CECL Frequently Asked Questions

(Updated January 2019)

1. What is CECL?

The Current Expected Credit Loss (CECL) model is a new accounting standard update from the Financial Accounting Standards Board (FASB) for recognizing and measuring credit losses on loans and debt securities. CECL represents a change from the current incurred loss model, where credit losses are recognized once they are determined to be "probable" and "estimable". In contrast, the CECL standard generally requires lenders to estimate and book expected credit losses over the life of a loan at origination. Many observers judge CECL to be the most significant accounting change to the banking industry in decades.

2. Why is FASB changing to the CECL standard?

FASB believes that the incurred loss model displayed a number of shortcomings during the financial crisis. First, they judged there to be a delay in recognition of credit losses. As the magnitude of the crisis came into view, it became clear that lenders would realize substantial credit losses. However, those losses were not booked until they met the "probable" threshold, which generally coincides with impairment. FASB believed that a forward-looking estimate of credit losses will more closely align loss estimates with current and expected future economic conditions.

Another related issue for FASB was a perceived lack of transparency as to lenders' credit loss exposures. FASB heard from investors that they had to use their own estimates of expected credit losses, which were substantially higher than the amounts that financial institutions reported on their financial statements. As a result, bank share values fell before credit losses were recognized.

Finally, FASB believes that lenders were under-reserved heading into the financial crisis, and that a forward-looking model would have had financial institutions better prepared for the recession and alleviated the need for the dramatic rise in reserves experienced during the crisis. The implication is that, relative to the incurred loss method, CECL will be countercyclical; that is, it will result in financial institutions holding higher reserves than they otherwise would in good times, but would not require such sizable increases in reserves once credit conditions deteriorate. However, others contend that CECL's requirement to recognize losses over the life of a loan will result in greater volatility with the business cycle. If they are correct, CECL could potentially result in greater financial instability. This particular aspect of CECL was the subject of a recent Congressional hearing.[1]

3. Why are credit unions subject to CECL?

There is an inherent misalignment between FASB's objectives in developing the CECL standard and the credit union industry. In the first place, a primary goal for CECL was to provide more reliable information on credit loss exposure to outside investors. Since outside capital is not

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[1] United States House Committee on Financial Services, Subcommittee on Financial Institutions & Consumer Credit. *Assessing the Impact of FASB's Current Expected Credit Loss (CECL) Accounting Standard on Financial Institutions and the Economy*. Hearings, Dec. 11, 2018.

even available to most credit unions, the standard is addressing a problem which simply does not exist within the credit union industry.

Secondly, credit unions did not engage in the types of lending practices that precipitated the crisis, and which ultimately led to the dramatic credit losses experienced during the crisis. Although credit unions were subject to the general decline in economic conditions during the Great Recession, their loans still performed far better than bank loans.

From the outset, NAFCU has stressed these points to FASB. However, FASB historically has been reluctant to create exemptions from its accounting standards. At this time, CECL will go into effect for both banks and credit unions.

4. What is the effective date for credit unions?

FASB created a staggered effective date for the CECL standard. In doing so, it recognized three classes of institutions: (1) SEC-filer public business entities (PBEs); (2) non-SEC-filer PBEs; and (3) non-PBEs. The effective dates for each are as follows:

Institution Type	Effective Date
SEC-filer PBE	Fiscal years beginning after Dec. 15, 2019, including interim periods within those fiscal years
Non-SEC-filer PBE	Fiscal years beginning after Dec. 15, 2020, including interim periods within those fiscal years
Non-PBE	Fiscal years beginning after Dec. 15, 2021, including interim periods within those fiscal years

Credit unions fall into the third category of non-public business entities. For call report purposes, all credit unions will need to incorporate credit loss estimates based on the CECL method starting with the first quarter 2022 call report.

Having said that, many sources are advising banks and credit unions to have their CECL processes in place one to two years prior to the effective date, in order to allow for parallel runs of CECL and the incurred loss model. This will provide the institution with greater certainty of the impact on capital and help the institution refine its processes prior to the effective date.

5. What is the CECL methodology for estimating credit losses?

In defining the CECL standard, FASB identified three key considerations that must be present in the measurement of expected credit losses: (1) relevant information about past events, including historical experience; (2) current conditions; and (3) reasonable and supportable forecasts that affect the collectability of the reported amount. Beyond this general framework, the standard is not prescriptive as to a particular type of model. FASB acknowledges that judgment must be used to determine, for example, the relevant information that impacts an institution's credit losses.

6. **What type of loss estimation model must I use? What level of sophistication will be required?**

   The standard is largely silent on the type of model that should be used. A NAFCU-sponsored CECL study reviews some of the available alternatives, along with the performance of each model tested on a common loan portfolio.

   In its review of the costs of CECL, FASB states that it intentionally "allowed various estimation methods because of the emphasis placed on the importance of a scalable approach for institutions of all sizes."[2] The banking agencies reiterated this in a 2016 CECL FAQ: "CECL is scalable to institutions of all sizes and the agencies expect smaller and less complex institutions will not need to adopt complex modeling techniques to implement the new standard."[3]

7. **What additional data will I need to collect?**

   One of the key anticipated costs to implementing CECL surrounds data collection and warehousing. As compared to the incurred loss methodology, CECL will likely involve increased data requirements. Additionally, credit unions may desire to maintain loan data over an entire business cycle.

   While the specific pieces of loan data used in a CECL model will vary, some common ones may include origination dates and balances, maturity dates, changes to delinquency status, loss history, borrower information including risk indicators, and other segmentation data. In a recent survey of NAFCU members, respondents reported that they anticipate collecting 22 percent more data points than they do presently.

   In addition, credit unions may want to recover and scrub historical data, if available, to populate the new data fields under CECL. In that same survey of NAFCU members, respondents said that on average they plan to incorporate six years of historical data.

8. **How will CECL impact my capital?**

   A critical consideration for credit unions will be the impact of CECL on capital. FASB did not allow lenders to build up their reserves in anticipation of CECL's effective date. As a result, many credit unions could experience a sharp increase in expected credit losses on the effective date, which could lead to a capital outage. This dynamic highlights the importance of early testing of CECL models prior to 2022.

   NAFCU continues to stress to FASB and lawmakers that credit unions have limited access to capital. As a result, the industry is uniquely impacted by the CECL standard. The possibility exists that credit unions could see their capital classification downgraded as a result of CECL, and it is likely that many credit unions will see their capital buffers shrink.

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[2] FASB, *Understanding Costs and Benefits: ASU Credit Losses (Topic 326)*, June 16, 2016.
[3] Federal Reserve, FDIC, NCUA, and OCC, *Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses*, December 19, 2016.

9. What additional CECL resources does NAFCU offer?

The following resources are available to NAFCU members and subscribers:

- CECL Study: Alternatives, Impacts, Accuracy, and Complexity (April 2017)
- Economic & CU Monitor (July 2018)
- Letter to FSOC on the Impact of the CECL Standard on Credit Unions (December 18, 2018)
- NAFCU Educational Resource Library