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KEEPING UP WITH THE CECL STANDARD

UNDER STRESS
Conduct stress testing to stay competitive

IS CRYPTOCURRENCY THE FUTURE OF BANKING?

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KEEPING UP WITH THE CECL STANDARD

It's been about six years since the Financial Accounting Standards Board (FASB) unveiled its current expected credit loss (CECL) model for estimating credit losses. After several deferrals, the new model is finally set to take effect in 2023 for nonpublic entities, including most community banks. (Technically, these nonpublic banks must adopt the new model for fiscal years beginning after December 15, 2022, or 2023 for calendar-year banks.)

By now, all banks are familiar with the CECL model, and most have taken concrete steps toward adopting it. If your bank is behind schedule in its transition efforts, kick those efforts into high gear. Time is running out, and the FASB has indicated that no further deferrals are expected. (See "FASB: No more CECL delays" on page 3.)

NEW MODEL IN A NUTSHELL

Under pre-CECL rules, banks generally measure credit impairment based on incurred losses. Under the CECL model, they'll apply a forward-looking approach, recognizing an immediate allowance for all expected credit losses over an asset's life. The FASB adopted the new guidance based on its view that the incurred-loss model, which delays recognition of credit losses until they become *probable*, provides information that's "too little, too late." The CECL model addresses this weakness by requiring banks to record credit losses that are expected, but don't yet meet the "probable" threshold.

> THE CECL MODEL PROVIDES BANKS WITH THE FLEXIBILITY TO USE THEIR JUDGMENT IN SELECTING METHODOLOGIES FOR ESTIMATING CREDIT LOSSES THAT ARE BOTH APPROPRIATE AND PRACTICAL.

The CECL model's requirements are complex. But many banks are expected to substantially increase loan loss reserves, which may have a negative impact on earnings and regulatory capital. The consequences for your bank depend on its circumstances. However, with some preparation, you can anticipate the impact on financial performance and take steps to prepare for it.

SELECTING A METHODOLOGY

Most banks have already identified the methodologies they'll use to estimate credit losses. If you haven't, time is of the essence: You must have the systems and processes in place to collect and analyze the data your methodology requires. Plus, it's help-

ful to do some trial runs to test the methodology before the implementation date.

The CECL model provides banks with the flexibility to use their judgment in selecting methodologies for estimating credit losses that are both appropriate and practical. And the federal banking agencies have said that they don't expect smaller, less complex institutions to implement complex modeling techniques. Rather, the CECL model will be scalable to institutions of all sizes, and regulators anticipate that many banks will be able to satisfy its requirements by building on existing systems and methods.

Many community banks have opted for one of these two popular methods:

The weighted average remaining maturity (WARM) method. Briefly, under the WARM method, a bank estimates the allowance for credit losses by applying an average annual loss rate to the projected paydowns of loans. One reason for this method's popularity is that it's viewed as the closest thing to traditional methods of accounting for loan and lease losses (ALLL), so the required data tends to be more readily available.

The Federal Reserve's Scaled CECL Allowance for Losses Estimator (SCALE) method. This is a spreadsheet-based tool that, according to the Fed, "draws on publicly available regulatory and industry data to aid community banks with assets of less than $1 billion in calculating their CECL allowances."

The right method depends on a number of factors, including your bank's complexity, available data and resources. Depending on your circumstances, you may want to consider more sophisticated methodologies, such as discounted cash flow techniques.

PARALLEL TESTING IS CRITICAL

One reason your bank needs to select a CECL methodology as early as possible is to give management time to do some parallel runs to validate the methodology before you "go live." This means running your CECL model (or even multiple CECL models) at the same time as your existing ALLL model, and comparing the results. Parallel runs provide several important benefits, including helping you spot errors and make appropriate adjustments to your new model's variables. They also offer you a sneak preview of the CECL model's impact on your bank.

If you have the luxury of running multiple models parallel to your existing ALLL model, you can evaluate a range of potential CECL loss estimates and evaluate which provides the most appropriate reserve. Or you might even consider selecting different models for different portfolio segments, if appropriate.

STAY IN CONTROL

As the transition to the CECL standard approaches, it's also important to evaluate — and, if necessary, update — your policies, procedures, systems and internal controls to ensure that your credit losses will be properly calculated and documented. Ideally, they'll be in place early enough to be operated as part of the parallel runs described above. ■

FASB: NO MORE CECL DELAYS

In light of previous deferrals of the CECL standard's effective date for nonpublic entities, as well as the disruption and economic uncertainty caused by the COVID-19 pandemic, many community banks hoped that another reprieve was in the works. But in February 2022, the FASB voted *not* to defer the effective date any further.

Despite the implementation challenges faced by smaller banks, the FASB decided that simplifications had been made to the CECL model that eased the impact on smaller institutions. It also emphasized the importance of applying a unified standard across all financial institutions.

