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Current Expected Credit Loss (CECL): Scaled CECL Allowance for Losses Estimator (SCALE) Method

July 15, 2021

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Welcome

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- Webinar: https://www.webcaster4.com/webcast/page/584/41882
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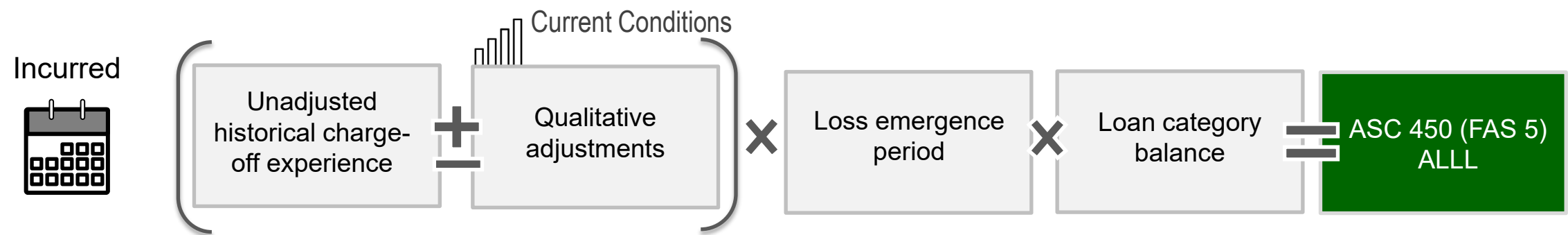
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Goals of Today's Session

- Review the use of the Scaled CECL Allowance for Losses Estimator (SCALE) Method and SCALE tool

- Discuss supervisory expectations

- Answer your questions

CECL Overview

Historical U.S. GAAP

Incurred

(Unadjusted historical charge-off experience **+** Qualitative adjustments) [Current Conditions] **×** Loss emergence period **×** Loan category balance **=** **ASC 450 (FAS 5) ALLL**

CECL

Lifetime

(Unadjusted historical charge-off experience **+** Qualitative adjustments) [Current & Forecast] **×** Loss emergence period **×** Loan category balance **=** **CECL ACL (ASC 326)**
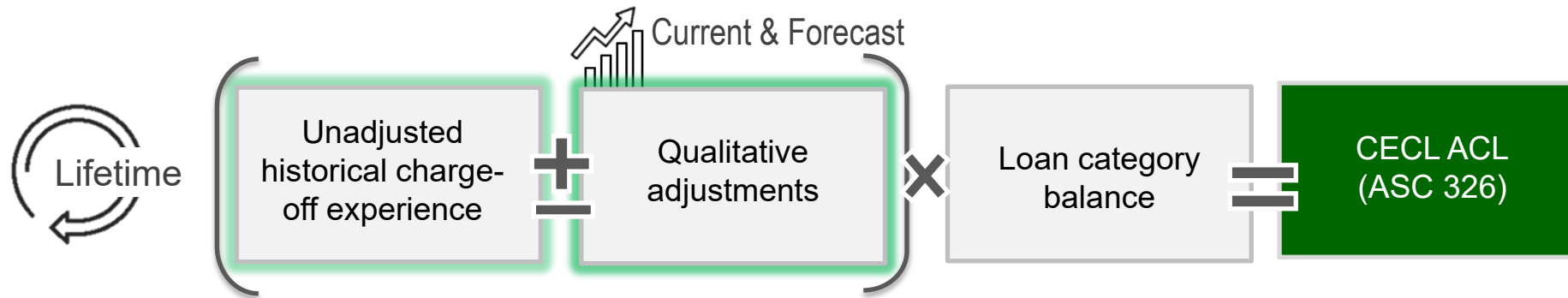
Polling Question #1

