MOSSADAMS

# CECL Update

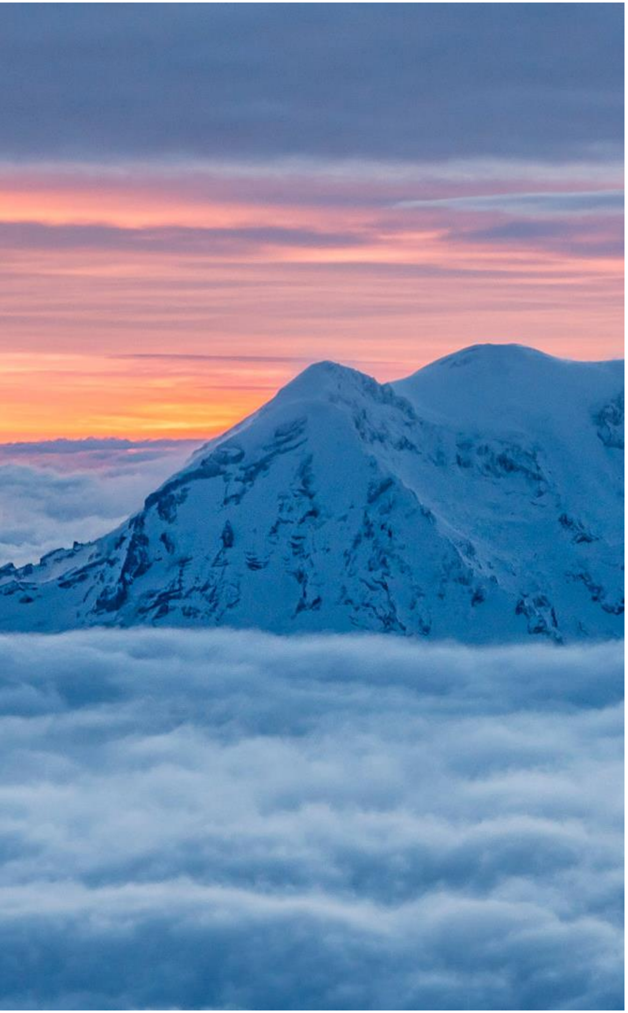
Anthony Porter, Partner

# Today’s Presenter

## Anthony Porter

***Partner - Financial Services***

**Moss Adams LLP**



# Agenda

1) CECL Post-Adoption Review

   Outline of CECL trends and reflection post-adoption

2) CECL: Lessons Learned from Auditors

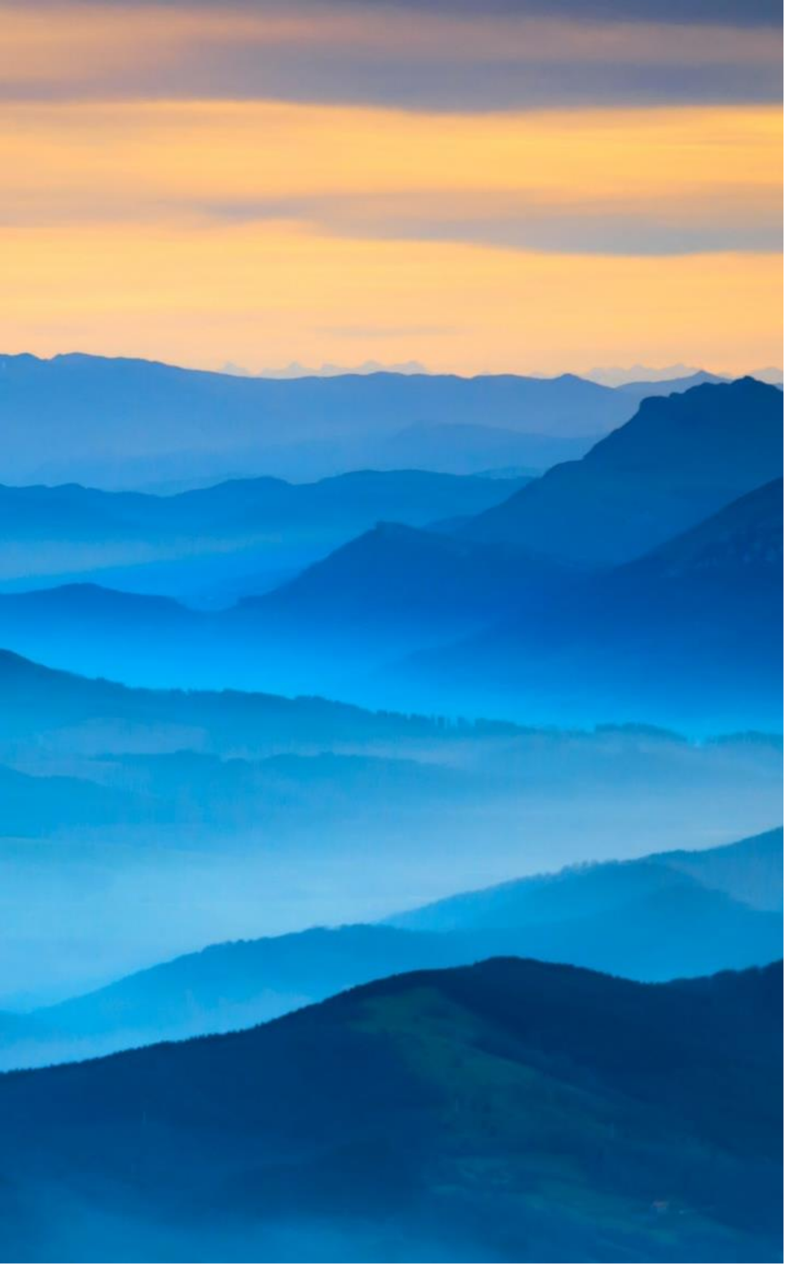
   Top 5 CECL internal control issues, ramifications, and example key controls to address

