FINASTRA

WHITE PAPER

PREPARING FOR CECL 2020: CONSIDERATIONS FOR US FINANCIAL INSTITUTIONS

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CONTENTS

EXECUTIVE SUMMARY

The new CECL (Current Expected Credit Loss) accounting standard takes effect in January 2020. It overhauls the way potential credit losses are calculated and accounted for by US financial institutions, and will fit in alongside the IFRS 9 standard that was implemented in January 2018 by most international banks. In this paper, we examine CECL's relationship with financial institutions' risk appetites and balance sheet volatility, as well as the challenges posed by impairment modelling and classification of loan instruments and assets under CECL.

One of the key differences between IFRS 9 and CECL is the timing of their introduction. With CECL coming into force two years after IFRS 9, US banks have a golden opportunity to observe and assess the implementation strategies of their international counterparts for IFRS 9, and make informed choices around CECL based on what did and didn't work well with IFRS 9.

From the day it comes into force, CECL may dramatically increase the capital provisions required to be held by financial institutions – but this effect will be offset going forward by lower volatility. CECL also offers various options for how financial institutions pool their assets and model Expected Credit Loss for those pools, with each potential choice bringing its own pros and cons. All of this means CECL has major implications for financial institutions' risk management and risk appetite.

Looking across the industry, financial institutions are essentially taking two approaches to implementing CECL. The first – widely termed the 'day 1' approach – focuses primarily on compliance, and centers on the choice of models and their applicability to the financial institution's portfolio. The second approach looks beyond compliance, and focuses on leveraging the new accounting standard as an opportunity to reach a wider, risk-based strategic end state in 'day 3'.

Experience with IFRS 9 confirms that the second approach is likely to be the more effective of the two in the long run. A 'day 1' approach might deliver compliance in January 2020, but is likely to result in additional costs and potentially full system re-platforming in the subsequent months and years. A 'day 3' approach will equip a financial institution to absorb CECL into its business as usual, while positioning it much better for future agility and growth in a post-CECL world.

At the root, CECL offers US financial institutions an opportunity to put effective risk analysis and capital planning at the heart of their accounting and financial reporting. In Finastra's view, it's an opportunity they should embrace.

Learning from IFRS 9

> "US financial institutions can start by expecting automation as a minimum and optimization as an option."

Learning From IFRS 9

What can the US market learn from the experience of adopting IFRS 9? The headline news around both CECL and IFRS 9 is that the accounting provision for credit losses is moving from a historically experienced basis to an expected loss. This is a very significant change, and is likely to have a major impact both on the accounting provision (up to 50% increase) and the volatility of that charge.

Impairment Assessment

CECL differs from IFRS 9, which has a three-stage impairment assessment, by constantly using the lifetime probability of default (PD), even for newly-minted credits with no deterioration. The effect of this is that US financial institutions will take a larger initial hit as the entire book of business is assessed using the higher PD, but will experience less volatility moving forward, as they will not be impacted by stage migration.

Timing Issues

The majority of the world adopted IFRS 9 at the January 2018 start date, whereas CECL becomes effective in January 2020. This time lag allows US financial institutions to observe and assess the implementation strategies of their international counterparts, and to make informed choices based on those observations.

The international markets that had a 2018 start date fell largely into three groups. Group one simply complied with the regulation in a largely manual, spreadsheet-led manner. Group two complied but automated the reporting cycle to avoid the operational cost and risk. Group three looked at the transformative opportunity to weave the balance sheet management and volatility into the risk appetite adoption and optimized their risk adjusted use of capital. We firmly believe that by learning lessons from abroad and using the

two years of preparation time to implement a solution that brings together risk, finance and management, US financial institutions can start by expecting automation as a minimum and optimization as an option.

After looking at the banner headline of CECL – the move from historical to expected credit loss – it should be restated that for the most part, CECL and IFRS 9 overlap in intention and detail. This most evident when the intention of the accounting standard is considered. Both measures are asking management and controllers to look at credit losses in a considered way that takes account of past, current and forecasted conditions. In this regard, the intention of CECL is almost identical to that of IFRS 9, and both are really just the latest step in ensuring that financial institutions and their balance sheets are conservatively managed in such a way as to decrease significantly a repeat of the last credit crisis.

