ACL Model Validation
What You Need To Know:
Part I

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In June 2016, the FASB issued ASU 2016-13, "Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments." The ASU and its subsequent amendments (collectively referred to as ASC Topic 326) became effective for all entities beginning in 2023. ASC Topic 326 instituted the Current Expected Credit Loss ("CECL") methodology for estimating Allowances for Credit Losses (ACL) and eliminated the previous incurred loss allowance methodology used by financial institutions for decades.

Now that your institution has implemented the Current Expected Credit Loss method of estimating its Allowance for Credit Losses, what remains to be done? What will regulatory agencies look for in terms of evaluating your institution's CECL compliance? Moreover, what should you do to prepare for your first regulatory exam since implementing CECL?

Whether your ACL model and process was developed within your institution or by a third-party vendor, have your process reviewed independently for conceptual soundness and compliance with the ASC Topic 326 standard.

As stated in the Interagency Policy Statement on Allowances for Credit Losses (revised April 2023):

> *"After analyzing ACLs, management should periodically validate the loss estimation process, and any changes to the process, to confirm that the process remains appropriate for the institution's size, complexity, and risk profile. The validation process should include procedures for review by a party with appropriate knowledge, technical expertise, and experience who is independent of the institution's credit approval and ACL estimation processes. A party who is independent of these processes could be from internal audit staff, a risk management unit of the institution independent of management supervising these processes, or a contracted third-party."* Find it here.

How will the supervisory agencies evaluate your institution's ACL estimation process under CECL?

Examiners will first review and evaluate your institution's ACL Policy for conformance to the standard and supervisory guidance. Make sure your ACL policy is reviewed and properly approved by your board of directors at least annually. Also, keep in mind that ASC Topic 326 fundamentally involves management's estimate of expected credit losses, requiring significant management judgment. Accordingly, the new standard provides significant flexibility in the method or approach used to estimate credit losses. As part of their supervisory activities, however, examiners are expected to "assess the appropriateness of management's loss estimation processes and the appropriateness of the institution's ACL balances." Throughout the Interagency Policy Statement referenced above, the terms "appropriate," "reasonable," "supportable" and "documentation" occur a myriad of times with respect to examiners' assessment of management's assumptions, methods and process, and the overall ACL. For each quarterly ACL estimate, be prepared to share with examiners the written rationale supporting management's estimation process, including the assumptions, forecasts, and qualitative adjustments used.

Throughout 2023 and 2024, our team has worked with a number of clients to validate their approach and offer further guidance on the ongoing ACL process. As most community-based financial institutions approach the first anniversary of this "new" accounting treatment, many may not have experienced a regulatory review since its implementation, lacking regulatory insights to the new ACL process. Conducting an ACL Validation will help identify areas for improvement either preemptively or in preparation for regulatory feedback.