UNDER STRESS

Conduct stress testing to stay competitive

Very few people saw the COVID-19 pandemic coming — nevertheless, it had a significant impact on businesses, including banking. In the ensuing volatile business environment, community banks need to ensure they're prepared for unexpected challenges by using all the tools at their disposal to help them stay profitable. One such tool is stress testing, which can be done at either the enterprise or individual loan level.

Stress testing enables banks to simulate specific "disaster" scenarios and evaluate the bank's (or loan's) potential for withstanding them in terms of earnings, capital adequacy and other financial metrics. It can provide valuable information about potential risks that community banks can use to stay afloat through inevitable economic ups and downs.

SET UP THE SCENARIO

Stress testing generally involves scenario analysis. This consists of applying historical or hypothetical scenarios to predict the financial impact of various events,

such as a severe recession, loss of a major client or a localized economic downturn. Tools for performing such tests can range from simple spreadsheet programs to sophisticated computer models.

The Office of the Comptroller of the Currency (OCC) considers "some form of stress testing or sensitivity analysis of loan portfolios on at least an annual basis to be a key part of sound risk management for community banks." But its guidance doesn't prescribe any particular methods of stress testing. It describes two basic approaches to stress testing: "bottom up" and "top down." A bottom-up approach generally involves conducting stress tests at the individual loan level and aggregating the results. In contrast, a top-down approach applies estimated stress loss rates under various scenarios to pools of loans with similar risk characteristics.

The guidance outlines four methods to consider:

1. Transaction-level stress testing. This estimates potential losses at the loan level by assessing the impact of changing economic conditions on a borrower's ability to service debt.

2. Portfolio-level stress testing. This method helps identify current and emerging loan portfolio risks and vulnerabilities (and their potential impact on earnings and capital). It assesses the impact of changing economic conditions on borrower performance, identifies credit concentrations and gauges the resulting change in overall portfolio credit quality.

3. Enterprise-wide stress testing. This considers various types of risk — such as credit risk within loan and security portfolios, counterparty credit risk, interest

rate risk, and liquidity risk — and their interrelated effects on the overall financial impact under a given economic scenario.

4. Reverse stress testing. This approach assumes a specific adverse outcome, such as credit losses severe enough to result in failure to meet regulatory capital ratios. It then works backward to deduce the types of events that could produce such an outcome.

The right approach and method for a particular bank depends on its portfolio risk and complexity, as well as its resources. Even a simple stress-testing approach can produce positive results.

GATHER INFORMATION

A bottom-up approach at the transaction level may offer a significant advantage: In addition to assessing the potential impact of various scenarios on a bank's earnings and capital, the OCC says it can help the bank "gauge a borrower's vulnerability to default and loss, foster early problem loan identification and strategic decision making, and strengthen strategic decisions about key loans."

For example, when evaluating a loan application, consider gathering information on the various risks the borrower faces. Examples include operational, financial, compliance, strategic and reputational risks. This information can be used to run stress tests that measure the potential impact of various risk-related scenarios on the borrower's ability to pay. An added benefit of this process is that, by discussing identified risks and stress test results with borrowers, you can help them understand their risks and develop strategies for managing and mitigating them. For instance, they might tighten internal controls, develop business continuity / disaster recovery plans or purchase insurance.

GET TO THE HEART OF THE MATTER

Risk management is at the heart of loan management. Stress testing can play a key role in helping community banks manage risk by enabling them to more fully envision and respond to potential loan portfolio problems. ■

IS CRYPTOCURRENCY THE FUTURE OF BANKING?

For community banks, cryptocurrency may not be quite ready for prime time, but it's definitely headed in that direction. The popularity of bitcoin, ether and other cryptocurrencies has exploded in recent years.

RECENT STATS

According to a recent poll by NBC News, 21% of American adults have invested in, traded or used cryptocurrency. And the numbers are even higher for younger people: Half of men between 18 and 49, and 42% of all people between 18 and 34, have dabbled in it. According to the White House, the market capitalization of digital assets, which includes cryptocurrency, recently topped $3 trillion, up from only $14 billion five years ago.

The benefits of cryptocurrency include "better transaction speeds, lower costs, privacy, security and an opportunity to provide underbanked communities with financial services," according to NBC News. At the same time, an absence of federal oversight "leaves consumers open to scams and dangerous price volatility," many lawmakers warn. However, that may change in the near future.

promote U.S. leadership in technology and economic competitiveness in the global financial system.

5. Financial inclusion. The U.S. approach to digital asset innovation should be informed by the critical need for safe, affordable and accessible financial services.

6. Responsible innovation. The U.S. government must promote responsible digital asset development that prioritizes privacy and security, while combating illicit exploitation and reducing negative climate impacts.

