SUPERVISORY COMMITTEE'S ROLE IN CECL

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Objectives:

1. Discuss Supervisory Committee's role in the implementation of CECL.
2. Examine how Supervisory Committees can help their credit unions in a more effective implementation.
3. Examine the CECL implementation process including potential pitfalls and where credit unions should be today.

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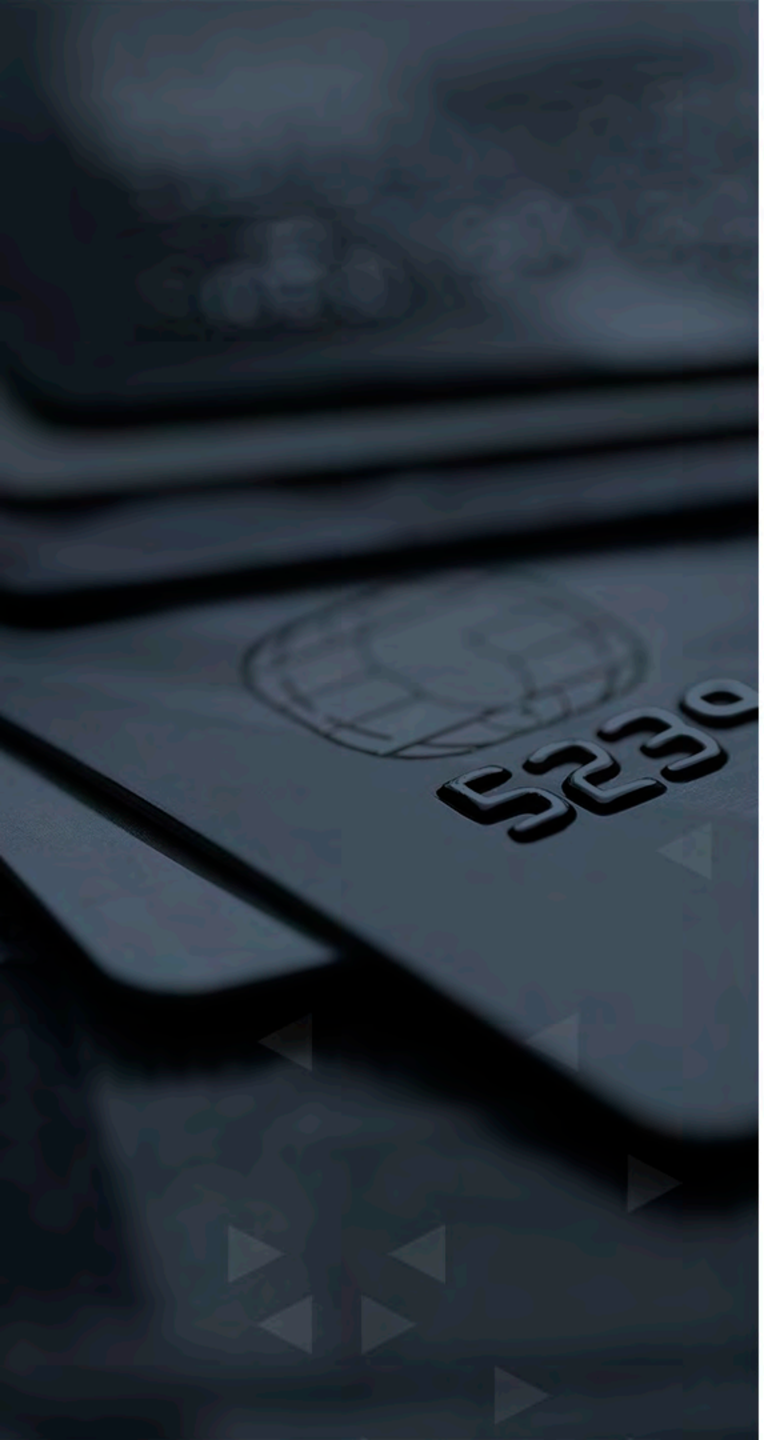

Supervisory Committee’s Role in CECL

Volunteer Leadership Institute – Hawaii 2019

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Today’s Agenda

- Cover regulatory expectations for BOD/Supervisory Committee involvement in ALLL estimates
- Cover new regulatory guidance for BOD/Supervisory involvement in CECL
- Discuss CECL implementation process
- Discuss how BOD/Supervisory Committees can maximize their role in implementing CECL

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Current Regulatory Expectations for BOD/Supervisory Committees in ALLL

Current Regulatory Expectations for BOD/Supervisory Committees

Question: Why does current regulatory expectations matter when talking about CECL?