3) CECL Best Practices

   Embracing Internal Controls, Proper Risk Assessment, and Effective Model Validation Process

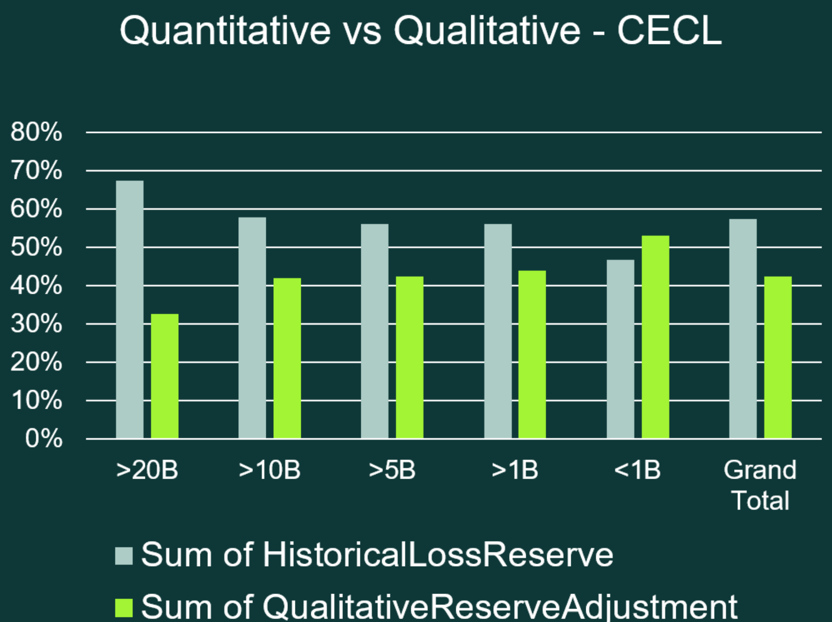
4) FASB CECL Update

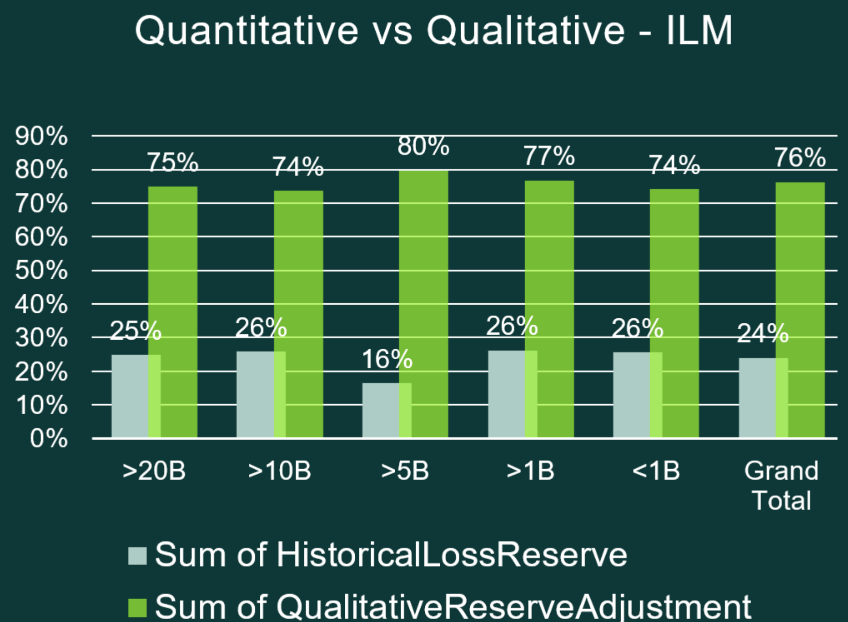
   Purchased Financial Asset Model and PDC vs Non-PCD



