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CECL – An Analysis of the April 2016 CECL Draft Presented to the Transition Resource Group

By Randal Rabe
Director at Credit Risk Management Analytics, LLC

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Executive Summary

CECL is becoming more of a reality with the late 2015 FASB announcement of effective dates and, more recently, with the release of a revised CECL document to the Transition Resource Group. FASB has clearly attempted to provide for flexibility in approach and data collection requirements. However, there are still unanswered questions that can have a significant financial and operational impact to community banks and credit unions.

Community banks and credit unions should now begin earnest preparation for CECL. Certainly data collection efforts can begin even if final-model choices have not been selected. The Federal Reserve Bank recently encouraged depository institutions to be proactive in estimating the potential impact to their regulatory capital ratios to assess whether they will have sufficient capital at the time that the CECL model goes into effect.

Introduction

The Financial Accounting Standards Board (FASB) is expected to release its final standard on accounting for credit losses by the end of June 2016. The new approach is called "CECL" (Current Expected Credit Loss) and will fundamentally change the Allowance for Loan and Lease Losses (ALLL) concept as well as the methodology of calculating the ALLL. The effective dates for CECL will be 2020 for SEC-filers and 2021 for other entities.

The proposed standard, which was released in December 2012, has been debated for over three years, and while we have seen the various "tentative decisions" that FASB has made on this proposal, there had not been a new exposure draft released except for the draft document made public prior to the initial Transition Resource Group (TRG) meeting held on April 1, 2016.

This FMS White Paper is designed to help financial institutions understand some of the key provisions of the **TRG CECL draft** as well uncover some of the important details.

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CECL Calculation

1. Methods Identified in the TRG CECL Draft

The primary methodology used by community banks and credit unions to calculate today's ALLL is based upon an annualized historical net charge-off approach. Many of these institutions perform these calculations utilizing spreadsheet software. FASB has indicated that financial institutions can use existing spreadsheet methodologies to calculate life of loan losses. However, this seems to be contradicted by section 825-15-55-24 of the 2012 proposed standard: "It typically would be inappropriate to estimate the expected credit losses for a long-term asset by multiplying an annual loss rate"…"by the remaining years of the asset's contractual term because loss experience is often not linear." This section is absent from the TRG CECL draft although we don't believe that the omission implies that FASB has changed its view of this approach.

Specifically, the TRG CECL draft states in section 326-20-30-3: "The allowance for credit losses may be determined using various methods. For example, an entity may use discounted cash flow methods, loss rate methods, roll-rate methods, probability-of-default methods, or methods that utilize an aging schedule." While FASB did not elaborate on different types of "loss rate methods", the examples contained in the document included both a vintage-year approach and a cumulative lifetime loss rate approach.

It remains unclear how existing spreadsheet methodologies can be utilized for CECL calculations without converting to vintage analysis, a cumulative lifetime loss rate or some other model approach and it will be important that the final standard provide better examples. Examples #1 and #2 in the TRG CECL draft (section 326-20-55-18 through 27) referred to using a "Loss-Rate Approach" but contained the phrase "cumulative historical lifetime credit loss rate"; however, there was no explanation of how to convert "annualized loss rates" to "lifetime loss rates".

2. Historical Credit Loss Experience

One of the key differences between today's "probable incurred" loss methodology and CECL is that CECL requires a calculation of losses over the contractual term of the financial asset. An entity shall not extend the contractual term for expected extensions, renewals, and modifications unless it has a reasonable expectation at the reporting date that it will execute a **troubled debt restructuring** with the borrower.

The TRG CECL draft appears to provide only minimal prescriptive guidance with respect to historical credit loss experience. As a starting point, "historical credit loss experience of financial assets with similar risk characteristics generally provides a basis for an entity's assessment of expected credit losses." The implementation guidance indicates that an entity may use historical periods that represent management's expectations for future credit losses or an entity may elect to use other historical loss periods, adjusted for current conditions, and other reasonable and supportable forecasts. In addition, the draft allows for use of either internal or external information.