Answer: Although current guidance was created for incurred loss estimates it provides a roadmap of expectations for creating an estimate under CECL

Sources of Current Regulatory Expectations for BOD/Supervisory Committees

For credit unions, regulatory expectations for BOD/Supervisory Committees involvement are primarily contained in the following:

- Interpretative Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions*, issued by the NCUA in May 2002 (IRPS 02-03)
- December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses (Interagency Statement)

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Regulatory Expectations for BOD/Supervisory Committees in IRPS 02-03

- Responsible for ensuring that control are in place to determine the appropriate level of ALLL
- Ensure policies specifically address unique risks and profile of credit union before approving them
- Each reporting period's provision and ALLL should be reviewed and approved by BOD
- Independent review of management's methodology and documentation by supervisory committee, internal or external auditors

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Regulatory Expectations for BOD/Supervisory Committees in Interagency Statement and FAQ's

- Reviewing and approving the institution's written ALLL policies and procedures at least annually
- Reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the institution
- Reviewing management's assessment and justification for the amounts estimated and reported each period for the PLLL and the ALLL
- Requiring management to periodically validate and, when appropriate, revise the ALLL methodology.
- Examiner expectation to consider the effectiveness of board oversight

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Key Takeaways from Current Regulatory Guidance

All of the current BOD/Supervisory Committee expectations will continue to exist going forward once CECL is implemented

If you are uncertain today on these expectations, revisit

Additional regulatory expectations will evolve over time

Key question for today is what additional involvement is necessary to ensure a successful implementation and transition to CECL

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New Regulatory Expectations for BOD/Supervisory Committees in CECL

New Regulatory Guidance for CECL

Formal regulatory expectations and guidance for CECL to date are set forth in the following

- ✓Joint Statement on the New Accounting Standard on Financial Instruments - Credit Losses (June 2016)
- ✓Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses (last updated September 2017)

Regulatory Expectations for BOD/Supervisory Committees in CECL Regulatory Guidance

- Requires attention of each credit union's board of directors
- BOD is responsible for oversight of senior management's implementation
- BOD should become educated on the standard and how it differs from today's incurred loss methodology
- BOD should be involved, to some extent, in discussion on how to best implement the new standard in a appropriate manner for the credit union's size and complexity

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Key Takeaways from New CECL Regulatory Guidance

