CECL – A Key Element in the Planning Process

Imminent changes will arise from the adoption of new accounting rules for the recording and reporting of credit risk (the Current and Expected Credit Loss “CECL” rules within FASB 825-15). Although the changes will be difficult, there will be tremendous strides in knowledge that will come from the need to record data on risk and risk outcomes that has not formerly been tracked, mainly because previous accounting rules did not require such information.

The new rules will engender a change in how data is gathered, what data is gathered and how that data must be reported. These changes are needed in order to satisfy a complex and different approach to credit risk by accounting for the future risk within a portfolio of loans and securities. The intent of this paper is to look at the new information that has or will become available and observe how this can and should be used by three different but very important audiences: the Boards of Directors, the Chief Executive Officers and the Chief Risk Officers. All have different agendas, but all have the same objectives. They must comply with the regulations and the accounting standards, but their responsibilities and needs go well beyond accounting, for they have to protect the shareholders from loss while at the same time manage the institution profitably.

Looking at the challenge in three directions is important. Risk managers have a very clear priority to make sure that the CEO can rely on their skill and judgment as does the CEO with the Board of Directors. The Board of Directors is in perhaps the most awkward position for their view of risk is generally limited by the information that the CEO provides them and many do not have the background to question whether that information is of sufficient depth or quality for them to carry out their duties as Directors.

For many banks the accounting changes can be cathartic. There are many examples of banks where the focus is on two elements: stopping the bad credit applications from getting approved and then focusing on ensuring that the bad ones that did get approved are managed to achieve the lowest possible loss. Loans that are performing as expected are simply off the radar. But CECL changes all that. The big difference is that the changes will come from the performing loans as much or more than from those that decline or fall into bankruptcy. Every loan throughout its life will have a reservation against loss and the amount of that reservation will change each time a set of financial statements is prepared.

The primary problem faced by the CRO is that, if asked, the CEO would generally be in favor of less risk while at the same time hoping for or expecting better returns. The business planning process tends to begin with a demand for growth in assets and profitability directed at the business heads and the CRO is expected to simply react to the consequences as business comes in.

So, the risk manager has to ask the CEO what his expectations are for the risk of the portfolio given the directive for significant growth. If the answer is that lower risk is preferable, then the consequences have to be addressed. If the answer is that the current risk profile is acceptable

there will be a risk plan together with the revenue plan which is where the risk manager needs to go.

If the CRO worries about risk, the CEO is paid to worry about everything. The CRO has to make sure that the CEO is well versed in risk concepts and well informed on risk measures and changes that are taking place. The unenviable task will be to take the changes and inform the CEO and the Board of the causes and of the steps that are being taken to keep the ship on an even keel. The CEO will be taking these to the Board where the knowledge level and experience will be varied. Only the most important items move upward.

Every CEO and every Board member must understand Expected Loss (EL). The CECL rules will have a profound effect on the reported earnings in the future. The CEO needs to see the forecast, for EL as part of the planning cycle for the macro economic environment is always a key consideration and there will be times where prudence dictates the plans for growth.

Not only is EL a key element in the planning process, it is a key element in the communication to the Board and a key element in the ongoing monitoring of the portfolio. If EL is the foundation of CECL and if the CEO must show it to the Board then the CEO will most certainly want to be able to answer any questions that arise from that disclosure.

The Board will always, for the most part, have to rely on what they see and thus on the CEO. But with the advent of CECL there is an opportunity for a substantial upgrade in the relationship of the Board and CEO when considering credit risk. It will be much harder to ‘store’ problem loans until they reach the watch list or worse. The data that is essential for compliance with the CECL rules mean that the CEO will have the facts to put to the Board that were altogether unavailable in the past.

It is likely that the CECL rules will have a major impact on the interests of the CEO for suddenly the 98% of the loan portfolio that is performing will require a charge that will hit the bottom line. If current forecasts are true, then this impact could be very significant indeed. Estimates by FASB and several analysts are for loss provisions to rise by 50% or more in the first year. It is highly likely that the senior management is going to need to know why this is happening and how they need to communicate it to people for whom such a precipitous change may well be alarming – including the Board of Directors, shareholders, regulators, and auditors.