EXECUTIVE ORDER ON DIGITAL ASSETS

On March 9, 2022, President Biden signed an executive order discussing the administration's strategies for "addressing the risks and harnessing the potential benefits of digital assets and their underlying technology." The order outlines six objectives:

1. Consumer and investor protection. The Department of Treasury and other agencies are directed to develop policy recommendations to protect consumers, investors and businesses as the digital asset sector grows and changes financial markets.

2. Financial stability. The Financial Stability Oversight Council is tasked with identifying and mitigating systemic financial risks posed by digital assets and developing appropriate policy recommendations.

3. Illicit finance. U.S. government agencies are directed to coordinate their efforts, and work with our international allies and partners, to mitigate the illicit finance and national security risks posed by digital assets.

4. U.S. leadership and competitiveness. The Commerce Department is called on to establish a framework to

The order also prioritizes research and development of a potential U.S. Central Bank Digital Currency (CBDC) if it's in the national interest.

WHAT'S NEXT?

The executive order has no immediate effect on community banks. But it signals support of "technological advances that promote responsible development and use of digital assets" and the potential benefits of a CBDC. So, the order may help banks and consumers become more comfortable with cryptocurrency, spurring further growth.

As cryptocurrency becomes more widely accepted, pressure will increase on banks to offer crypto investing or trading services. According to a recent survey by Paxos, a leading blockchain platform, 62% of current cryptocurrency holders would take advantage of crypto investment functionality if their banks offered it. To stay competitive, community banks should familiarize themselves with cryptocurrency and other digital assets, as well as explore potential product and service offerings. They should also monitor developments in the cryptocurrency industry and the government's regulation of it in the future. ■

CFPB EXPANDS ITS AUTHORITY TO PUNISH BANKS FOR DISCRIMINATION

In a March 16 announcement, the Consumer Financial Protection Bureau (CFPB) announced that it will expand its antidiscrimination efforts to situations in which fair lending laws may not apply. Examples include servicing, collections, consumer reporting, payments, remittances and deposits.

Fair lending laws, such as the Equal Credit Opportunity Act (ECOA), target discrimination in the extension of credit. But discrimination in other consumer finance areas also may trigger liability under the Consumer Financial Protection Act (CFPA), which prohibits unfair, deceptive, and abusive acts or practices. For example, the announcement explains, denying access to a checking account on the basis of race could be an unfair practice even if ECOA doesn't apply. Discrimination can violate the CFPA regardless of whether it's intentional.

The CFPB updated its exam manual to reflect its antidiscrimination stance, noting that discrimination may be deemed unfair if it "[causes] substantial harm to consumers that they cannot reasonably avoid,

where that harm is not outweighed by countervailing benefits to consumers or competition." Examiners will require banks and other supervised companies to "show their processes for assessing risks and discriminatory outcomes, including documentation of customer demographics and the impact of products and fees on different demographic groups." ■

FinCEN'S RAPID RESPONSE PROGRAM FOR CYBER-ENABLED FINANCIAL CRIME

In a recent fact sheet, the Financial Crimes Enforcement Network (FinCEN) highlighted its Rapid Response Program (RRP). This program helps victims and their financial institutions recover funds stolen as the result of certain cyber-enabled financial crime schemes, including business email compromise. RRP is a partnership among FinCEN, U.S. law enforcement and foreign partner agencies. It facilitates recovery of stolen funds through rapidly sharing financial intelligence and collaborating with foreign partner agencies to block fraudulent transactions, freeze funds, and stop and recall payments.

To date, the RRP has been used in approximately 70 foreign jurisdictions to recover more than $1.1 billion. The fact sheet provides guidance on how to activate the RRP. This guidance includes a flow chart that outlines the complaint process, as well as instructions on filing suspicious activity reports in connection with activities targeted by an RRP complaint. ■

FDIC IMPOSES NOTICE REQUIREMENT FOR BANKS INVOLVED IN CRYPTO ACTIVITIES

In a recent financial institutions letter (FIL), the FDIC required FDIC-supervised institutions to notify the FDIC if they plan to engage in or are currently engaged in any activities involving or related to crypto assets. Unlike a similar policy announced earlier by the Office of the Comptroller of the Currency (OCC), the FDIC policy doesn't require institutions to obtain specific approval of such activities. ■

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acxell (“acxell”) has been meeting the specific risk management needs of community banks of all sizes since 1991. As a high quality and affordable alternative to other firms, acxell provides internal audit, regulatory compliance, BSA/AML, information technology, SOX/FDICIA and enterprise risk management review services and software. acxell is exclusively dedicated to the banking industry, providing clients with dedicated, focused and hand-held services reflective of a wide range of skills, experience and industry expertise. As a Firm, we have also been proactive in assisting our clients with the designing, implementation and testing of the internal control environment to assist management with the attestation requirement under the Sarbanes-Oxley Act.

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We believe that a significant aspect of our services is our degree of involvement and responsibility to assist management by making suggestions for improvement, keeping them informed of professional developments and by acting as an independent counsel and sounding board on general business matters and new ideas.

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