# CECL Post-Adoption Review

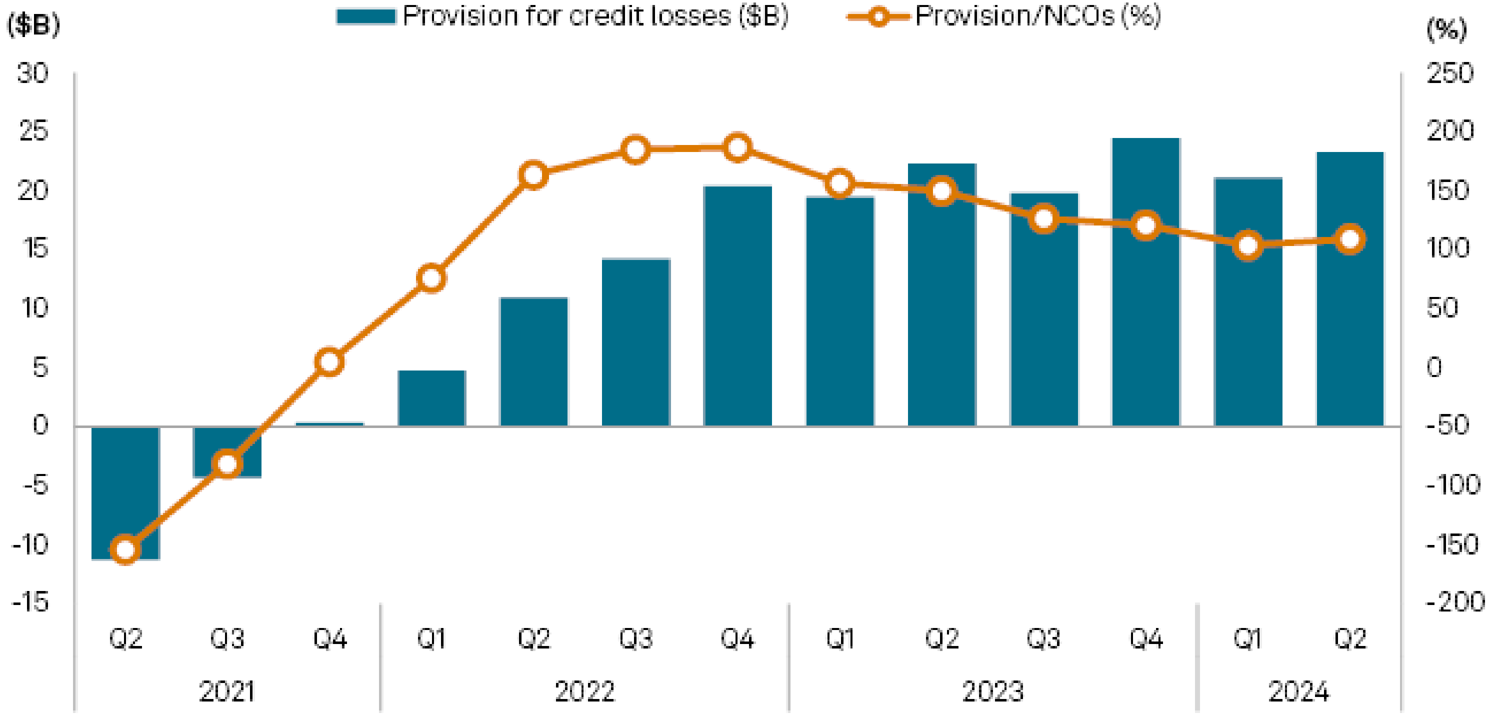
# Post-CECL Reserves: What's Changed??




*Source: Finalized client models in Sageworks. ILM as of date is 12.31.19; CECL as of Date is 12.31.23.*

## Credit provision trends at US banks




Data compiled Aug. 12, 2024.