50%

The CECL standard is expected to significantly impact the accounting provision and volatility – an increase of up to 50%.

02 BALANCE SHEET VOLATILITY

> CECL is likely to increase the capital provision by between 30% and 50% – an impact that is in stark contrast with IFRS 9.

Higher Provisions

When exploring the impact that CECL is likely to have on balance sheets, and the implications this has for that financial institution's risk management function, a key question arises: are financial institutions prepared for higher capital provisions? This is because CECL will dramatically increase the capital provision required by financial institutions. What's more, this will be a 'day 1' impact, as the accounting standard requires financial institutions to move from accounting for historic losses towards expected future losses. Essentially, this single change is likely to increase the capital provision by between 30% and 50% – an impact that is in stark contrast with IFRS 9. (Note that the banking regulatory agencies have proposed a capital transition period, which would allow for a three-year straight-line amortization of the incremental effect that CECL will have on a bank's regulatory capital level at the effective date).

The reason behind the large increase in capital provision is that the new provision will use models that have been more traditionally associated with credit risk. Financial institutions will be able to pool assets on the basis of shared characteristics, including credit scores, asset type, loan size, geography or industry. Once the pooling has been decided, then a model is needed to calculate the Expected Loss (EL) for that pool. It is here that financial institutions must think seriously about the current and future impacts of the pooling characteristic.

Acceptable Approaches To Expected Loss

The regulator does not provide prescriptive guidance as to the methodology used to estimate expected credit losses provided it incorporates reasonable and supportable forecasts. The main acceptable EL approaches are the Discounted Cash Flow (DCF) model and the Probability of Default (PD)/Loss Given Default (LGD) model.

The DCF approach estimates the EL by projecting the future principal and interest, using scenarios such as prepayments, amortization profile, and expected Loss Rates. The allowance for credit losses will reflect the difference between the amortized cost basis and the present value of the expected cash flows, discounted at the Effective Interest Rate. Finally, this loss allowance could be transformed into default probability.

By contrast, the PD/LGD model approach is used in conjunction with 'Exposure at Default' (the value of the asset at the time of possible default or EAD) while the LGD model (the amount of the asset value that cannot be reclaimed through collateral), to give the expected loss amount that needs to be provisioned for.

The type of PD used in the CECL accounting standard is a lifetime PD, which – in simple terms – means the probability of the asset defaulting at any time during its entire lifetime. This is the big difference between CECL and IFRS-9. IFRS-9 uses a one-year probability for assets considered 'good' and reserves the lifetime PD for assets that are considered 'higher risk'. The resulting impact is that IFRS 9 financial institutions have a smaller starting capital provision increase, but face higher volatility as assets are considered riskier.

Exposure At Default

The EAD is a function of valuing the asset by using forward-looking yield curves. Between the PD and the EAD, we can see that there are significant reasons to expect an increase in balance sheet volatility and by extension, financial institutions' profitability. The main sources of volatility risks are:

- *Increases in PD* – This is where the credit score/rating of the asset or pool does not change, but the likelihood of default associated with that rating increases. This puts a multiplier at the heart of the provision calculation, and is likely to occur as economic conditions deteriorate for that pool – which could mean that balance sheet valuations are under pressure in any case.
- *Changes in PD* – This is where there is a more structural rating change in an asset or pool (this is mostly associated with corporate debt). Essentially the underlying PDs remain constant but the asset itself transitions between ratings/scores (such as moving from an AA to an A). This has the same effect as the PDs changing (above) and is a multiplier within the calculation.
- *Yield curve changes* – Changes in economic indicators such as yield curves will impact the effective interest rate and the EAD used to determine the provisioning. Unlike changes in PD, yield curve changes are less about credit risk and more about econometrics. Future economic changes – forecasted macroeconomics and market seasonality – will contribute strongly to the volatility and impact of the EL approach.