Credit unions BOD are more comfortable with ongoing controls and monitoring

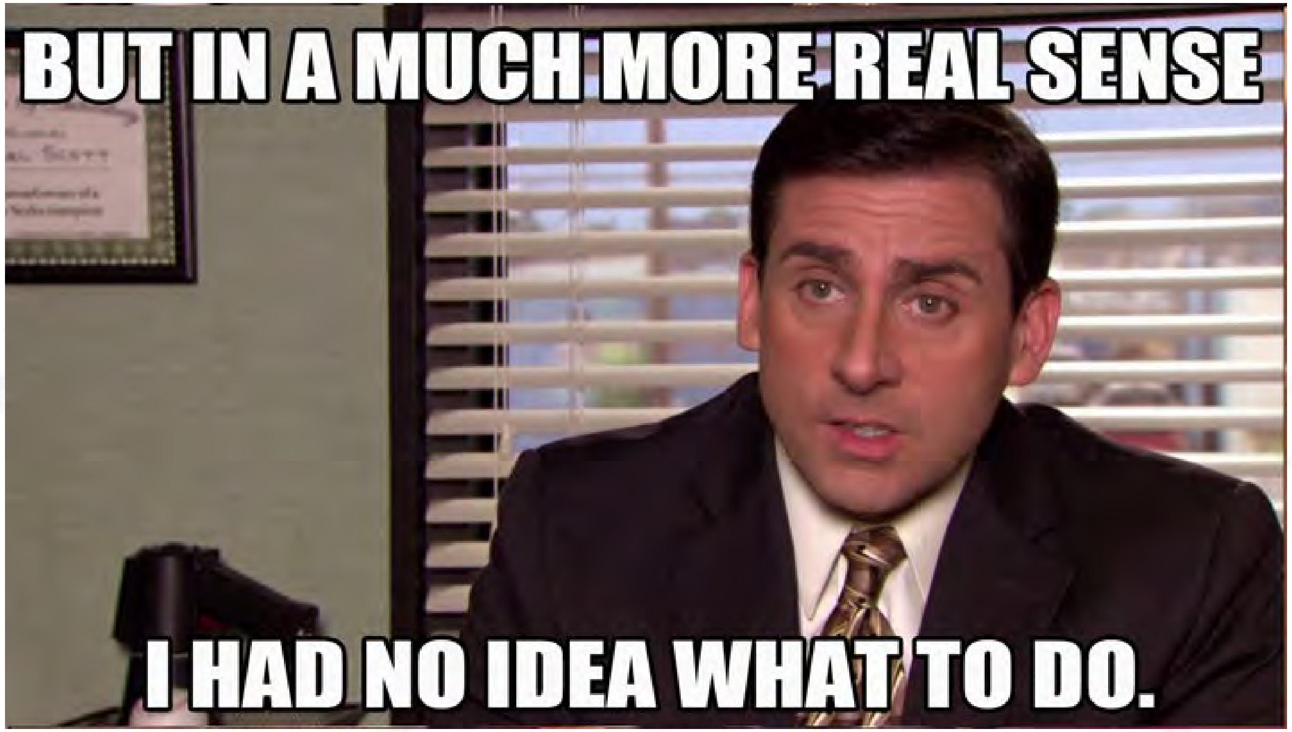
Day 1 implementation brings it's own set of challenges, processes and controls that need oversight by the BOD

Getting comfortable with the estimates being created under brand new models and inputs requires more work

Each BOD needs to determine how best to maintain open communication and involvement with management

CECL Implementation Process

IMPLEMENTATION – LESSONS LEARNED



CECL READINESS & IMPLEMENTATION PROCESS

Planning & Readiness

- Education
- Create committee & timeline
- Determine in-scope financial assets
- Pooling segment identification
- Data inventory & gap analysis

Implementation

- Model(s) selection & development
- Model(s) finalization & parallel run
- Modify policies, procedures, controls & disclosures

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OVERALL IMPLEMENTATION CONSIDERATIONS

- Document conclusions & process followed in selecting models & complying with the standard
- It is a substantial project management challenge so make sure you have implemented appropriate monitoring tools (timelines, project manager, etc.)
- The overall implementation process will be scalable based on size & complexity of institutions

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IMPLEMENTATION/STEERING COMITTEE

- Responsibilities should include
  - Develop an understanding of the standard & regulatory guidance
  - Communicate with executive management & those charged with governance
  - Monitor regulatory guidance & industry trends
  - Designate project manager(s) to track status
  - Determine if outside vendors are needed & follow third-party risk management guidance
  - Consider potential effect on capital & capital planning
  - Outreach with external auditor & regulators
  - Consider effect of future events such as
    - Acquisitions
    - New product lines (lack of loss history)
    - System conversions

IMPLEMENTATION/STEERING COMMITTEE

- Highly recommend using an implementation committee, including senior management from the following:
  - Accounting/Finance
  - Credit
  - Risk
  - Operations
  - IT
  - Audit