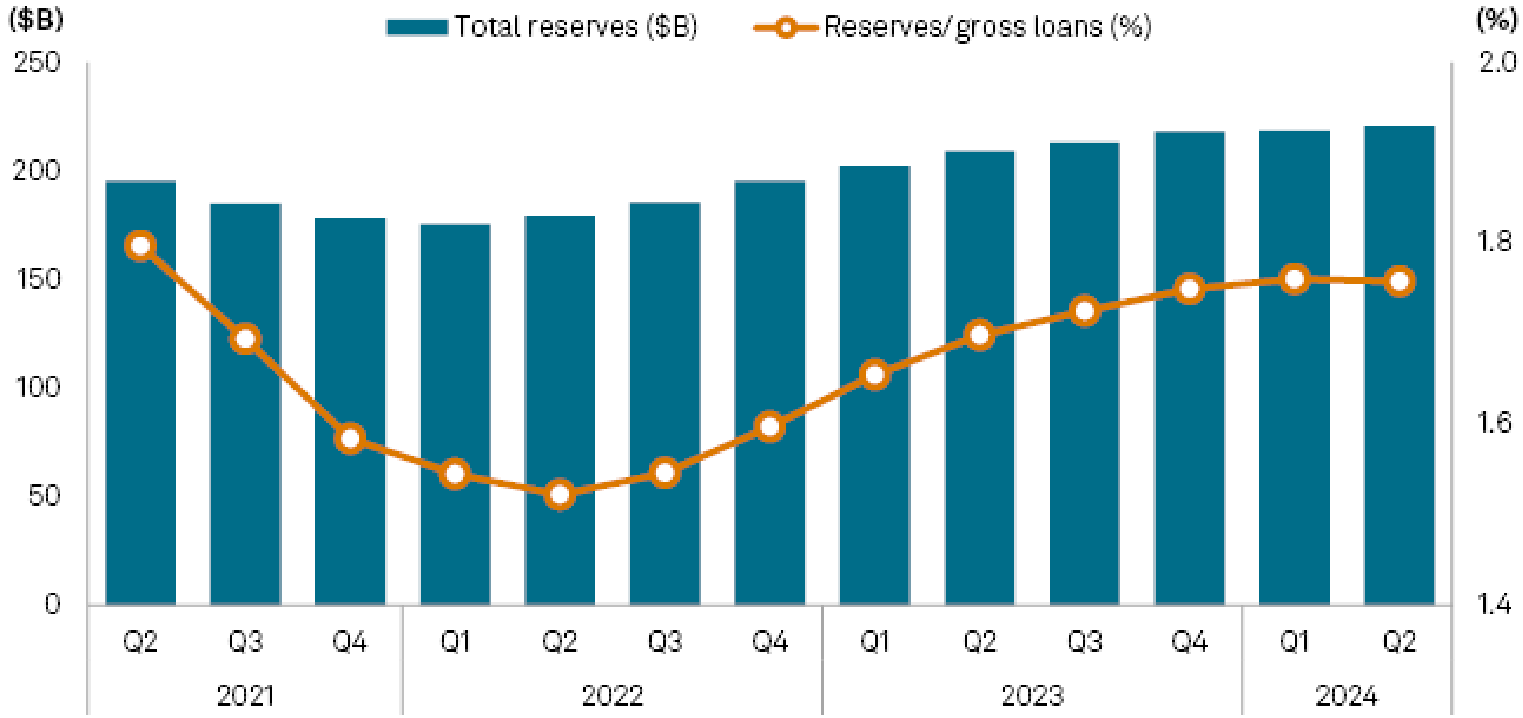
NCOs = net charge-offs.

Analysis includes US commercial banks, savings banks, and savings and loan associations. Nondepository trusts and companies with a foreign banking organization charter are excluded.

Data based on regulatory filings.

Source: S&P Global Market Intelligence.

# Total reserves at US banks




Data compiled Aug. 12, 2024.

Analysis includes US commercial banks, savings banks, and savings and loan associations. Nondepository trusts and companies with a foreign banking organization charter are excluded.

Data based on regulatory filings.

Source: S&P Global Market Intelligence.

# CECL –Year 2 (for most)

2024 will be year 2 for most Banks.

- For many Banks, it was largely an exercise in justifying the ACL that they had held previously/built up to adoption.
- Almost 50% of the Banks had $0 impact.
- For Credit Unions (just for context!), less than a third had $0 impact. Many also saw a significant increase.

# CECL Adoption –What we saw

## Methodology

- Method selected didn't make sense
  - Used the best number vs best methodology
- Lookback period not appropriate
- Individually evaluated not applied consistently
- Segmentation too general for credit risks

# CECL Adoption –What we saw

**Qualitative/Forecast Adjustment**

- Completely missed it when vendor model allowed or suggested it
- Didn't weight/factor recent trends to compensate for long look back period
- Macro economic data didn't make sense based on some loan types
- No documentation for use or selection of factor # or %

# CECL Adoption –What we saw

## Vendor/Model

- Didn't understand the model and behaviors
- Didn't use Q factors appropriately
- Too much trust in the output – no gut check or common sense
- Vendor SOC report or model validation expectations/lack of management review
- Model governance missing

