NCUA Issues Guidance on CECL Audit Minimum Procedures

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Michael Umscheid, President and CEO of ARCSys

Introduction

The complexities of the Current Expected Credit Loss (CECL) standard remain a significant challenge for credit unions, particularly those juggling diverse portfolios. Navigating this new accounting landscape while ensuring compliance can be overwhelming. The NCUA's recent Supervisory Committee Audit Minimum Procedures Guide Addendum, issued in January 2024, aims to provide much-needed clarity and specific procedures for credit unions of all sizes.

This whitepaper serves as a guide to the updated audit procedures, based on CECL. We delve into the key concerns regarding investments, providing detailed procedures for both available-for-sale and held-to-maturity debt securities. This whitepaper empowers you to navigate these new obligations with confidence.

One crucial aspect of the updated requirements is the mandatory periodic validation of all CECL models, regardless of whether they're internally developed or sourced from third-party vendors. The NCUA emphasizes the importance of thorough and independent validations, underscoring the need for accuracy, reliability, and appropriateness in credit loss estimations. This whitepaper further clarifies the NCUA's validation requirements for both third-party models and internally developed models.

By understanding these requirements and embracing robust validation practices, you can ensure your credit union remains compliant and equipped to make informed financial decisions.

Investments - Credit Unions Over $10 Million

Under CECL, credit losses are recognized for available-for-sale (AFS) Debt Securities and held-to-maturity (HTM) Debt Securities.

- For AFS Debt Securities: Individual evaluation for impairment is required when the fair value is less than the carrying amount and certain conditions are met, such as the intention to sell the security, the likelihood of being required to sell it, or the expectation of not recovering the amortized cost basis. If a credit loss event exists, a credit loss is calculated using a discounted cash flow approach and recognized as an allowance. Changes in cash flows are adjusted through a valuation allowance.

- For HTM Debt Securities: Securities with a net realizable amount less than their amortized cost are assessed to determine estimated credit losses. If a credit loss event exists, a credit loss is calculated using the same model used for loan portfolios.

The procedures also include steps related to the Allowance for Credit Losses on Investments. These steps involve confirming that the credit loss measurement methodology aligns with the policy, obtaining a schedule listing the allowance, confirming the output of the methodology matches the general ledger, and reviewing a listing of all Debt Securities. A sample-based review is conducted to ensure that each selected security on the listing of Debt Securities is properly included or excluded in the schedule listing the allowance.

It's important to note that certain Debt Securities, such as U.S. Treasury securities, Mortgage Backed Securities (MBS), and Government Sponsored Enterprises securities, may not require a credit loss allowance if expected non-repayment is zero, as per FASB Accounting Standard Codification (ASC) 326-20-30-10. Additionally, credit losses on investments in certificates of deposit above the financial institution's deposit insurance coverage should be measured.

Reserving for Loan Losses

Allowance for Loan and Lease Losses - Credit Unions Under $10 Million

Credit unions with assets of $10 million or more were required to adopt CECL for financial reporting after December 15, 2022. However, federally insured credit unions with assets of less than $10 million are generally not required to implement CECL and should follow the allowance for credit loss (ACL) procedures outlined below.

The ACL procedures involve obtaining various documents, including the schedule of the ACL for the testing period, detailed listings of charge-offs and recoveries, management's support of the ACL calculation, and the Board of Directors' approved ACL Policy.

The procedures also include performing several checks and agreements to ensure accuracy and compliance. This includes agreeing the required ACL amount to the amount reported on the general ledger, agreeing the beginning and ending balances, provision expense, and totals on the detailed listings to the appropriate schedules, and checking the accuracy of the schedules.

The credit union's policy should include specific requirements, such as using the incurred loss methodology for the calculation, defining the roles and responsibilities of various departments and personnel, outlining accounting policies for loans and loan losses, establishing an internal control system for the estimation process, and specifying the primary elements of the incurred loss methodology.

Credit unions should consider impairment when they do not anticipate receiving full repayment. The ACL reserve for an individually impaired loan is determined based on a reasonable estimate of the expected loss. There are three methods for evaluating impairment: using the fair market value of collateral, the present value of future cash flows, or loan pricing (which is uncommon among credit unions). The fair market value method is typically used for collateral-dependent loans such as vehicle or mortgage loans. The ACL reserve is calculated by subtracting any liquidation costs from the expected fair market value of the collateral. A current appraisal should be obtained to accurately determine the collateral's value. The present value of future cash flows method is used when there is some expectation of receiving cash payments. The evaluation should utilize the original interest rate as the discount rate. The total impairment reserve in the ACL is determined by subtracting the total expected cash flows from the total recorded investment.

It is important to confirm that loans with similar characteristics are grouped and evaluated for impairment, and that qualitative and environmental factors appropriately adjust loss rates or other loss measurements. These factors may include trends in financial assets, concentrations of credit, past due financial assets, changes in collateral value, lending strategies and policies, credit review function, staff experience and ability, external factors, and changes in local market and business conditions.

Allowance for Credit Losses - Credit Unions More Than $10 Million

Federally insured credit unions with more than $10 million in assets and credit unions with less than $10 million in assets that have adopted the CECL methodology should follow the procedures outlined for the Allowance for Credit Losses (ACL).

The procedures involve obtaining various documents from the credit union, including the schedule of ACL movements for the testing period, detailed listings of charge-offs and recoveries, management's support of the ACL calculation, the Board of Directors' approved ACL Policy, and the CECL Model and its documentation.

For the ACL Policy, it is important to confirm that management has taken responsibility for determining the appropriateness of the CECL methodology based on the credit union's unique facts and circumstances. The ACL Policy should be approved by the Board of Directors and include assertions, required policy components, and descriptions of roles and responsibilities, accounting policies, and the internal control system.