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There is also little guidance for the length of the historical look-back period. Example #1 assumes a ten-year contractual term loan portfolio and utilizes the most recent ten-year cumulative loss rates as a starting point. Example #3 is a vintage approach for a portfolio of four-year loans and uses nine years of historical loss experience which provides five years of lifetime loss rates and four years of partially-complete data sets.

It is important to note that for periods beyond the "reasonable and supportable forecast period", the draft becomes more definitive: "historical loss information can be internal or external historical loss information (or a combination of both) and **<u>shall reflect the historical loss information over an economic cycle</u>**."

3. Qualitative and Environmental Factors

Qualitative & Environmental (Q&E) factors will remain under CECL and may become more complicated. Under today's regulatory guidance, the purpose of Q&E factors is to provide for an adjustment to historical loss rates to account for changes from the historical conditions to the conditions that exist as of the balance sheet date. The 2006 Interagency Guidance on ALLL recognized the **<u>qualitative</u>** nature of these adjustments and stated "Management must exercise significant judgment when evaluating the effect of qualitative factors on the amount of the ALLL because data may not be reasonably available or directly applicable for management to determine the precise impact of a factor on the collectability of the institution's loan portfolio as of the evaluation date." Current audit requirements for documentation of calculations and controls have created challenges in this area of ALLL.

In a CECL world, these Q&E factors will not only be used to adjust historical loss rates for current conditions, but they will also be used to adjust for conditions expected during the reasonable and supportable forecast period. The key questions:

- How will these adjustments be determined?
- How will these adjustments be documented to satisfy audit requirements?

While the TRG CECL draft did not answer these questions, the implementation guidance did provide some insight into the factors to consider. In addition to the nine factors from the 2006 Interagency Guidance, section 326-20-55-4 also identified four potential new factors to consider:

a. The borrower's financial condition, credit rating, credit score, asset quality, or business prospects
b. The borrower's ability to make scheduled interest or principal payments
c. The remaining payment terms of the financial asset(s)
d. The remaining time to maturity and the timing and extent of prepayments on the financial asset(s)

Example #1 (section 326-20-55-18) assumes a portfolio of ten-year term loans (originated over the past ten years) and while it provides for some qualitative adjustments to the historical cumulative lifetime credit loss rate of 1.5%, it doesn't attempt to adjust the rate to the

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remaining contractual maturity of the loan portfolio. We believe that this is a necessary yet challenging adjustment to quantify using this type of loss-rate model approach, whereas a discounted cash model would directly calculate the expected loss over the remaining contractual term of the loan.

4. Reasonable and Supportable Forecast Period

Much like the flexibility (and lack of specificity) regarding historical loss periods, FASB provides little in the way of prescriptive guidance regarding the length of the reasonable and supportable forecast period. Section 326-20-30-9 indicates that “some entities may be able to develop reasonable and supportable forecasts over the contractual term of the financial assets. However, an entity is not required to develop forecasts over the contractual term of the financial assets if those forecasts are not supportable.”

The examples included in the TRG CECL draft do provide some insight in that we noted the use of both a one-year and two-year reasonable and supportable forecast period within the examples.

We do find it curious that entities are required to disclose a discussion of the reversion method applied for periods beyond the reasonable and supportable forecast period but that there is no requirement to disclose the length of the reasonable and supportable forecast period utilized in the CECL calculation.

Collateral-Dependent Financial Asset

The definition of collateral-dependent loans is changing under CECL. First, the extent of loan repayment provided for by the operation or sale of the collateral is being reduced from “solely” to “substantially”. Second, collateral-dependent loans require that the borrower is experiencing financial difficulty based on an entity’s assessment as of the reporting date. This significantly narrows the scope of loans that would qualify as collateral-dependent. For those who may be thinking that you can justify zero reserve on non-collateral dependent loans based upon strong loan-to-value ratios, FASB has specifically thwarted that approach in section 326-20-30-10 by stating “entity shall not expect nonpayment of the amortized cost basis to be zero solely on the basis of the current value of collateral securing the financial asset(s) but, instead, also shall consider the nature of the collateral, potential future changes in collateral values, and historical loss experience for financial assets secured with similar collateral.”