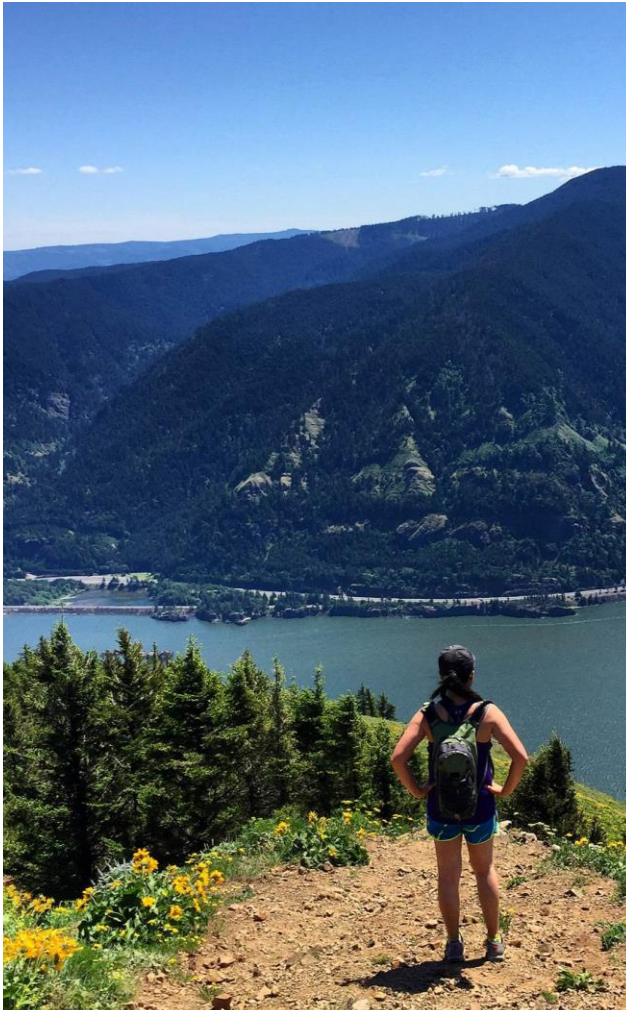
# ACL/CECL – Year 2 focus

- Credit quality has gotten worse – but how much worse will it get?
  - How are models behaving? What needs to be adjusted?
- Did management change assumptions (Q factors)?
  - If so, who authorized? Did they make sense?

# ACL/CECL – Year 2 focus

- With FRB rates high (but with a September rate cut) how are commercial loan repricing/renewals going? Will the loans cash flow (DCR>1.10-1.20, etc.)?
- Office space exposure? (over 100bps higher NCO's than other CRE)
- How active are clients in collections?
- Twelve years of no losses have skewed a lot of trends.

# CECL: Lessons Learned from Auditors



# Post-Adoption CECL Lessons Learned

*Top 5 CECL internal control issues, ramifications, and example key controls*

1. Lack of documentation to support critical assumptions
2. Significant changes to the CECL methodology that are not substantiated
3. Overreliance on vendors/systems
4. Unsupported reserve levels in excess of model calculated reserves
5. Loan data not complete and accurate within the CECL calculation

# CECL Control Deficiency #1

*Lack of documentation to support critical assumptions*

**Examples of what we see…**

- *Qualitative adjustments and/or changes of adjustments from prior periods with no related documentation*
- *Decision points (peer group selection, loss rate lookback periods, prepayment speeds, etc.) with no basis for the conclusion*

**Ramifications for what could go wrong…..**

- *Increased scrutiny from auditors or regulators*
- *Shift of focus moves to management rather than methodology*
- *In a period of credit quality shifts, there's no baseline for decision points for prior conclusions*

**Key Control Activity Examples to Address**

"Management prepares a monthly/quarterly memorandum outlining the CECL results, including each critical assumption or change thereto, with evidential documentation to support the conclusion."

"For changes to critical assumptions as defined within the CECL Policy, supporting documentation is presented to the CECL Committee for review and approval."

"Qualitative adjustments and supporting analysis are reviewed and approved by the CFO prior to finalizing the calculation, as documented within the minutes."

"Periodically, the CECL methodology, including all critical assumptions are reviewed by CFO, and approved by the Audit Committee." (LESS PRECISION)

# CECL Control Deficiency #2

*Significant changes to the CECL methodology that are not substantiated*

**Examples of what we see…**

- *Change in methodology selection within existing CECL provider or change in CECL provider with minimal documentation surrounding the change or reason for change.*
- *Material new information obtained that existed upon adoption of CECL but factored into the methodology on a go-forward basis, with no consideration of prior reporting period effects.*

**Ramifications for what could go wrong…..**

- *Potential for management bias*
- *Prior financial statements could be materially misstated*
- *Additional deficiencies may result depending on the cause, which may require additional work/costs*

**Key Control Activity Examples to Address**

"As outlined within the CECL policy, changes to CECL providers and methodology changes, including the supporting documentation for reasons for change and retrospective review to compare methodology results, are presented to the Audit Committee for review and approval."

"Proper due diligence is conducted for critical vendors surrounding significant estimates and presented to the Audit Committee for approval."

"Changes to significant estimates resulting from new information obtained are considered for a potential correction of an error, which may warrant restating previously issued financial statements."