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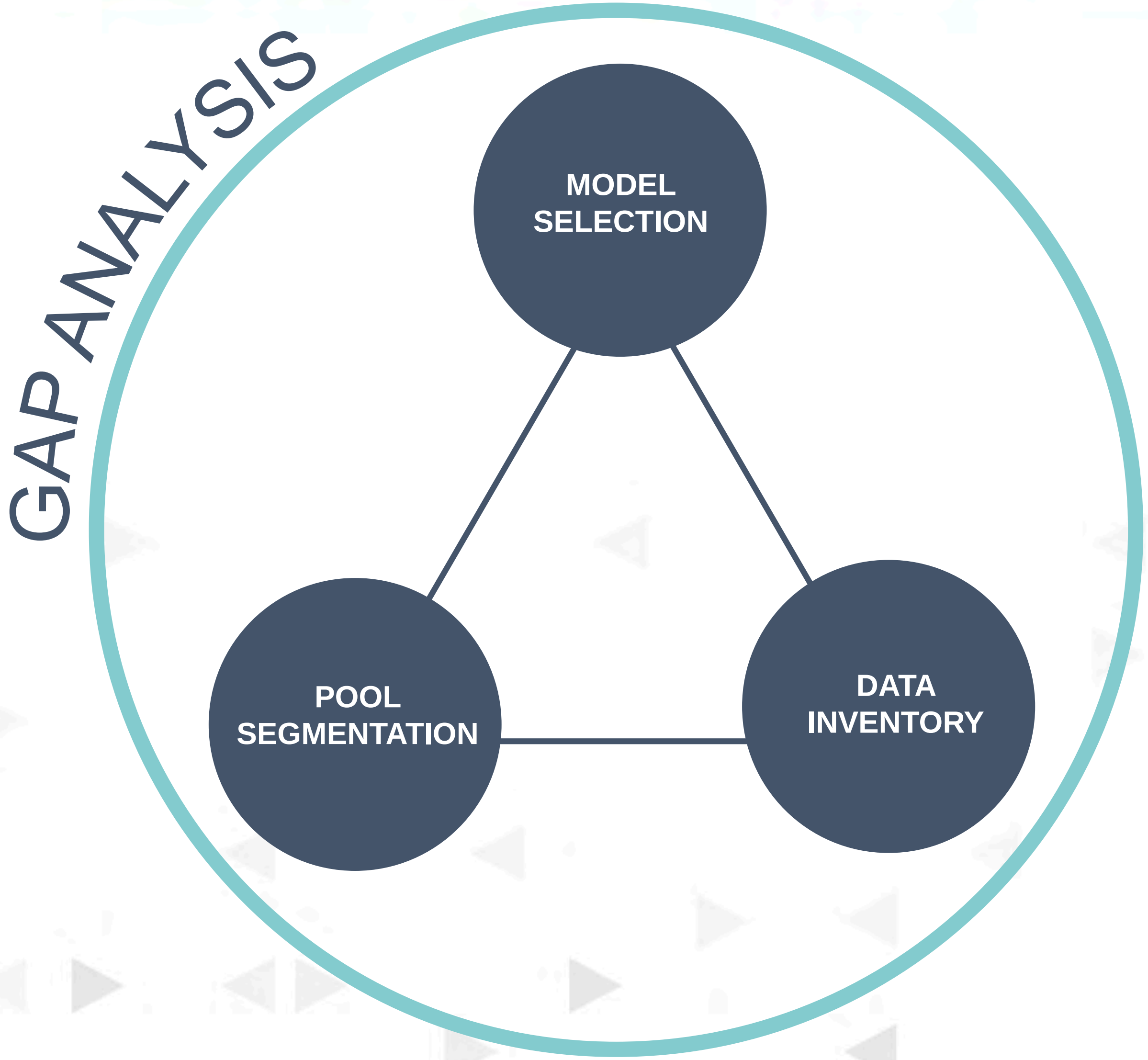
CECL IMPLEMENTATION TRINITY



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POOLING SEGMENTS IDENTIFICATION

ASC 326-20-30-2:

"An entity shall measure expected credit losses of financial assets on a collective (pool) basis when similar risk characteristic(s) exist (as described in paragraph 326-20-55-5)."