The valuation approach on collateral-dependent loans continues to use fair value when repayment is expected to be provided through the operation of the collateral, and at fair value less selling costs when repayment is expected to be provided through the sale of the collateral.

Disclosures for collateral-dependent financial assets have been enhanced. An entity shall describe the type of collateral by **class of financing receivable** and major security type. The entity also shall qualitatively describe the extent to which collateral secures its financial assets,

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significant changes in the extent to which the collateral secures the entity's financial assets, and whether the change in value is because of a general deterioration or some other reason.

Purchased Financial Assets with Credit Deterioration

Upon a first reading of the 2012 proposed standard, we were pleased to see that the credit marks on Purchased Credit Deteriorated ("PCD", formerly PCI) loans would become a component of ALLL rather than be netted into the fair value loan balance. Later analysis has become more concerning as it now appears that non-PCD loans would be subject to CECL accounting as well as fair value measurement at the merger date. We are all hopeful that the final standard will clarify that this "double-counting" of the credit mark will not be required.

In addition, while PCD loans will be accounted for using a gross-up method with the credit mark being included in ALLL, the definition of PCD assets has been expanded to include assets with **more than insignificant credit deterioration** since origination (previously required **significant deterioration)**. FASB has attempted to provide some insight into the definition of "more than insignificant credit deterioration" by way of Example #11 in the TRG CECL draft. This example provides some characteristics to be considered:

a. Financial assets that are delinquent as of the acquisition date
b. Financial assets that have been downgraded since origination
c. Financial assets that have been placed on nonaccrual status
d. Financial assets for which, after origination, credit spreads have widened beyond the threshold specified in its policy.

The example provides some cautionary wording: "Judgment is required when determining whether purchased financial assets should be recorded as purchased financial assets with credit deterioration. Entity N's considerations represent only a few of the possible considerations. There may be other acceptable considerations and policies applied by an entity to identify purchased financial assets with credit deterioration." The TRG CECL draft provides extensive flexibility to define PCD assets and we wonder if financial institutions will be forced to utilize the PCD definition flexibility to avoid the "double-counting" of the credit mark for non-PCD loans.

Liability for Unfunded Commitments

A liability for estimated losses on unfunded commitments is not included in ALLL under today's methodology, but, if required, is recorded as a liability on the balance sheet. Today's treatment and calculation methodology of this liability is fairly wide-ranging. Under CECL, the estimated losses on unfunded commitments should be calculated using the contractual period for unfunded lines unless unconditionally cancellable by the bank.

This more prescriptive language will likely lead to more consistency in the calculation methodology but could have a negative financial impact on the financial institution depending upon current practice and the extent of unfunded lines.

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Disclosure has again been enhanced as an entity shall disclose a description of the accounting policies and methodology the entity used to estimate its liability for off-balance-sheet credit exposures and related charges for those credit exposures. The description shall identify the factors that influenced management's judgment (for example, historical losses, existing economic conditions, and reasonable and supportable forecasts) and a discussion of risk elements relevant to particular categories of financial instruments.

The only applicable example provided (Example #10) related to a credit card portfolio and it specifically addressed the example bank's ability to unconditionally cancel the available credit. We surmise that some regulators were surprised by the conclusion: "Bank M does not record an allowance for unfunded commitments on the unfunded credit cards because it has the ability to unconditionally cancel the available lines of credit. Even though Bank M has had a past practice of extending credit on credit cards before it has detected a borrower's default event, it does not have a present obligation to extend credit. Therefore, an allowance for unfunded commitments should not be established because credit risk on commitments that are unconditionally cancellable by the issuer are not considered to be a liability." So, while there may be some instances where a financial institution would recognize a lower liability for unfunded commitments under CECL than exists today, we believe that the new, more prescriptive wording will result in an increase in the industry-wide liability for unfunded commitments.