"Significant changes to the CECL methodology are reviewed and approved by the Audit Committee." (LESS PRECISION)

# CECL Control Deficiency #3

*Overreliance on vendors/systems*

**Examples of what we see…**

- *Management is unable to explain, even at a high level, the CECL methodologies utilized by the institution, and key loss drivers.*
- *Management does not review the SOC 1 reports for the CECL provider, or periodically test any calculations or outputs of the CECL model.*

**Ramifications for what could go wrong…..**

- *Errors may not be identified timely or at all*
- *Management cannot adequately set expectations or assess results of the calculation*
- *Methodologies or key inputs within the methodologies might not be appropriate for the underlying loan segments*

**Key Control Activity Examples to Address**

"Upon adoption of significant accounting standards (CECL), management researches and documents the implementation, including critical assumptions, key decisions, and effects on financial reporting."

"Periodically, management performs a loss driver analysis to assess the validity, completeness and accuracy of data, and appropriateness of key loss drivers within the CECL methodology."

"Annually, management obtains the SOC 1 report covering the reporting period, and reviews for deficiencies affecting the CECL methodology. Complimentary user entity controls are mapped to the institutions control activities and documented accordingly."

"Annually, management obtains an independent model validation on the CECL methodology."

# CECL Control Deficiency #4

*Unsupported reserve levels carried compared to calculated reserves*

**Examples of what we see…**

- *CECL calculation and analysis do not agree to the recorded balance in the general ledger, with no supporting documentation for the difference.*
- *Management has a qualitative adjustment recorded to maintain a 1.5% level of ACL to loans.*

**Ramifications for what could go wrong…..**

- *Management bias called into question*
- *Actual expected credit losses are not accurately reflected for financial reporting*
- *CECL methodology is not nimble enough to increase recorded reserves when forecasting points to increase in expected credit losses*

**Key Control Activity Examples to Address**

"Quarterly, management prepares a memorandum in conjunction with the CECL calculation, concluding on calculated reserves, qualitative adjustment, and the overall recorded ACL reserve."

"Recorded ACL reserves are maintained at a level within 10% of calculated ACL reserves, which is in accordance with policy thresholds set forth by the Board of Directors."

"Qualitative adjustments and supporting analysis are reviewed and approved by the CFO prior to finalizing the calculation, as documented within the minutes."

# CECL Control Deficiency #5

*Loan data not complete and accurate within the CECL calculation*

**Examples of what we see…**

- *CECL calculation did not incorporate certain acquired loans not maintained within the loan subledger.*
- *Certain loan purpose/call report codes were modified, but not updated within the CECL methodology.*

**Ramifications for what could go wrong…..**

- *Actual expected credit losses are not accurately reflected for financial reporting*
- *Financial statement disclosures are inaccurate*

**Key Control Activity Examples to Address**

"Reconciliation by CECL loan segment to the loan subsidiary ledgers and general ledger is completed to ensure that loans are accurately reflected within the CECL methodology, and the internal loan data used to calculate the ACL is complete."

"When loan call report, purpose, active status, or accrual status codes are changed, management notifies the CECL provider to ensure current and historical information is updated accordingly."

"Annually, on a sample basis, key loan attributes are tested against the CECL methodology to ensure information used to calculate the ACL is complete and accurate."

# CECL Best Practices

# CECL Best Practices: Effective Internal Controls

1. **Embrace internal controls!**

   Successful organizations have a culture to lean in to controls and the control environment and understand the value they provide.

2. **Ensure all parties know their role**

   CECL is a cross-institutional process, with information coming from multiple areas of an organization. When people understand how their work product fits into the process, there is a better understanding of what could go wrong, and fewer errors.

3. **Utilize a proper risk assessment**

   Focusing on risks identifies the areas of focus for control activities. Start with higher level risks (management bias, estimation uncertainty, 3rd parties, etc.) and move to more detailed risks (elements of the model, subjective/objective inputs, IT general controls, etc.).

# CECL Best Practices: Effective Internal Controls

### 4. Utilize control flowcharts or narratives

A cradle to grave process documented for the entire CECL process ensures completeness and helps identify both control gaps and areas for precision.

### 5. Find a balance of granular and higher-level controls

CECL is complex and has a lot of moving parts, but CECL control process owners need to do their day job, so controls should be in place to an acceptable risk tolerance, focusing on critical control activities. Internal controls should be effective to provide comfort to stakeholders but should not drive the bus.

### 6. Documentation is more important than ever

"If you don't document it, it didn't happen." Not exactly, but with the subjective nature of CECL estimation and significant assumptions, it is imperative that conclusions are supported.

# CECL Best Practices: Proper Risk Assessment

***What could go wrong?***

- ➢ Risk assessment is foundational to identify risks of material misstatement within the CECL estimate and the actions management should take to mitigate the identified risks.

- ➢ The risk assessment ***requires reevaluation on a continuous basis*** as the risks of material misstatement within the CECL estimate may change.