Pooling Choices and Risk Appetite

Overall, the likely increase in balance sheet/provision volatility means pooling choices are likely to be extremely important to financial institutions, as certain pool types are likely to be more susceptible to change than others. Obviously, the pooling selections will be dependent on the underlying book makeup and the volatility implications.

It is at this point that CECL becomes intertwined with the financial institutions' stated risk appetite. The risk appetite of a financial institution looks at the possible losses the financial institution may be exposed to as a result of:

- *Market risk* – Losses arising from strategic market decisions and investments (what the financial institution owes)
- *Credit risk* – Losses arising from not being paid unrealized gains (what is owed to the financial institution)
- *Liquidity risk* – The financial institution becomes unable to cover its debts due to discrepancies between liquid assets, incoming cash flow and outgoing cash flow

Clearly, balance sheet volatility has a huge impact on financial institutions' liquidity risk, and this volatility should be considered when financial institutions look to adhere to their stated risk appetite, which will include:

- Identification of both individual and cumulative risk factors
- Measurement and monitoring of those risk factors
- Matching risk factor monitoring to board agreed risk appetite/limits
- Reporting risks and limit breaches to risk committee
- Imposition of limits on front line business to support the risk appetite

Unique Impacts

Taken together, these factors mean CECL not only borrows from classic credit risk management, but actively impacts risk assessment and control across the financial institution. It is this aspect that makes CECL unique in terms of who it impacts and how that impact is felt. While it is 'only' an accounting number, its true impact will be felt by the CFO, the CRO, the risk department, the treasury and the frontline business units. Given the heightened focus on risk and volatility since the credit crisis, the risk factors CECL brings to the balance sheet should be included in any risk assessment or risk audit of a financial institution.

Including CECL in the risk assessment will mean stress-testing the pools, the PD models and the EAD models. Stress-testing will also need to be included in the annual liquidity reporting, as it will change the value of the assets being used within the liquidity calculations. This added complexity has a fundamental impact on how CECL is planned for, implemented and integrated into the wider financial institution reporting mechanisms. This is just one example of the way in which wide-ranging CECL effects will be felt within a financial institution, and why the adoption of this accounting standard should happen in a wider and far more comprehensive context.

03 IMPACTS ON FIRM-WIDE RISK APPETITE

Key Points From Basel Committee Guidance

When it comes to exploring the extent to which CECL will affect – and interact with – a financial institution's risk appetite, the vital first step is to understand precisely what is meant by 'risk appetite.' One way to approach this topic is to consider the Basel Committee guidance BCBS294 on 'Risk Appetite.' This provides a set of guidelines around the principles for corporate governance, published in its final form in July 2015. Within this document, there are three chapters covering risk management and identification. These are some of the clearest official guidance notes published on risk appetite and high level risk management. Here are four key points from the guidance.

First, there is the risk management function, a role that includes:

- Identifying material individual, aggregate and emerging risks
- Assessing these risks and measuring the financial institution's exposure to them
- Developing and implementing the enterprise-wide risk governance framework, which includes the financial institution's risk culture, risk appetite and risk limits
- Ongoing monitoring of the risk-taking activities and risk exposures in line with the board approved risk appetite, risk limits and corresponding capital or liquidity needs
- Establishing an early warning or trigger system for breaches of the financial institution's risk appetite or limits
- Influencing and, when necessary, challenging decisions that give rise to material risk
- Reporting to senior management and the board or risk committee on all these items, including but not limited to proposing appropriate risk-mitigating actions

Second, the role of the Chief Risk Officer (CRO) is explained as an independent function with an enterprise-wide brief, charged with ensuring that risk management is consistently implemented and followed firm wide.