Credit Quality Disclosures

The 2012 proposed draft included a requirement to disclose period-to-period roll-forward of loan balances by loan segment. After hearing significant feedback regarding the operational challenges of this disclosure, FASB eliminated the proposed disclosure through a FASB tentative decision in February 2015 but replaced it with the addition of a credit quality disclosure requiring that financial institutions disclose balances by credit quality indicator for each loan class disaggregated by year of origination including the current year and the previous four years along with a total for originations prior to the fifth year back.

In the implementation guidance, FASB did offer some example credit quality indicators:

a. Consumer credit risk scores
b. Credit-rating-agency ratings
c. An entity's internal credit risk grades
d. Loan-to-value ratios
e. Collateral
f. Collection experience
g. Other internal metrics

We appreciate that FASB has included an example (Example #15) in the TRG CECL draft, but the example may challenge the current data collection practices of most community banks and credit unions. The example for risk-graded commercial loans utilized risk-grade buckets to

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capture the credit quality indicators for each vintage and for each loan class which should be readily available. The consumer loan class used updated FICO scores as the credit quality indicator which becomes challenging depending upon whether all consumer loans receive periodic credit score updates. Finally, the residential mortgage loan class utilized both updated credit scores as well as updated current loan-to-value (CLTV) ratios as credit score indicators. This would likely present additional challenges for community banks and credit unions.

As financial institutions consider how to begin to capture necessary disclosure information, FASB did provide some information which deserves special attention:

a. An entity shall use the guidance in paragraphs 310-20-35-9 through 35-12 when determining whether a modification, extension, or renewal of a financing receivable should be presented as a current-period origination.
b. For purchased financing receivables and net investment in leases an entity shall use the initial date of issuance to determine the year of origination, not the date of acquisition.

Conclusion: Financial Institutions Don't Need to Wait to Start Preparations for CECL

Many community banks and credit unions have not begun preparation for CECL. Initially, we believe the delay was largely due to a hope that CECL would ultimately not be approved. Once FASB provided effective dates in late-2015, banks and credit unions attributed further delay to a desire to see more definitive wording for CECL than what was contained in the original 2012 proposed standard.

Now that FASB has provided the TRG CECL draft, financial institutions no longer have an excuse to delay preparation. Certainly data collection efforts can begin even if final-model choices have not been selected. The Federal Reserve Bank recently stated "Nonetheless, depository institutions should be proactive in estimating the potential impact to their regulatory capital ratios to assess whether they will have sufficient capital at the time that the CECL model goes into effect."

Credit Risk Management Analytics, L.L.C. has been working with its clients for more than a year generating CECL impact analyses. These allow our clients to better understand the projected impact at a loan category level and provide more time to adjust portfolio strategies to mitigate the CECL risk.

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About the Author:

Randal J. Rabe, CPA

Randy Rabe is a director with Credit Risk Management Analytics, LLC. Most recently he served as Chief Financial Officer of a $1 billion publicly traded community bank headquartered in Ann Arbor, Michigan. He was a member of the ABA Accounting Administrative Committee and the ABA Impairment Working Group (2013-2014). Previously, he served as President & Chief Executive Office of a $500 million Michigan-based community bank. He began his career with the public accounting firm KPMG. He graduated Summa Cum Laude with a BBA from the University of Toledo and obtained his MBA from the University of Michigan.

About Credit Risk Management Analytics, L.L.C.

Credit Risk Management Analytics (CRMª) enables financial institutions to manage risk by delivering fully integrated credit lifecycle quantitative products and services. Built on extensive and practical experience, CRMª offers advanced analytics, state of the art software, and customizable solutions.

For further information please contact:

Charles C. Stuard
EVP/Chief Revenue Officer
Credit Risk Management Analytics, LLC
888-600-7567 Office Main
cstuard@creditriskmgt.com
www.creditriskmgt.com

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Financial Managers Society
1 North LaSalle Street, Suite 3100
Chicago, IL 60602
info@fmsinc.org

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