- ➢ Result of proper risk assessment is the design and operation of control activities to address identified risks.

# CECL Risk Assessment

***Start high-level, more to more granular***

Examples of key high-level risks are as follows:

### METHODOLOGY SELECTION

- Has the model changed since adoption of CECL?
- Do credit risks within the loan portfolio remain the same?
- Is management and those charged with governance comfortable with the methodology?

### MANAGEMENT BIAS

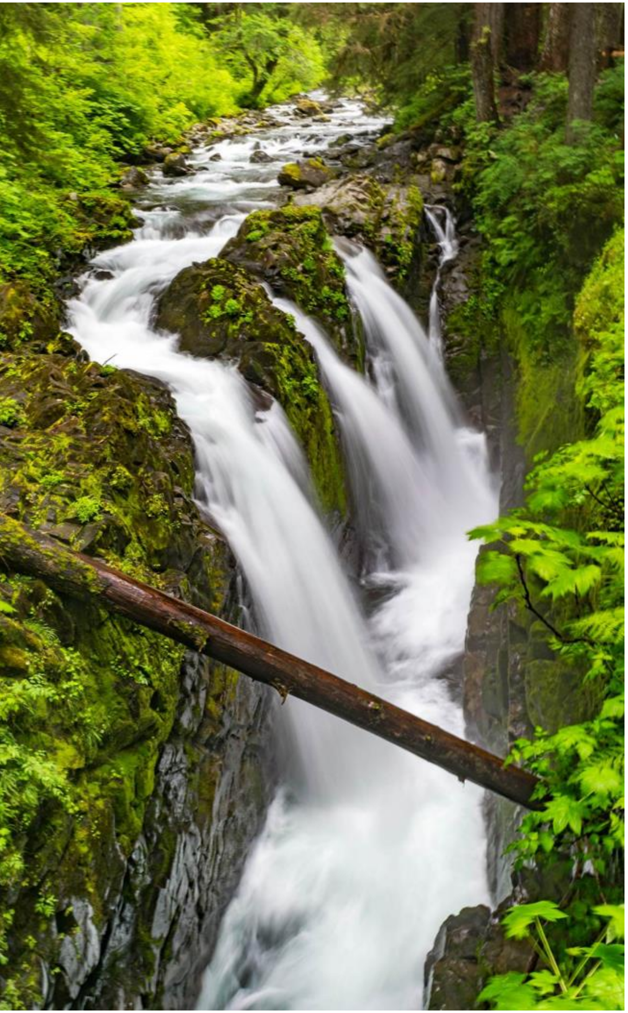
- Are significant assumptions well documented?
- Is data being utilized the most relevant for the intended purpose?
- Does the methodology anchor to a specific result for CECL as a percent of loans?

### MANAGEMENT'S SPECIALISTS/ THIRD PARTIES

- Is post-adoption monitoring "due diligence" needed?
- Have we reassessed the use of the specialist/third party?
- Are controls established by the specialist/third party sufficient to rely on information (SOC 1)?

### ESTIMATION UNCERTAINTY

- Where are sources of estimation uncertainty?
- Has a loss driver analysis been completed?
- What were the results of back-testing/retrospective review?



# CECL Risk Assessment

*Get more granular to assess control systems*

Management should...

1. *Consider elements of the estimate*

   (Completeness and accuracy of inputs, method selection and techniques, uncertainty, management bias)

2. *Assess objective inputs*

   (Current loan data, historical losses, prepay rates, contractual terms)

3. *Assess subjective inputs*

   (Management adjustments for current conditions/forecasts, discount rates, or cash flow assumptions, recovery estimates, definition of default)

4. *Ensure integration of IT general controls and the ACL*

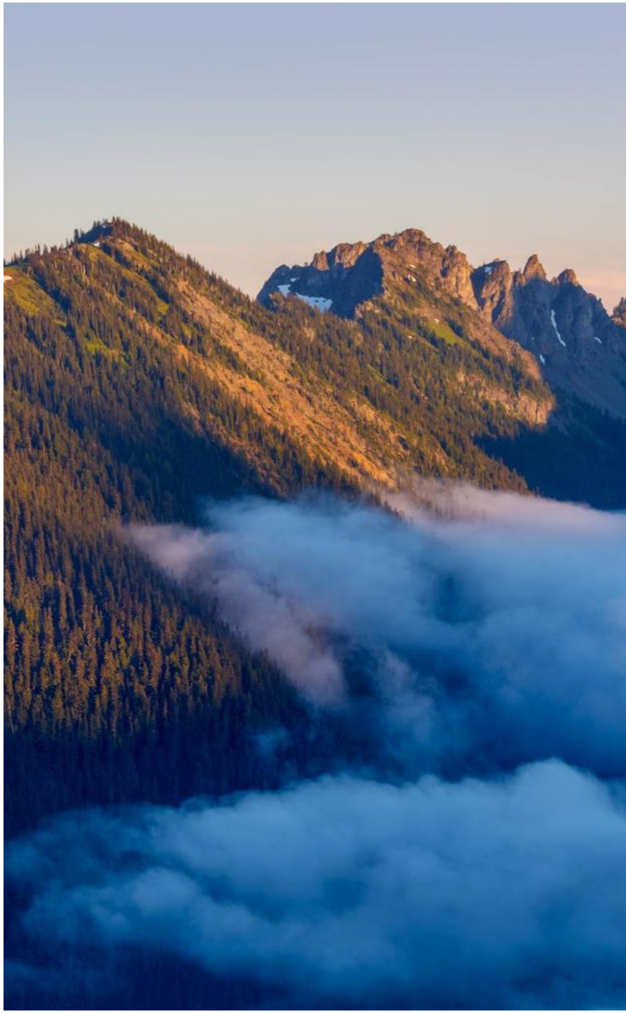
   (Management adjustments for current conditions/forecasts, discount rates, or cash flow assumptions, recovery estimates, definition of default)

