners and auditors so that you have a leg up on that and know what to expect. And I'm going to be leaning in on for some help from Harrison and Michele because I know they actually have a client that's early adopted CEC, and they're working through that. So want to know what their perspectives are as they go through that process. But some of the regulator questions, and you've probably been asked these from your regulators, is number one, hopefully, everybody is familiar with CECL. And I think by attending this webinar today, you hopefully have a better understanding of CECL.

Steve Schiltz:

Are you familiar with the interagency statement frequently asked questions document? There's a lot of information that has been issued by the financial institution regulators, including NCUA. I jotted down some notes just to share with you because I think these are some big points, and I think we've covered some of these during the presentation today, but the regulators are not endorsing any single method. They're not requiring you to use any single CECL methodology. So you really do have some freedom in which methodology you select.

Steve Schiltz:

Try using your existing... Leveraging your existing risk systems in place, ALM systems in place. And I think that's important because you can leverage what you're already doing with those risk-rating systems and ALM modeling systems that you have in place for CECL. There shouldn't be discrepancies between assumptions that you use for ALM modeling, for example, and under a CECL methodology.

Steve Schiltz:

You don't have to use a third-party. They've made that clear. Hopefully, we've debunked that this is unnecessarily complex, and you can't do it on your own. You can use Excel. There are easy ways to do it. Harrison mentioned the WARM Method is a good choice if you're a little bit behind at this point, and not as far along in getting ready to adopt. You have to comply with current gap. And Harrison mentioned that you can't start inflating your allowance and adding to it today beyond current gap. So take that into account as well.

Steve Schiltz:

Do you have an implementation plan? Hopefully so. I mean, we mentioned most credit unions are less than six months out, so it's just around the corner. And have you discussed CECL with your audit firm? I think this is a key one, from my perspective. I've already had some clients that have reached out, asked to set up some team meetings, some discussions, just so that I have an understanding of where they're leaning towards, which methodology they're selecting, what my expectations are, what our expectations are from an audit perspective.

Steve Schiltz:

Any thoughts on this one, guys, in terms of having that open, honest conversation with your audit firm?

Harrison Powers:

Yeah. Well, I know that Michele and I can probably speak from our experience with different clients. You don't want any surprises with your audit firm. Auditors, we are routine people. We like to know what we're doing day before we do it. That's just our disposition. And so explaining your approach in advance of adoption, I think is critical.

Harrison Powers:

And I think, Steve, you make a good point that the regulators have not endorsed a particular methodology. They also have not endorsed what sufficient means. they haven't said you need to have 1.25% of your reserve. Really, that distinction, I'm sure they'll come out with some more nudge guidance once they run adopts. It's how it seems to work. But the determination of whether it's sufficient really falls with your audit firm. And having a discussion with them, do you think this is reasonable forecast, do you think this is a reasonable reserve is really critical to arriving in a number that everyone's comfortable with when they adopt.

Steve Schiltz:

Yeah, it seems like it's better to have that discussion up front than post-adoption because, at that point, it's almost too late. The injury's already been posted. The call report's been submitted. Maybe, in some cases, financial statements have already been distributed to the board. Seems like it'd be a lot easier to have that conversation before the entry is posted.

Harrison Powers:

Yeah. And Michele, I know we get interested to get your input. I think that there's also a lot of small details that the audit team has to focus on that maybe the management team, and not for any fault, it's just auditors and management are different, but the management team may not be considering when you adopt. Adopting in the middle of the year can sometimes be more challenging at the beginning of a period. Right?

Michele Cinciripino:

Sure. I think another thing that's helpful when having that conversation upfront, we can talk through some of the request items we might want. So helping have guidance on the reports and the things that we'll be looking at, I think will make the week of field work a lot easier if you can get those ahead of time and know what we're expecting.

Steve Schiltz:

Absolutely. So other questions you may have been asked, or will be asked, have you formed an implementation committee? Hopefully, everybody has already done that. Are you retaining data for the calculation, including data from third-party service providers. Mentioned the challenges associated with third-party servicers, like mortgage loan servicers, credit card servicers, are they retaining the data in the format that you need for CECL? Do you plan to use a third-party to calculate CECL? I've heard... This might be in the unofficial category too, Harrison, where if a credit union says, "Yes, I'm using a third-party," and you say, "Yes, I'm using Encino, or 2020 Analytics," or whoever it may be, it gives the regulators a warm, fuzzy, oh, okay, well, I don't need to ask anymore questions or prod. It seems like they have it covered. But I think some of that probably depends on the reputation of the third-party that you're utilizing too.

Harrison Powers:

Yeah. I think it depends on the management team. I mean, sometimes I'll go out to a smaller organization. They have a very large expensive program. And my first question is like, do y'all have the resources and time to really dig into this? Or do you have a Cadillac parked in your driveway that you're going to have to deal with? I think that, not to use it for Q&A time, but you mentioned the credit card servicer, Steve, participations are a big one. I know that when we're out with clients, a lot of our credit unions have participated loans. A lot of times, those don't get to you on time because you're way relying on other credit union to generate a report. Those are conversations you may want to talk about with the management team and with those lenders because not getting that information timely can impact CECL more now than it used to with the old standard.