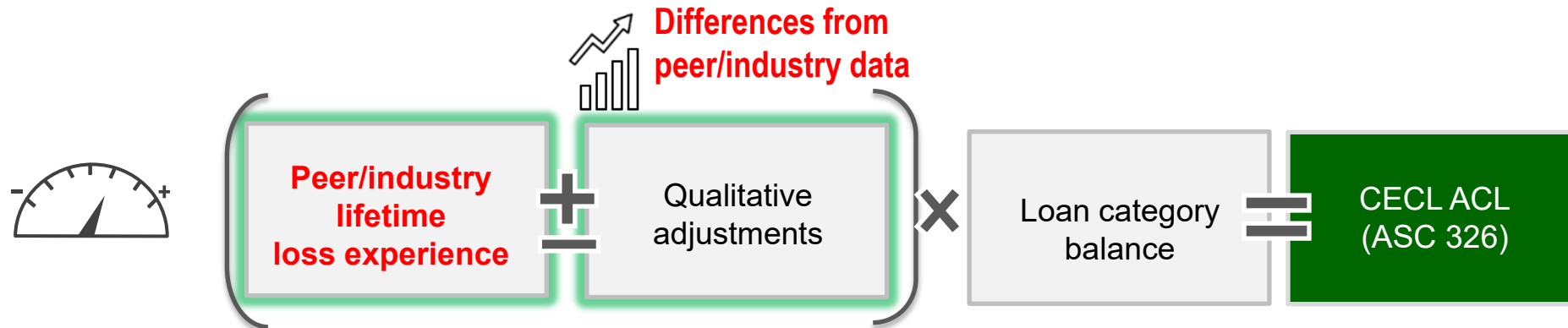**What is the current status of your transition to the CECL methodology?**

1. **In the discussion and planning phase**
2. **In the data collection and analysis phase**
3. **Method is selected and is in testing phase**
4. **Have not started yet**

SCALE Method: Overview

CECL

SCALE Method

SCALE Method: *What is it?*

- One of many acceptable methods of applying CECL.

- Designed for smaller, less complex institutions (not designed for larger institutions.)

- SCALE tool leverages peer data from publicly available regulatory reports as a <u>starting block</u>.

- Like all other CECL methods, each institution MUST individually determine whether this method is appropriate based on its own unique facts and circumstances.

SCALE Method: *What it is __not__?*

- Not a regulator-preferred method.

- Does not ensure compliance with U.S. GAAP without proper management adjustments uniquely determined by each institution.

- Not a safe harbor methodology, examiners will continue to review the overall ACL process.

- SCALE tool cannot be used by institutions with assets greater than $1 billion.

SCALE Tool: Example

Portfolio Segment	End of Period Loan Balance		Loans Assessed on Individual Basis (From Tab 2)		Loans Assessed on Pooled Basis (Calculated)	CECL ACL Lifetime Loss Rate		Adj. for Qualitative Factors (From Tab 3)		Life of Loan Loss Rate (Calculated)	CECL ACL (Calculated)
Real Estate - Construction	$ 14,960	-	$ -	=	$ 14,960	1.7407%	+/-	0.0500%	=	1.7907%	$ 268
Real Estate - Commercial	$ 79,473	-	$ 697	=	$ 78,776	1.5314%	+/-	0.0500%	=	1.5814%	$ 1,246
Real Estate - Residential	$ 51,063	-	$ 361	=	$ 50,702	0.8228%	+/-	0.0500%	=	0.8728%	$ 443
Commercial	$ 46,568	-	$ 211	=	$ 46,357	1.2572%	+/-	0.1000%	=	1.3572%	$ 629
Credit Cards	$ 294	-	$ -	=	$ 294	12.0382%	+/-	0.0000%	=	12.0382%	$ 35
Other Consumer	$ 7,644	-	$ 243	=	$ 7,401	1.7409%	+/-	0.1000%	=	1.8409%	$ 136
Additional Segments	$ -	-	$ -	=	$ -	0.0000%	+/-	0.0000%	=	0.0000%	$ -
Total	$ 200,001				$ 198,489						$ 2,757

Adjustment for Historical Loss Experience — From Tab 4   -0.1214% $ (241)

Expected Losses on Loans Assessed on Individual Basis — From Tab 2 $ 429

Total Expected Losses on Loans $ 2,945

Ending Loss Rate (1.47%)

ACL/Total Loans   1.47%

Note: Some numbers may not reconcile due to rounding.

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Step 1: Calculate expected credit losses for loans evaluated on individual basis

Total loan balance	−	Loans assessed individually	=	Loans assessed on pooled basis

⇨ Similar to current process under incurred loss methodology

SCALE Tool: Step 1 (continued)

