# CECL Frequently Asked Questions

*(Updated August 2020)*


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1. **What is CECL?**
   The Current Expected Credit Loss (CECL) model is a new accounting standard update from the Financial Accounting Standards Board (FASB) that was first finalized in 2016. The purpose of CECL is to improve recognition and measurement of credit losses on loans and debt securities. CECL represents a change from the 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

[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. Although we at NAFCU continue to work every angle in order to provide relief to credit unions from the CECL standard, we urge our members to begin the process for developing a CECL-compliant loss reserving methodology as soon as possible. CECL is a massive departure from the incurred loss method, and for most credit unions will involve the collection of a broader range of data, require additional staff training and coordination, and result in an immediate loss of capital when new reserves are recognized.

### 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. In October 2019 FASB announced a delay which brought the effective dates for non-SEC-filer PBEs and non-PBEs into alignment. 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, 2022, including interim periods within those fiscal years |
| **Non-PBE** | Fiscal years beginning after Dec. 15, 2022, 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 2023 call report.

It should be noted that many sources are advising banks and credit unions to have their CECL processes in place one year 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. However, the NCUA has not stated whether it expects parallel testing to occur at any particular time, or whether such tests are strictly necessary.

### 5. What are the chances of seeing legislation to block CECL?

Some members of Congress have been outspoken in their concerns over the impact CECL could have on financial institutions and the broader economy. In August 2020, House Financial Services Committee Member Blaine Luetkemeyer, R-Mo. introduced a bill to eliminate regulatory requirements that would compel financial institutions to adopt CECL. Luetkemeyer

has long criticized the CECL standard, arguing that it could negatively impact credit unions' ability to lend to consumers in need. He was part of a bipartisan group of lawmakers who introduced a "stop and study" bill in 2019.

However, there are a number of headwinds facing such a legislative solution. First, Congress has typically been reluctant to involve itself in FASB decisions. FASB is a private standard-setting body, and Congress has historically chosen not to venture into the domain of challenging FASB on accounting issues. Second, with a divided Congress any solution must be a bipartisan one. Nevertheless, unexpected financial disruption caused by the COVID-19 pandemic has likely changed the political calculus around CECL. NAFCU will continue to engage with members of Congress on this issue.

6. **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.

7. **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]

8. **I am a small credit union. Is there an example of a loss estimation model that would be appropriate for me?**

In July, the NCUA Board proposed to exempt credit unions with assets under $10 million from the CECL standard. In doing so, the Board is using its authority under the Federal Credit Union Act to apply non-GAAP accounting for loan losses to credit unions below that threshold. If finalized, those credit unions could continue to use the incurred loss method for credit loss recognition.

Currently there is no asset threshold for CECL, and many critics argued that the standard would be particularly challenging for small financial institutions. This is an especially relevant question

[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.

for the credit unions industry, where the median institution has just over $30 million in assets and only eight full-time employees. In response to such questions, FASB, NCUA, and the other banking regulators have offered one voluntary option: the weighted-average remaining maturity, or WARM, method. In January 2019 FASB staff issued a Q&A document outlining the method and showing examples. In an April 2019 "Ask the Regulators" webinar, the federal banking regulators, including NCUA, presented similar material on the WARM method.

Although the WARM method is presented as a straightforward, spreadsheet-based solution that can be implemented by any sized institution, credit unions should thoroughly review the method before adopting it. This would involve an end-to-end examination of the loss estimate and disclosures at adoption, but also for subsequent years. Dialogue with your auditor during the selection process and leading up to CECL's effective date is critical.

### 9. 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.

### 10. How will CECL impact credit union 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. In order to ease the transition from the incurred loss method to CECL, the federal banking regulators provided banks with a three-year capital phase-in option. Under the option, banks would generally take the difference between retained earnings in the period immediately prior to CECL adoption and retained earnings in the period of CECL adoption. Banks would then be able to count as regulatory capital a declining share of that amount over the phase-in period. In July 2020, the NCUA Board proposed a similar rule for credit unions, which would work as follows:

- Quarters 1-3 (2023) - retained earnings and total assets as reported on the Call Report are increased by 100 percent of the FICU's CECL transitional amount
- Quarters 4-7 (2023-2024) – Call Report retained earnings and total assets increased by 67 percent of the FICU's CECL transitional amount.
- Quarters 8-11 (2024-2025) – Call Report retained earnings and total assets increased by 33 percent of the FICU's CECL transitional amount.

- Quarter 12 (Q4 2025) - FICU's net worth ratio will completely reflect the day-one effects of CECL.

If finalized, such a provision would ease the transition, but the overall capital impact could still be significant for many credit unions. This 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 and the NCUA has limited authority to accommodate CECL's impact on net worth. 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 and some could enter prompt corrective action status.

Below are some impact estimates across a range of scenarios:

| | | Aggregate Drop in Net Worth ($B)* | | | | Additional Nbr of FICUs subj. to PCA* | | | |
|---|---|---|---|---|---|---|---|---|---|
| **Asset Class** | **Nbr. Of FICUs** | **+25% ALLL** | **+50% ALLL** | **+100% ALLL** | **+150% ALLL** | **+25% ALLL** | **+50% ALLL** | **+100% ALLL** | **+150% ALLL** |
| <$50M | 3,040 | $0.1 | $0.2 | $0.3 | $0.5 | 16 | 42 | 109 | 166 |
| $50M - $100M | 680 | $0.1 | $0.1 | $0.2 | $0.3 | 4 | 8 | 17 | 30 |
| $100M - $250M | 679 | $0.1 | $0.3 | $0.6 | $0.8 | 2 | 3 | 13 | 23 |
| $250M - $500M | 333 | $0.2 | $0.3 | $0.7 | $1.0 | 3 | 4 | 7 | 15 |
| $500M - $1B | 259 | $0.3 | $0.5 | $1.0 | $1.5 | 1 | 2 | 5 | 7 |
| $1B+ | 317 | $1.3 | $2.7 | $5.5 | $8.2 | 0 | 0 | 1 | 1 |
| **Total** | **5,308** | **$2.0** | **$4.1** | **$8.3** | **$12.4** | **26** | **59** | **152** | **242** |

*NWR = Net worth ratio*

** Figures are specific to each scenario (i.e., should not be added across scenarios)*

*Estimates based on credit union call report data as of June 30, 2019*

### 11. What are NCUA's expectations at this stage?

NCUA listed CECL as a supervisory priority for 2019, stating that "examiners will inquire about efforts a credit union has taken to prepare for the new accounting standard, and whether a credit union has performed analysis for how CECL would alter the Allowance for Loan and Less Losses funding needs." In May the agency released a CECL questionnaire that examiners will use to assess a credit union's progress in preparing for the standard.

Additional guidance related to supervisory expectations upon adoption of CECL and the development of credit review systems can be found in the following policy statements:

- Interagency Policy Statement on Allowances for Credit Losses (effective at the time of each institution's adoption of CECL)
- Interagency Guidance on Credit Risk Review Systems (describes a broad set of practices that can be used either within a dedicated unit or across multiple units throughout an institution to form a credit risk review system that is consistent with safe and sound lending practices)

## 12. 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)
- NCUA AIRES Questionnaire (May 2019)
- NAFCU Educational Resource Library
- NCUA CECL Resources Webpage