Life AFTER CECL

3 Strategic Ramifications to Consider

CECL is capturing a lot of headlines these days. Numerous articles and presentations at conferences are focused on the data that will be needed to forecast expected life of loan credit losses. While the data component of CECL is very important, in this c. notes we want to hit pause on that and take a look at life under CECL beyond the data.

Because CECL won't cause actual loan losses to increase, we often hear that any change in earnings after the one-time adjustment is just temporary and "it all evens out." This is only true if the loan mix stays the same, the amount of credit risk doesn't change, the economic forecast remains stable, and loans don't grow.

After holding two invitation-only CECL workshops in the summer of 2017, our participants, who included some of the largest credit unions in the industry, observed some major takeaways they were not expecting before the workshops. CECL could result in:

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1. A disconnect between financials and ultimate financial performance

2. Increased volatility in the financials in an economic downturn

3. A significant mindset shift in how success is measured

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1. I didn't know CECL could cause a disconnect between our financials and our ultimate financial performance…

How could loans with a rate of 5.50% earn negative 58 basis points for the fiscal year?

Under CECL, expected credit losses (ECL) over the entire lifetime of the loans will be set aside when the loans are made. How much income will you earn on the day the loans are made? None, right?

This will create a disconnect between what is seen on the financial statements and what the loans may ultimately be able to contribute once they begin to earn income.

Clearly, the amount of credit losses expected will play a key role in how big this disconnect is for different credit unions. Consider these examples:

	X	Y	Z
Loan Rate	2.25%	4.50%	5.50%
Lifetime ECL	0.25%	1.50%	2.50%

For Example X, loans are made at a low rate of 2.25% with a low level of ECL. Example Z shows loans at a higher rate with a higher ECL. Example Y is in the middle. When these loans are made, the credit union will set aside the lifetime ECL, but not collect any income.

Let's take a look at Example Z in more detail. In this example, we are assuming that loans are put on evenly throughout the course of the year, say $10 million per month. So each month, it makes $10 million in Z loans, sets aside the lifetime ECL of $250K, and does not collect any income on those loans until the next month. Over the course of the fiscal year, the amount of credit loss expense the credit union sets aside for the Z loans is greater than the income they earn, resulting in a fiscal year net yield of negative 0.58%.

	X	Y	Z
Loan Rate	2.25%	4.50%	5.50%
Lifetime ECL	0.25%	1.50%	2.50%
Fiscal Year Net Yield			**-0.58%**
Lifetime Net Yield			4.18%

Note: Loans are added evenly throughout the year

Yes, in the fiscal year they are made, the contribution of these loans to the credit union's financials is negative!

This will be hard for some credit union stakeholders to get their heads around. They may wrestle with understanding how making loans is hurting the financials. This is the disconnect that needs to be understood.

Start getting your mind around the concept of Lifetime Net Yield

Once the lifetime ECL is set aside, the Example Z loans are poised to earn 5.50% for the remainder of their lives for a lifetime net yield of 4.18%. Now, this could change if the economic environment is expected to change (a downturn, for example) or if initial credit risk assumptions were off, but setting those aside, these loans will earn 5.50% for the rest of their lives.

Credit unions will need to get really good at understanding lifetime net yield. For Example Z, looking only at the impact to the financials, a credit union might make the decision to stop making these loans, not realizing that over the life of the loans their contribution to the financials is 4.18%.

In Example Z, there is a material disconnect between the financials and ultimate financial performance: -0.58% versus 4.18%. This will not always be the case. The impact of CECL will be unique to each credit union's business model.

In Example X, the fiscal year net yield is 1.64% and the lifetime net yield is 2.11%. There is a difference here, but not like the big disconnect found in Examples Y or Z.

	X	Y	Z
Loan Rate	2.25%	4.50%	5.50%
Lifetime ECL	0.25%	1.50%	2.50%
Fiscal Year Net Yield	1.64%	0.85%	-0.58%
Lifetime Net Yield	2.11%	3.70%	4.18%

As we pointed out, the amount of credit risk being taken will play a key role in how large the disconnect is. If your credit union takes more credit risk, it may experience a larger disconnect than another credit union that takes less credit risk.

Could CECL affect when – or if – our credit union runs loan promotions?

In the examples above, loans were assumed to be made evenly over the fiscal year. Now, let's isolate loans made at two different points during the year.

Using Example X from above, will loans made in January have the same net yield for the year as loans made in October? No, they will not. The loans made in October only have 2 months remaining in the fiscal year in which to earn income, where the loans made in January have 11 months. In this example, the October loans have a negative yield in the fiscal year.

An example of loans made in January and in October and their potential fiscal year net yields and lifetime yields.