Third, the risk identification section includes specific guidance including:

- On and off balance sheet risks, should be considered
- Risk identification should be firm-wide
- The risk infrastructure should keep pace with the firm's risk taking activities
- Stress testing is given an extremely prominent place in the guidance with pointers toward stress tests including all prominent risk factors, reverse stress testing and high level board approval of the stress tests themselves

Last, but not least, the risk identification section concludes with two strong points:

- There should be a full and frank assessment of risks under a variety of scenarios, as well as an assessment of potential shortcomings in the ability of the financial institution's risk management and internal controls to effectively manage associated risks
- An assessment of the extent to which the financial institution's risk management, legal and regulatory compliance, information technology, business line and internal control functions have adequate tools and the expertise necessary to measure and manage related risks

The message is very clear: The risk management function – and the CRO, in particular – are responsible for ensuring that all risks that can impact capital and liquidity are identified, monitored and controlled. This needs to be carried out in full accordance with a board-approved risk appetite that acknowledges the risks being taken, recognizes the risk measurement framework, and runs the financial institution strategically with those risk mitigation plans in place. This is an integrated risk approach that needs to be taken by the CRO and the financial institution, which is vastly different from how risk is managed today.

CECL and Risk Management

All of this has implications for CECL, both in terms of the risk concerns it evokes and its impact on the risk appetite framework itself. In the previous section we looked at the balance sheet, focusing specifically on the initial increase in provisions under CECL and the volatility of the balance sheet moving forward post-CECL. It is here that this accounting standard has a very direct impact on the risk management function and the way the risk appetite is written, reported and monitored.

In high-level terms, CECL will reduce the amount of capital available, and will create a situation of potential capital uncertainty as the volatility impacts become reality. In turn, this means that the firm's liquidity will be directly impacted by CECL, and that this effect will need to be reflected within its liquidity stress-testing program.

Essentially, if the amount of available capital is reduced and more volatile, then the same risk factors that drive those outcomes must be used within the stress tests, and the resulting liquidity changes recorded, reported and included in forward-looking contingency planning. This will fall under the purview of the CRO, given the Basel Committee's definition of enterprise-wide independent risk oversight.

Other factors that should also be considered include the credit and risk models used to calculate CECL; how those models work alongside any existing risk models; how they will be back-tested; and how those models will be retrofitted into the stress-testing framework – and indeed into the risk appetite itself? These are not trivial questions. It is highly likely that larger institutions have some credit risk models in house already, whether used to calculate Risk Weighted Assets (RWA) or unexpected losses due to credit risk. There is a very high correlation between the models used by the traditional credit risk department and the ones needed by CECL.

That said, it is equally likely that due to the nature of CECL, and its impact area (including retail and commercial lending), models that have been designed for trading-based credit risk will have to be enhanced or homogenized in some way. It does not appear that the best course of action would be to have differential sophistication in credit modelling between the two groups, particularly as these groups report through the same officer (CRO) to the same risk audit board. This will require significant work within the credit risk department.

Handling Risk Factors

It's also important to consider the inclusion and monitoring of any new risk factors that are now included in the risk appetite/management framework. As we move into areas of the financial institution that – up to now – have been left out of the risk appetite, we have to ensure that all risk factors that drive CECL and the resulting capital impacts are captured within the risk appetite, present in the stress-testing and reported to the board. As always with data, this will mean that they will need to be included in data collection and cleansing activities. Again, this is an integrated whole-risk approach that must be taken to connect all areas impacted by CECL and to move away from a departmentalized approach based on function.

As a final point to consider, the CRO should make sure that risk factors impacting CECL – and therefore the capital/liquidity levels of the financial institution – are being monitored by an 'early warning' system. In practice, this means including these factors in the various risk measures/stress tests, but it will also likely involve moving to pre-deal analysis of new business on the balance sheet and CECL provisioning. This opens the area of strategy and how the risk appetite is reflected by the strategy undertaken by the financial institution. With CECL, this quickly becomes a discussion around risk return. Financial institutions and their boards will need to decide how to risk adjust returns – via Funds Transfer Pricing (FTP) analysis for example – and then how to apply front-line limits to business lines that reflect the risk adjusted tolerance.

What's clear is that CECL brings accounting and balance sheet calculation together with risk management and liquidity management. What's more, it does this at a time when the role of risk management, the risk appetite and the CRO are under a historically unprecedented amount of scrutiny. This is both an additional factor to consider with CECL, and a potential opportunity to put risk-based strategy on a common framework throughout the organization – which could be a game-changing move for financial institutions willing to make it.