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POOLING SEGMENTS IDENTIFICATION

Aggregation of similar risk characteristics in ASC ***326-20-55-5*** may include one or a combination of the following (not all inclusive)

- Credit ratings
- Risk ratings or classifications
- Collateral type
- Size
- Term
- Geographical location
- Industry of the borrower

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POOLING SEGMENTS IDENTIFICATION

Standard is non-prescriptive in how to determine appropriate level of aggregation of similar risks for pooling. Consider the following best practices:

- Start with how you pool based similar risks today under ASC 450
- Using both ASC 326-20-55-5 and how your institution manages credit risk as a guideline to identify potential areas for additional or reduced segmentation
- Using **dollar, count** and **loss/default events** determine whether current and potential future pooling have statistical relevance
- Consider the reliability of data fields being considered for segmentation (i.e. LTV, DSCR, FICO, NAICS)
- Look to historic loss experience in different risk characteristics being considered to support conclusions

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DATA INVENTORY & GAP ANALYSIS

Scalability of this process is driven off:

- Institution's pooling risk characteristics
- Models being considered by an institution
- Does the institution have an existing data warehouse and has it been audited

DATA INVENTORY & GAP ANALYSIS

Four main areas of data gaps and issues

- What you don’t have
- What you do have
- How you got it
- How you will maintain it going forward

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DATA INVENTORY & GAP ANALYSIS

What you don't have:

- Inability to access historic data after a certain time frame
- Lack of quality historic data from acquired institutions
- Data points for future forecasts

DATA INVENTORY & GAP ANALYSIS

What you do have:

- Accuracy and consistency of how data is input and recorded into loan systems
- Changes in underwriting or grading systems causing lack of consistency in historic data sets

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DATA INVENTORY & GAP ANALYSIS

How you got it:

- Validation of completeness & accuracy of data
- Documented internal controls

DATA INVENTORY & GAP ANALYSIS

How you will maintain it going forward:

- Maintained in-house vs. vendor solution
- Spreadsheet controls
- Documented internal controls over changes

MODEL SELECTION

Specific model approach is not mandated; however, start by considering what is used currently

Institutions can leverage existing credit risk management systems & allowance methods, including

- Loss rate methods
- PD/LGD
- Discounted cash flow

MODEL SELECTION

“The agencies do not have a definition for smaller and less complex. We have not established a bright line. Maybe another way to really look at it as that we're saying generally an institution should not have to leapfrog into an econometric model or a discounted cash flow model for pools to estimate CECL if you are not already using that type of methodology. ***So for example, if you're using a loss rate based methodology, and there are several of those, it's not likely that you'll have to move to an econometric model or a discounted cash flow model.*** *It is likely you'll be able to continue use the type of methodology that you have been using under the incurred loss (method). But please note, your assumptions and inputs will need to change in order to arrive at a lifetime estimate.”*

Source: Joanne Wakim Chief Accountant, Federal Reserve July 30, 2018 CECL Q&A for Community Institutions

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How can BOD/Supervisory Committee maximize their role in implementing CECL

Maximizing the Role of BOD/Supervisory Committee

The level of involvement of BOD/supervisory committees can vary but needs to meet the regulatory expectations discussed

When determining the level of involvement consider the following:

- Expertise and availability of management's resources
- Size and complexity of the credit union
- Other potential large projects that may impact resources
- Is management considering vendor vs internal models
- History of issues in current ALLL/control structure

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Maximizing the Role of BOD/Supervisory Committee

Consider the following for maximizing the role of the BOD/Supervisory Committee:

- Set the tone at the top
- Require management to formalize an implementation timeline and committee
- Set a defined frequency for reporting to the BOD/supervisory committee on progress
- Create a monitoring process to hold management accountable to their timeline and plans
- All discussions and formal reporting to the BOD needs documentation in minutes
- Make sure management is creating good quality documentation to support conclusions reached and implementation efforts undertaken to be provided to regulators and external auditors
- Look for continual education to stay current on CECL
- Have a member of the BOD/supervisory committee on the CECL committee
- Consider the need for external expertise to supplement BOD expertise
- Consider model validation and control testing prior to implementation (internal audit vs external)
- Make sure management is starting now and performing a gap analysis and have planned for a parallel run

Questions?

Thank You!

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