$10 Million in Autos

Loans Made in January		
	Fiscal Year	**Net Yield**
Year 1	Jan – Dec	2.57%
Year 2	Jan – Dec	4.50%
Life		3.70%

Loans Made in October		
	Fiscal Year	**Net Yield**
Year 1	Jan – Dec	-4.65%
Year 2	Jan – Dec	4.50%
Life		3.70%

In the illustration above, the loans made in January have a positive 2.57% Year 1 net yield while the loans made in October have a negative 4.65% Year 1 net yield. Does this mean the credit union should not make loans in October? Or that the loans made in October are bad loans? No, but it again points out how important it will be to shift your mindset and evaluate financial performance in light of lifetime net yields. For these loans, they are the same at 3.70%. The credit union's financials would favor the January loans, but from an ongoing financial performance perspective they are the same.

Could this potentially change how credit unions – or other financial institutions – do business? Imagine having a very successful loan promotion near the end of the year, only to have it hurt earnings because the net yield on the promotion was very low or even negative! What are some unintended consequences of this? Do credit unions stop running promotions? Or only run them early in the year? What about banks who have to report to their stockholders? Might they only run promotions early in the year and could that potentially open up lending opportunities for a credit union that understands the difference between the fiscal year net yield and the lifetime net yield?

Can loan growth actually hurt earnings under CECL?

In addition to decreased earnings due to low fiscal year net yields, a growing loan portfolio can add another disconnect. If a credit union is growing loans and the fiscal year net yield on those loans is less than what the credit union could earn on investments, this will actually hurt the credit union's earnings further. In other words, the credit union's financial statements would indicate that the credit union would be better off just leaving the money in investments. However, over the long run, keeping the money in investments may not be the best business decision. How much earnings drop depends on how low the fiscal year net yield is, and how fast the credit union is growing loans – the lower the fiscal year net yield and the faster the loan growth, the more it will hurt.

Returning to our Examples X, Y, and Z, the impact to ROA from CECL will be different for each. An additional scenario, increasing loan growth on Example Z, has been added to the table.

	X	Y	Z	Z +Growth
Loan Rate	2.25%	4.50%	5.50%	**5.50%**
Lifetime ECL	0.25%	1.50%	2.50%	**2.50%**
Fiscal Year Net Yield	1.64%	0.85%	-0.58%	**-0.58%**
Yield on Investments	**1.50%**	**1.50%**	**1.50%**	**1.50%**
Loan Growth	**10.00%**	**10.00%**	**10.00%**	**20.00%**
CECL Impact to ROA Compared to Current Rule	**-0.02%**	**-0.11%**	**-0.17%**	**-0.35%**

Again, this is something that will be confusing for many managements and boards. Imagine having a great year of lending – and it hurts earnings. Communicating the ongoing financial performance of the organization by understanding lifetime net yield will be key.

2. I didn't know CECL could cause so much volatility in our financials during an economic downturn…

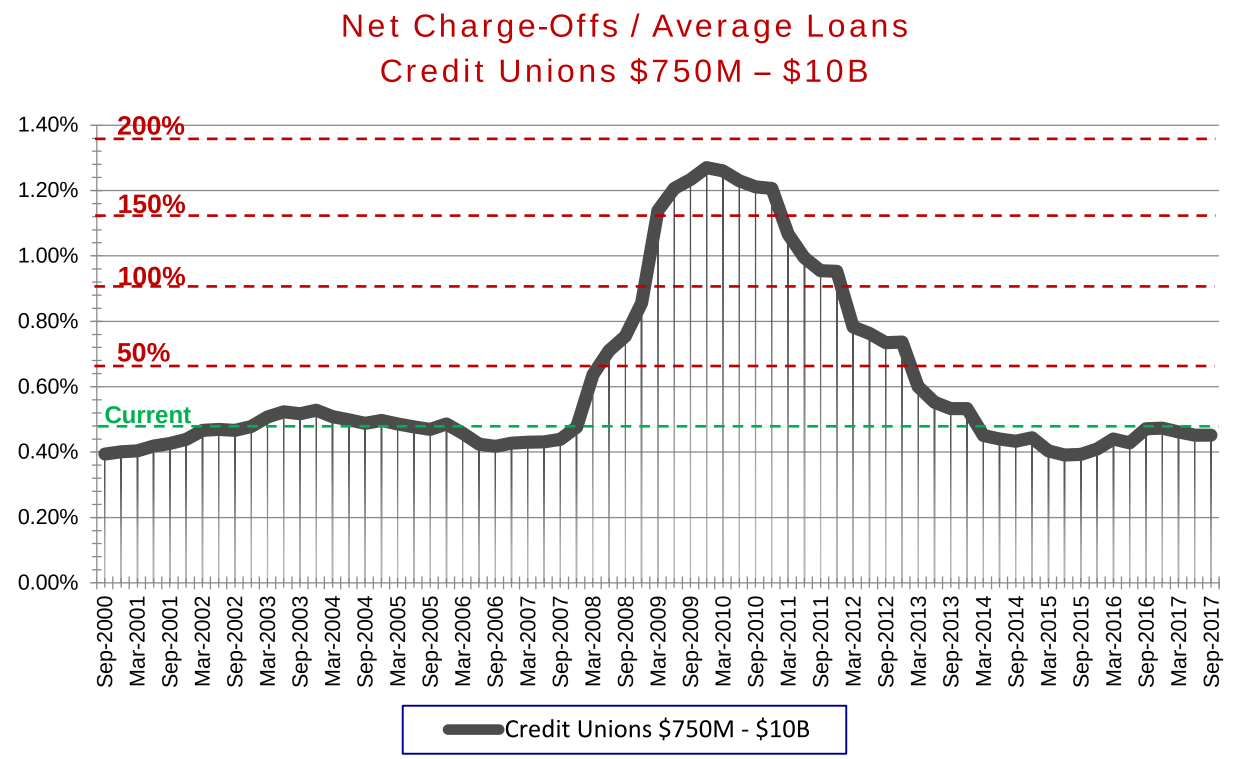
Under CECL, credit unions must tie their forecasts of expected lifetime credit losses to "reasonable and supportable" economic forecasts.

