www.creditriskmgt.com
info@creditriskmgt.com
1-888-600-7567

White Paper

CECL – An Analysis of Accounting Standards Update No. 2016-13 Financial Instruments – Credit Losses

By: Randal Rabe, Director at Credit Risk Management Analytics, LLC

Executive Summary

CECL has become a reality with the June 2016 release of the final CECL standard. FASB has clearly attempted to provide for flexibility in approach and data collection requirements. There are still unanswered implementation 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. Credit Risk Management Analytics, L.L.C. has been working with its clients for more than a year generating CECL impact analyses to better understand the projected impact at a loan category level and provide more time to adjust portfolio strategies to mitigate the CECL risk.

Introduction

The Financial Accounting Standards Board (FASB) recently released its final Accounting Standards Update (ASU) No. 2016-13 Financial Instruments – Credit Losses (Topic 326). 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.

This White Paper is designed to help financial institutions understand some of the key provisions of the Final CECL Standard as well uncover some of the important details.

CECL Calculation

1. Methods Identified in the Final CECL Standard

The Final CECL ASU 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 ASU included both a vintage-year approach and a lifetime loss rate approach.

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 "many of the loss estimation techniques applied today will still be permitted, although the inputs to those techniques will change to reflect the full amount of expected credit losses." Examples #1 & #2 in the final standard were referred to as using a Loss-Rate Approach but contained the phrase "historical lifetime credit loss rate"; however, there was no discussion of how to convert "annualized loss rates" to "lifetime loss rates".

In the June 17, 2016 "Joint Statement on the New Accounting Standard on Financial Instruments – Credit Losses", the regulators explained it more clearly by stating "For example, the input to a loss rate method would need to represent remaining lifetime losses, rather than the annual loss rates commonly used under today's incurred loss methodology". While both FASB and the regulatory bodies appear to be sensitive to the potential cost burden for smaller institutions, it is quite clear that "annualized net-charge off rates" cannot be utilized to calculate lifetime credit losses and that some input modifications will be necessary.

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 Final CECL ASU 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 standard allows for use of either internal or external information, or a combination of both.

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.

For periods beyond the "reasonable and supportable forecast period", the standard remains fairly flexible: "historical loss information can be internal or external historical loss information (or a combination of both)" and shall be "**reflective of the contractual term of the financial asset**." Interestingly, the phrase "over an economic cycle" was removed from an earlier draft version.

3. Qualitative and Environmental Factors

Qualitative & Environmental (Q&E) factors will remain under CECL and will likely 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. Current audit requirements for documentation of calculations and controls have created challenges in this area of ALLL.

According to the CECL final standard, "when an entity uses historical loss information, it shall consider the need to adjust historical information to reflect the extent to which management expects current conditions and reasonable and supportable forecasts to differ from the conditions that existed for the period over which historical information was evaluated."

The key questions:

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

The examples in the final standard were deficient in providing practical guidance to these adjustments. This issue will need to be kept at the forefront during the model development and/or selection process as the regulators have stated "institutions are encouraged to build strong processes and controls over their allowance methodology".

While the standard did not answer the abovementioned 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)

The use of a discounted cash flow method that incorporates a probability of default would enable financial institutions to account for these new qualitative factors directly into the expected loss calculation at the loan level.

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 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."

The examples included in the CECL ASU 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.

FASB has allowed significant flexibility in the method of reversion to historical loss information after the reasonable and supportable forecast period. Specifically, per 326-20-30-9 "An entity shall not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods that are beyond the reasonable and supportable period. An entity may revert to historical loss information at the input level or based on the entire estimate. An entity may revert to historical loss information immediately, on a straight-line basis, or using another rational and systematic basis."

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 implied 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. The final standard also considered that fair value of collateral treatment should be used when the entity determines that foreclosure is probable (326-20-35-4).

We believe that these changes will narrow 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, by class of financing receivable and major security type, the extent to which collateral secures its collateral-dependent financial assets, and significant changes in the extent to which collateral secures its collateral-dependent financial assets, whether 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 became more concerning as it is now apparent that non-PCD loans will be subject to CECL accounting as well as fair value measurement at the merger date. This has been confirmed by Topic 805-20-30-4A in the ASU which states "For acquired financial assets that are not **purchased financial assets with credit deterioration,** the acquirer shall record the purchased financial assets at the acquisition-date fair value. Additionally, for these financial assets within the scope of Topic 326, an allowance shall be recorded with a corresponding charge to credit loss expense as of the reporting date."

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 <u>**more than insignificant credit deterioration**</u> since origination (previously required <u>**significant deterioration)**</u>. FASB has attempted to provide some insight into the definition of "more than insignificant credit deterioration" by way of Example #11 in the CECL ASU. 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 final standard 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.

Troubled Debt Restructurings (TDR's)

At first blush we thought that the accounting for TDR's was being simplified. Upon analysis of the final standard, we are not so sure. TDR's are covered by Topic 326 which provides for fair value of collateral treatment for collateral-dependent loans and provides for either a discounted cash flow method (DCF) or a non-DCF method for other loans. If the entity selects a DCF approach, Topic 310-40-35-12 states that "the interest rate used to discount expected future cash flows on a restructured loan shall be the same interest rate used to discount expected future cash flows on the original loan." However, if the entity selects a non-DCF approach for CECL calculation, the standard "requires credit losses to be recorded through an allowance for credit loss account, including concessions given to the borrower upon a troubled debt restructuring." Therefore, we believe that an interest rate concession would need to be captured in the ALLL even if the entity is utilizing a non-DCF approach for CECL.

Current disclosures for TDR's, both regarding current period restructures, as well as current period payment defaults on troubled debt restructurings within the previous twelve months, will still be required under the new CECL standard.

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 the new CECL ASU, the liability for 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.

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

In the final standard, FASB provided relief to non-public business entities which will not be required to complete this disclosure. In addition, FASB provided some transition relief to public entities which are not SEC-filers. FASB has included an example (Example #15) in the final standard, and has simplified the credit quality indicators from an earlier draft by using internal risk grading for all classes of financing receivables. The credit quality disclosure may challenge the current data collection practices of some community banks and credit unions. Current risk-grades for commercial loans should be readily available to capture the credit quality indicators for each vintage and for each loan class. The practice of periodically updating internal risk grades, FICO scores, or current loan-to-value (CLTV) ratios as the credit quality indicators for consumer and residential mortgage loan classes may present challenges for community banks and credit unions and should be considered during the CECL implementation planning process.

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 issued the final standard, 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.

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.

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.

CRMª has formed an interest group on Linked-In named CECL. The purpose is to share thoughts, ideas and new information with each other so that we can all effectively prepare for CECL from both a cost and impact perspective. We invite you to join and participate in the group: *www.linkd.in/18yYLk4*.

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