Expected Credit Loss Modeling

A close look at the Expected Credit Loss (ECL) modelling area of CECL suggests that this is arguably the part of the accounting standard that demands the most direct attention from a financial institution's risk analysts. It is important to stress that CECL is not an attempt to capture unexpected or remote catastrophic events, which will continue to be accounted for under regulatory capital. Instead, the focus is on expected losses and changes to allowance calculations that will enable an institution to better account for these types of losses.

CECL provides institutions with various options for how to approach ECL, the main methods being:

- Loss Rate Methods
  - Loss Rate Approach
  - Vintage Analysis
- Discounted Cash Flow Analysis
- Migration Analysis
- PD/LGD

As might be expected, there are pros and cons to each of these approaches and financial institutions will need to think through data availability, analytic capability and balance sheet impact before building out the final solution. It is important to mention the expected credit losses should be discounted using the effective interest rate (EIR). To put some perspective around these methodologies, we will look at each in turn.

04 WHERE FINANCIAL INSTITUTIONS STAND ON CECL READINESS

So, in light of the impacts we've described – from timelines and driving factors to model selection for the credit loss calculations, and more – how well-prepared are financial institutions for the introduction of CECL? By synthesizing various interviews, 'round-table' discussions and poll results from webinars on CECL, it's possible to get a sense of where financial institutions currently stand. In assessing readiness, three questions are especially relevant.

> "Financial institutions who achieve compliance 'tactically,' quickly come to see the cost of the ongoing maintenance of that tactical solution."

Question 1: Have You Started To Prepare?

The first question to ask is whether financial institutions have started their CECL projects. By way of background, public companies that file with the Securities and Exchange Commission (SEC) will be required to apply CECL January 1, 2020. Other public companies that are not SEC filers will begin in 2021. Private and non-profit companies will be required to apply CECL beginning in 2022. An important reason for the longer timeframe is the widespread impacts of the accounting standard and the high complexity the compliance involves. This means smaller organizations will require more time to plan and implement their CECL programs, to avoid or at least minimize the worst impacts of the change.

Surprisingly, financial services industry figures suggest that 25% of institutions have not yet started the project at all, with another 36% having CECL 'under investigation.' Taken together this means that over half the impacted market is still working out what to do and how to do it. This is in line with various comments from the market, where smaller regional and community banks are looking at building out credit risk models that have not been required previously and are juggling the twin demands of data availability/quality and model applicability.

The task of model selection becomes all the more complex when 'pooling' is brought into the equation. Effectively this means that the way the assets are pooled is decided in terms of both asset characteristics and data availability. In the worst case, financial institutions may select models, move through the implementation and discover the data/pooling incompatibility too late in the process to switch to a more appropriate model.

On the upside, 12% of banks have said that their models have been determined, with the rest reporting they will be determining model selection soon. The banks that have already decided tend to be the larger organizations or those that are US-based subsidiaries of international banks, which will already have implemented IFRS 9.

Question 2: Which Models Will You Use?

The second key question to ask is which models financial institutions are planning to use. Because of the diversity of their assets, many financial institutions will inevitably use multiple models. But the clear favorite amongst the larger banks appears to be the PD/LGD (Probability of Default/Loss Given Default) model. Almost two-thirds of institutions questioned on this issue said they would use that model for at least some of the credit loss estimation, while almost one-third replied that they would use the Discounted Cash Flow method for at least some of their loss estimation.

These proportions are precisely in line with general conversations in the market. As mentioned above, the model selection is as much about supporting data availability as it is about model complexity/applicability. The larger banks, and particularly those with an international presence, tend to have both the core modelling capability and data to implement the PD models, and to be confident about the ongoing back-testing and model governance. The smaller regional and community banks often don't have the same datasets available to them, and are therefore more likely to utilize the Discounted Cash Flow method, where the model governance and data requirements are significantly reduced.