Steve Schiltz:

Absolutely. And then the big one, have you determined the impact on capital? That could have a material impact to a lot of credit unions, even with the three-year phasin that Harrison mentioned. And auditor questions, these are some of the things that you both are dealing with, I think, and I will be dealing with in the future. But I think a lot of it's going to come down to testing inputs and output similar to how we test current allowance calculations that what's going into the model. Is that accurate? Is it supportable? Can we tie out the charge offs, the recoveries, the loan balances that are going into whatever methodology you select? Michele, what you think about that one? Would you agree?

Michele Cinciripino:

Yeah, I agree. Making sure that it's calculating correctly, making sure you know how it's calculating, making sure that the data flowing into it is complete and accurate. Those are all essential things that we'll want to verify as well.

Steve Schiltz:

The key assumptions, I think that ties into some of the qualitative environmental factors, reasonable and supportable forecasts. There has to be some way to quantify those, and some support for how management has derived those assumptions. What do you think about that?

Michele Cinciripino:

Yeah, I agree. Making sure if you are using peer ratios or things like that, that you have your own analysis on how those impact your credit union and how those apply.

Steve Schiltz:

And then, financial statement disclosures, they're going to look a little bit different under CECL. There's going to be some additional information there. I imagine that the participants today will be able to consult and work with their audit firms to help them determine what disclosures are necessary in their audited financial statements.

Steve Schiltz:

And then, the key one, the million dollar question, is the allowance sufficient? The allowance is always a significant accounting estimate when we perform our audits in CECL, under CECL, it will be no different. That's going to be the key in performing the audit, is determining whether or not it's reasonable and sufficient.

Steve Schiltz:

I know we have five minutes. I think originally where were hoping for some more time for Q&A, but we'll try to get through as many questions as we can, Michele. And then, certainly any questions we don't get to today, we'll follow up with the individuals as necessary, but any questions that we can answer at this time?

Michele Cinciripino:

Yeah. So a couple questions came in regarding Q&E Factors. So I think those might be helpful to cover. One of them was, how often, if ever, do you see negative factors? For example, if an institution has become more conservative with LTB, DTI, et cetera, should they consider it negative qualitative factor?

Steve Schiltz:

Yeah. It's a good question. I think it's possible. I have seen it occasionally. Maybe I should use rarely because I think it gets a little more scrutiny than adding to the allowance when you're actually taking away from the allowance. But, Harrison, any experience with that one?

Harrison Powers:

It really depends on the management team. I have some management teams that are very aggressive on negative key factors, but I think that your point's a good one, Steve. If you're going down, that's against the grain of what your auditor and examiner expect to see. It doesn't mean it's wrong. It doesn't mean you can't do it. It doesn't mean it's inappropriate. It does mean that, at a basic level, there's going to be a question. And that's just unfortunately how we operate as auditors, is if it's going the direction we expect it to go, we're still going to ask about it, but we won't. It matches our expectation a little bit more closely. When you go the other direction, well, we have to spend a little more time understanding why.

Steve Schiltz:

Agreed. I think, especially in today's economy where losses, loan, losses have been in an all time low, I wouldn't think that most credit unions are having negative Q&E Factors at this point. If anything, it might be the opposite because we're at a abnormally low loss rate, historical loss rate. Might be appropriate to use a higher loss rate in some cases.

Michele Cinciripino:

Another question regarding Q&E Factors. Since most institutions will be incorporating economic forecasts into their models, is it really necessary to add an additional Q&E Factor for the economy?

Steve Schiltz:

Maybe not, depending on the methodology selected. I think if it's already incorporated into it, and well documented, and supported on how those assumptions were determined, there's no need to double up on a factor or have additional reserves beyond the core methodology, is my thoughts anyway.

Harrison Powers:

No, I agree with that. I mean, I think one of the things that's, both nice and frustrating with CECL is that there are no strict rules. You have to consider it, but the way you consider it is up to your organization. And I think that that can be really frustrating for some people, but I think it's important that, if asked, you can point to where that consideration is, whether it's in the model, outside of the model. The WARM Method, for instance, it usually fits better outside of the loss history analysis just because that's that model sets up. But if you're using discounted cash flows, well, it's in there to an extent.

Harrison Powers:

I know we have a lot of questions that came in at the end here. So we may need to reach out to the individual attendees separately. But if you do have questions, I know we have our contact information on the last slide, we do encourage y'all to reach out to us. We love our credit union clients, and we love helping them and being involved with their success. So please take a screenshot, reach out to any of us. We have the time zones covered. So depending on where you're located, the time of day you want to make a phone call, you can catch one of us in a time zone. We would love to walk through your calculation and your specific questions. This is a complex standard, so we understand if you need to have that professional resource.

Steve Schiltz:

Well, great. Any final thoughts, or should we wrap it up for today?

Harrison Powers:

I think I'd keep an eye out for any communications from us and from the regulators. I think it's going to be a fast and furious six months getting ready. But if you have questions, now is the time to ask.

Steve Schiltz:

Agreed. Yeah. We look forward to hearing from you.

Harrison Powers:

Thank you, everybody, for attending.

Michele Cinciripino:

Thank you.

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