> CECL says…You must consider the need to adjust for management's expectations of current conditions and reasonable and supportable forecasts in contrast to the conditions that existed for the historical information.[1]

In other words, as you study historical losses, you will need to make sure you are viewing those losses in the context of the economic environment that was happening at the time and adjust them to what you are expecting going forward. For example, if historical credit losses had been low in a relatively stable economic environment, but you are expecting a downturn, you would not forecast loan losses to be the same in the future as what they were historically. You would expect them to increase. Not only would you expect losses on new loans to increase, you would likely also expect that losses on loans already made would increase. The opposite scenario could happen as well.

[1]FASB ASU No. 2016-13, *Financial Instruments - Credit Losses (Topic 326)*, June 2016

Remember 2009? The graph below shows net charge-offs to average loans for credit unions $750 million to $10 billion in assets from 2000 until mid-2017. For this group of credit unions, net charge-offs as of the second quarter of 2017 were about 0.45% of average loans. This is also about what net charge-offs were prior to the Great Recession. Under the severe economic downturn that was experienced, these credit unions saw credit losses increase almost 200%, or roughly three times, what they were.



Source: *Callahan & Associates*

Imagine heading into another economic downturn. What could be the impact to earnings if a credit union reforecasts 50% higher losses? Or 100%?

The table below shows the significant impact to earnings from reforecasting for a downturn.

Economic Reforecast (Example Y)

Loan Rate	4.50%	4.50%
Original Lifetime ECL	1.50%	1.50%
If Lifetime ECL is	50% Higher	100% Higher
Hit to ROA	-0.68%	-1.36%

Coming out of a downturn, a credit union would expect losses to be lower and reforecast in the opposite direction, causing earnings to swing to the positive.

3. CECL will likely require a significant mindset shift in how our credit union measures success and could unintentionally cause us to hold back strategically…

As demonstrated so far, CECL is definitely more than an accounting change. It can drive a disconnect between a credit union's financials and its ultimate financial performance, it can hurt fiscal year earnings, and it can be volatile. And while the impact of CECL will be unique to each credit union, it will impact all credit unions. All of this will likely lead to requiring a mindset shift for decision makers in terms of how they ultimately view financial performance.

The magnitude of adjusting lifetime expectations for all loans on your books, or yet to be made, has the potential to cause earnings and net worth to be very volatile under CECL

Having lower fiscal year earnings may cause some credit unions to make different decisions, or to rethink when or whether to implement strategic initiatives. For example, how might lower earnings impact your credit union's strategic positioning with regard to payments or your technology budget? Does it potentially impact dividends paid on deposits or rates charged on loans? Should a credit union increase fees to make up for the shortfall? Beyond these considerations, do lower earnings keep your credit union from hiring the talented employees it needs to deliver on its value proposition?

While lower fiscal year earnings could drive many decisions, having a clear understanding of CECL's contribution to the lower earnings will result in more informed and possibly different decisions.

Remember, a mindset shift will be required. Don't let CECL, a new accounting rule, undermine the strategic focus of your business

Life after CECL

CECL is a fact of life. Credit unions who start the preparation process early and begin to run parallel financials to understand the disconnect between the financials and ultimate financial performance will be in a much better position when it takes effect for credit unions in 2021. Making sure that all stakeholders understand the strategic ramifications, including the unintended consequences, of CECL will make the transition to life after CECL as little of a distraction as possible.

About c. myers

We have partnered with credit unions since 1991. Our philosophy is based on helping clients ask the right, and often tough, questions in order to create a solid foundation that links strategy and desired financial performance.

We have the experience of working with over 550 credit unions, including 50% of those over $1 billion in assets and about 25% over $100 million. We help credit unions *think to differentiate* and *drive better decisions* through real-time ALM decision information, CECL consulting, financial forecasting and consulting, liquidity services, strategic planning, strategic leadership development, process improvement, and project management.