One of the key benefits of the Discounted Cash Flow method is that it is not impacted by the pooling choices in the same way as the PD/LGD is. This means there's less pressure to make all the decisions up front. The prevailing wisdom for smaller firms seems to be that the Discounted Cash Flow method will work and will achieve compliance, leaving the financial institution with the option of changing to other models later as the accounting standard and its impacts become more fully understood by the market.

Question 3: What Factors Guide Your CECL Choices?

The third vital question for financial institutions is what actually guides the CECL choices within the firms themselves. The context here is the conversation around risk appetite, capital cost optimization and compliance. Our industry figures suggest that over half of banks are looking for swift compliance, with a quarter aiming for improved risk controls. This finding runs somewhat counter to what is being heard generally in the market regarding centralized risk appetite and control, but it does match the experience on the global/European side, where 'day 1' compliance became the main driver during the design/implementation phases of IFRS 9.

An interesting follow-up that we have seen with previous regulations such as IFRS 9, is that the banks who achieve compliance 'tactically,' quickly come to see the cost of the ongoing maintenance of that tactical solution. These banks then tend to look towards automating the solution (day 2) and finally optimizing the cost using the automated process (day 3). This pattern has been seen across Europe and is being replicated in Asia, Africa and the Middle East.

There is every reason to believe the same flow will be the case in the US with CECL. That said, the US does have an 18-month window to avoid going down the tactical route by learning the lessons from Europe. If the planning and strategy are thought through now, at the early stage that we are currently in, then there should be little or no need to revisit the solution base later. Crucially, a clear end-state is needed throughout the design process – and any tactical implementation that does not sit on the path to that end-state needs to be reevaluated to avoid duplication of effort later.

Overall, the US does seem to be heading in a direction similar to that of Europe in terms of CECL implementation, where the need for compliance becomes the main driver and financial institutions tactically select models according to the availability of the necessary data. However, for non-SEC filers in particular, there is a real opportunity to avoid this approach, and build an effective capital-optimizing CECL solution that could enhance that financial institution's market competitiveness rather than simply achieve compliance.

05 WHAT DOES A 'GOOD' CECL IMPLEMENTATION LOOK LIKE?

"The financial institutions taking a holistic approach to CECL have looked at the European experience and learned the lessons from IFRS 9, and as a result will be well ahead of the competition once CECL reporting becomes standard."

The Importance of High-Level Planning

As financial institutions approach the switch to the CECL standard for credit losses in January 2020, those international banks that have already implemented IFRS 9 are significantly ahead of the rest in terms of preparedness. This means it's entirely reasonable that domestic US financial institutions have looked at the IFRS 9 approach as a basis for their CECL implementations. However, due to the differences, the applicability of lessons learned from IFRS 9 are largely dependent on how flexibly the institution manages its implementation of the new standard.

Looking across the CECL implementation approaches currently underway, it's clear that most of the planning and conversation is around the models to be used, and the various considerations that surround those models such as the computational and data implications. However, the factor that really determines what good looks like is the high-level planning around the entire process, and around how that process fits into the financial institution's wider strategic objectives.

The Problem With a Tactical Focus on Compliance

Essentially, financial institutions are taking one of two fundamental approaches to CECL: either one that focuses primarily on compliance, or one that leverages CECL as an opportunity to reach a wider, risk-based strategic end-state. With compliance-focused CECL implementations, the conversation tends to revolve around models and model applicability to the portfolio of the financial institution. In turn, we have seen evidence that smaller financial institutions are looking at Discounted Cash Flow or Loss Approach models, while larger institutions are tending more towards PD/LGD models. This differential is largely a consequence of the data and model governance that comes with the PD/LGD method. The Discounted Cash Flow model is easier to manage as a model, but can be computationally challenging and does require the EIR to be calculated for each loan or pool of loans.

The problem with a compliance-focused approach is less around the specific model selected, and more with the consequences of concentrating on pure compliance. This is commonly termed a 'day 1' approach, where compliance is not optional and the overriding objective is to report the accounts properly in 2020. Obviously, it is possible to collect the cash flows, calculate the EIRs manually, run the scenarios – which may include PD/LGD impacts, macro-economics and behavioral impacts such as prepayments – and calculate the CECL provisions required.