In terms of the Schedule of the ACL, it is necessary to agree the beginning balance, total charge-offs, total recoveries, and ending balance to the general ledger. Additionally, the amount that adjusts to the period-end ACL balance should be agreed to the Credit Loss Expense general ledger accounts.

For the CECL model, specific procedures need to be performed based on the type of model being used.

- Simplified CECL Tool: It is important to confirm that the version of the tool corresponds to the period end and to review and check various aspects of the tool, including inputs, individual basis, adjustments, checklist, and summary. Additionally, the worksheets of the tool should be scanned for any obvious formula errors.
- Internally developed models: Procedures include agreeing inputs to source documents, mathematically checking for accuracy, confirming independent validation by individuals not involved in determining the ACL value, reviewing management and board approval of the validation report, ensuring support for qualitative adjustments, and agreeing output to the general ledger.
- Third-party models: Procedures involve agreeing inputs to source documents, obtaining SOC 1 and SOC 2 reports (if available) and confirming management's understanding and implementation of mitigating controls, obtaining external validation and documentation of management's review and approval, ensuring support for qualitative adjustments, and agreeing output to the general ledger.

Regardless of the type of CECL model, it is important to confirm that loans with similar characteristics are grouped and evaluated for impairment (homogeneous pools). Risk characteristics to consider include credit scores, risk ratings, financial asset type, collateral type, size, interest rate, term, geographical location, industry of the borrower, vintage, historical or expected credit loss patterns, and reasonable and supportable forecast periods.

For expected loss models, such as the Weighted Average Remaining Maturity (WARM), it is important to confirm the accuracy of major components of the estimate, such as loss rates and WARM factors.

- Testing individually evaluated loans involves confirming proper segregation from pools, selecting loans on a sample basis to confirm the valuation process, and verifying accuracy of outstanding balances and estimation processes.
- Testing model input includes selecting loans on a sample basis to confirm accuracy of input, such as outstanding balances and appropriate inclusion in pools, and tracing

relevant modeling data for accuracy, including loss rates and qualitative factors.

If applicable, procedures for CECL adoption involve obtaining the calculation of the cumulative-effect adjustment to opening retained earnings, scanning for mathematical errors, and tracing the entry to recording in the general ledger.

Allowance for Credit Losses on Off-Balance Sheet Credit Exposures

Federally insured credit unions with more than $10 million in assets and those with less than $10 million in assets that have adopted the CECL methodology should follow the procedures outlined for the Allowance for Credit Losses on Off-Balance Sheet Credit Exposures.

The procedures involve obtaining various documents from the credit union, including the schedule of movements for the testing period, detailed listings of charge-offs and recoveries, management's support of the calculation, the Board of Directors' approved Policy, and the CECL Model and its documentation.

It is important to confirm the appropriateness of the credit loss measurement methodology and obtain management's documentation evaluating financial assets and off-balance sheet credit exposures falling within the scope of Subtopic 326-20.

The schedule listing the Allowance for Credit Losses on Off-Balance Sheet Credit Exposures should be obtained and the output of the methodology should be confirmed to agree with the general ledger.

Additionally, a list of all loan commitments and other commitments should be obtained, and on a sample basis, it should be confirmed whether a commitment from the obtained list is properly included or excluded in the Allowance for Credit Losses on Off-Balance Sheet Credit Exposures. It is important to note that for unilaterally cancelable commitments, an allowance is not required.

Income and Expense

Federally insured credit unions with more than $10 million in assets and credit unions with less than $10 million in assets that have adopted the CECL methodology should perform procedures to trace the credit loss expense into the income statement. The values for these procedures come from documents previously obtained.

The credit loss expense should be agreed to the support for various categories, including loans and leases, available-for-sale debt securities, held-to-maturity debt securities, and off-balance sheet credit exposures.

Why Choose ARCSys for CECL Model Validations

1. Expertise and Experience: ARCSys boasts a team of highly skilled professionals with extensive experience in CECL modeling. Our experts possess a deep understanding of the regulatory landscape and are well-versed in the intricacies of CECL modeling methodologies. With our comprehensive knowledge, we can effectively evaluate the soundness and effectiveness of your institution's CECL models.
2. Tailored Validation Approach: We recognize that each financial institution has unique needs and requirements. ARCSys takes a customized approach to CECL model validations, tailoring our services to align with your institution's specific circumstances. Our team will work closely with you to understand your model's intricacies, data sources, and assumptions, ensuring a thorough and accurate validation process.
3. Independent and Objective Assessments: ARCSys provides an independent and objective assessment of your CECL models, offering an unbiased evaluation of their strengths and weaknesses. Our rigorous validation process includes a comprehensive review of model inputs, assumptions, methodologies, and outputs. By engaging ARCSys, you can demonstrate to regulators and stakeholders that your institution's CECL models are reliable and compliant.
4. Timely and Efficient Service: We understand the importance of meeting regulatory deadlines. ARCSys is committed to delivering timely and efficient CECL model validations, ensuring that your institution remains in compliance with NCUA requirements. Our streamlined processes and advanced technology enable us to provide accurate and comprehensive assessments within the specified timeframes.

With the NCUA's recent guidance mandating CECL model validations, it is crucial for credit unions to partner with a trusted third-party provider. ARCSys offers the expertise, tailored approach, independence, and efficiency necessary to ensure compliance with regulatory requirements. By choosing ARCSys for your CECL model validation needs, you can have confidence in the accuracy and reliability of your institution's credit loss estimates.

Contact ARCSys today to learn more about our CECL model validation services and how we can assist your institution in meeting regulatory obligations.