# CECL Risk Assessment

*Transition from risk assessment to control activities*

At the conclusion of an effective risk assessment exercise, action items are as follows:

- Compare identified risks to current control activities
- Identify control gaps or enhancements needed
- Assess desired precision vs resources available
- Put together an action plan
- Ensure all relevant stakeholders are part of the process



# CECL Best Practices: Effective Model Validation Process

# Key Elements of a Model Validation

*A model validation is a set of process and activities intended to verify that models are performing as expected and in line with both the design objectives and business use purpose.*

An effective model validation has three core elements:

1) Evaluation of conceptual soundness
2) Ongoing monitoring, including process verification and benchmarking
3) Outcomes analysis, including back-testing

# CECL Validation:
# Evaluation of Conceptual Soundness

**RISKS/POTENTIAL ERRORS TO ADDRESS**

- Model selected might not be optimal for the bank
- Quality of model design and construction inadequate
- Data (internal loan, peer, economic) is not relevant to address risks
- Model may have limitations to fully estimate lifetime credit losses
- Q-factors and forecasts may be double-counted, misused, or  not supported

The importance of documentation cannot be overstated!

# CECL Validation: Ongoing Monitoring

Confirm that the model is appropriately implemented and is being used and performing as intended:

## MAIN COMPONENTS:

1) **Process verification:** checks that all components are functioning as designed
2) **Evaluate changes:** tests whether changes in operations, credit, market conditions, etc. have necessitated model adjustment
3) **Benchmarking:** comparing a model's inputs and outputs to estimates from data or other models

# CECL Validation: Outcomes Analysis

**HOW DO WE KNOW THE MODEL IS WORKING AS INTENDED?**

- Compare model outputs to corresponding actual outcomes
- Back-testing: assesses actual outcomes with model forecasts during a sample time period not used in model development
- Utilize previous sensitivity or stress testing to assess assumptions and inputs used

# CECL FASB Update

# Financial Instruments—Credit Losses (Topic 326)—Purchased Financial Assets (CECL)

## Project Objective

- To address investor concerns related to comparability and complexity resulting from:
  - PCD vs. Non-PCD
  - “More-than-insignificant deterioration of credit”
  - Non-PCD “double count”
  - Non-PCD interest income

## Current Status and Next Steps

- Proposed ASU issued in 2023
- The Board is conducting redeliberation of the proposed ASU
- No timeline for issuance, but moving forward

# QUESTIONS??

# Thank You!

THANK YOU

The material appearing in this presentation is for informational purposes only and should not be construed as advice of any kind, including, without limitation, legal, accounting, or investment advice. This information is not intended to create, and receipt does not constitute, a legal relationship, including, but not limited to, an accountant-client relationship. Although this information may have been prepared by professionals, it should not be used as a substitute for professional services. If legal, accounting, investment, or other professional advice is required, the services of a professional should be sought.

Praxity does not practice the profession of public accountancy or provide audit, tax, consulting or other professional services. Services are delivered by member firms, which are independent separate legal entities. The Alliance does not constitute a joint venture, partnership or network between participating firms and Praxity does not guarantee the services or the quality of services provided by participating firms. Praxity is not a ‘network’ within the meaning of the IESBA Code of Ethics. Praxity is organised as an international not-for-profit entity under Belgian law with its registered office in Belgium. Praxity has its registered administrative office at Suite 2, Beechwood, 57 Church Street, Epsom, Surrey KT17 4PX, UK. which is operated under Praxity - Global Alliance Limited (company number: 07873027), a limited by guarantee company registered in England and Wales.

Assurance, tax, and consulting offered through Moss Adams LLP. ISO/IEC 27001 services offered through Moss Adams Certifications LLC. Investment advisory  offered through Moss Adams Wealth Advisors LLC.