However, this is where the lessons from the IFRS 9 experience in Europe are most useful. Compliance is time-consuming and tactical, and 'compliant' implementations tend to consume resources at a greater rate than was initially expected. Typically, this leads to either expensive long-term consultancy engagements or pressure on internal resources. Consequently – as we mentioned in the previous secretion – tactical 'day 1' builds quickly generate a need for automation ('day 2') to reduce this burden. This often involves implementing an entirely new system, meaning that the initial effort becomes throwaway work. The same tactical thinking can be seen in the US with institutions looking at compliance as the only goal for the CECL project.

Including CECL in Capital Panning and Risk Analysis

Another consideration with CECL is that automating a manual process does not entirely mitigate the problems with tactical 'day 1' implementations. When CECL is looked at on a standalone basis, the new standard will clearly resultant in increased provision/ decreased capital. Indeed, the switch to CECL is expected to increase the credit loss accounting provision by between 20 and 35 percent. This impact will have very serious implications for business planning and future lending practices.

Financial institutions will quickly see that CECL has to be integrated into their future capital planning. That means that loans and their pricing must be managed in the context of risk, accounting provision, and profitability. Whilst seemingly obvious, that in turn means that CECL must be included in all capital planning and risk analysis.

However, this is where the lessons from the IFRS 9 experience in Europe are most useful. Compliance is time-consuming and tactical, and 'compliant' implementations tend to consume resources at a greater rate than was initially expected. Typically, this leads to either expensive long-term consultancy engagements or pressure on internal resources. Consequently – as we mentioned in the previous secretion – tactical Day 1 builds quickly generate a need for automation (Day 2) to reduce this burden. This often involves implementing an entirely new system, meaning that the initial effort becomes throwaway work. The same tactical thinking can be seen in the US with institutions looking at compliance as the only goal for the CECL project.

The Benefits of Holistic 'Day 3' Thinking

The message is clear: simple 'day 1' compliance answers the question of reporting correctly in the first quarter of 2020, but does not ultimately address the broader context of CECL. This is where we come to 'day 3' thinking. Financial institutions that take this approach have pulled in finance, risk, accounting, and liquidity management; have looked at the impacts across all of them; and have made concerted efforts to use the opportunity to rethink risk in general—including data management and sharing—and revisit the junction between risk-adjusted pricing, profitability, and future strategy.

The financial institutions taking this holistic approach to CECL have looked at the European experience and learned the lessons from IFRS 9, and – as a result – will be well ahead of the competition once CECL reporting becomes standard. Essentially, taking steps now to look at the impacts on the second, third, and fourth quarters of 2020 and beyond will pay big dividends in terms of agile business decisions and market share.

CONCLUSION

CECL is much more than just a regulatory and accounting change. Much more.

It brings significant implications for financial institutions' risk management and risk appetite, and across functions including finance, accounting and liquidity management. And its impacts will be felt by the CFO, the CRO, the risk department, the treasury and the frontline business units.

Given these wide-ranging impacts, approaching CECL implementation as 'purely' a compliance issue is a big mistake. Significantly, it's the same mistake that a number of international banks made with IFRS 9 – and they counted the cost later.

The financial institutions that are approaching CECL in the right way are those that have adopted a 'day 3' mindset: looking at CECL from a strategic standpoint, and addressing its implementation on the basis of a detailed, contextual and holistic analysis of what it means for their business.

In a post-CECL world, these are the financial institutions that will illustrate what 'good' looks like. By taking a similar approach, your financial institution can join them.

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Marcus Cree has worked in financial risk management for over 20 years, including asset management and tier 1 banking, in the role of practitioner as well implementation and consultancy. Covering Market, Credit and Liquidity risk, Marcus has worked through Basel 2 and 3, as well as Dodd Frank and IFRS9 implementations. His current role is as a Specialist for Global Risk Practice for Finastra.

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About Finastra

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