Loans Assessed for Expected Credit Losses on Individual Basis

Borrower/Relationship Name	Note Number(s)	Loan Balance by Portfolio Segment							Amount Expected to be Collected	CECL ACL
		Real Estate - Construction	Real Estate - Commercial	Real Estate - Residential	Commercial	Credit Cards	Other Consumer	Additional Segments [1]		*Calculated*
Customer A	#####		$ 159	$ -					$ 99	$ 60
Customer B	#####			$ 147					$ 122	$ 25
Customer C	#####						$ 85		$ 63	$ 22
Customer D	#####			$ 67					$ 33	$ 34
Customer E	#####			$ 59					$ 47	$ 12
Customer F	#####				$ 117				$ 120	$ -
Customer G	#####		$ 278						$ 125	$ 153
Customer H	#####						$ 42		$ 6	$ 36
Customer I	#####						$ 24		$ 15	$ 9
Customer J	#####		$ 260						$ 200	$ 60
Customer K	#####			$ 88					$ 70	$ 18
										$ -
										$ -
Cash Secured	Various				$ 94		$ 92		$ 186	$ -
										$ -
										$ -

[Add rows as needed]

Totals:	$ -	$ 697	$ 361	$ 211	$ -	$ 243	$ -

$ 429

$ 429

SCALE Tool: Step 1 (continued)

Loans Assessed for Expected Credit Losses on Individual Basis

| Portfolio Segment	End of Period Loan Balance	From Tab 2 Loans Assessed on Individual Basis	Loans Assessed on Pooled Basis *(Calculated)*	CECL ACL Lifetime Loss Rate		Adj. for Qualitative Factors *(From Tab 3)*		Life of Loan Loss Rate *(Calculated)*	CECL ACL *(Calculated)*
Real Estate - Construction	$ 14,960	$ -	14,960	1.7407%	+/-	0.0500%	=	1.7907%	$ 268
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Credit Cards	$ 294	$ -	294	12.0382%	+/-	0.0000%	=	12.0382%	$ 35
Other Consumer	$ 7,644	$ -	7,401	1.7409%	+/-	0.1000%	=	1.8409%	$ 136
Additional Segments	$ -	$ 243	-	0.0000%	+/-	0.0000%	=	0.0000%	$ -
		$ -							
Total	$ 200,001		198,489						$ 2,757

Adjustment for Historical Loss Experience	*From Tab 4*	-0.1214%	$ (241)
Expected Losses on Loans Assessed on Individual Basis		*From Tab 2*	$ 429
Total Expected Losses on Loans			$ 2,945
ACL/Total Loans			1.47%

SCALE Tool: Step 2

Step 2: Enter proxy expected lifetime loss rate

- May use aggregated data from Schedule RI-C of the Call Report:

  - Schedule RI-C contains allowance data for institutions with $1 billion or more in total assets disaggregated by portfolio category

    – Incorporates reasonable and supportable economic forecast, estimated prepayments and some qualitative adjustments

  - Serves as the starting point for management's estimate of expected losses
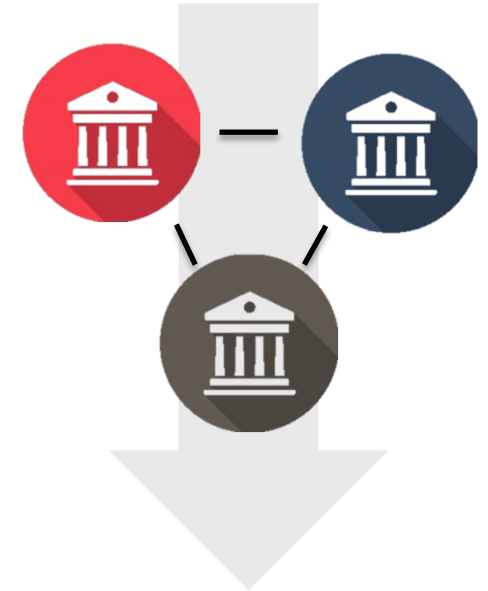
SCALE Tool: Step 2 (Schedule RI-C) (continued)

Part II. Disaggregated Data on the Allowances for Credit Losses[1]

Schedule RI-C, Part II, is to be completed by institutions with $1 billion or more in total assets.[2]

	(Column A) Amortized Cost		(Column B) Allowance Balance	
Dollar Amounts in Thousands	RCON	Amount	RCON	Amount
Loans and Leases Held for Investment:				
1. Real estate loans:				
a. Construction loans	JJ04		JJ12	
b. Commercial real estate loans	JJ05		JJ13	
c. Residential real estate loans...............	JJ06		JJ14	
2. Commercial loans[3]...........................	JJ07		JJ15	
3. Credit cards	JJ08		JJ16	
4. Other consumer loans	JJ09		JJ17	
5. Unallocated, if any			JJ18	
6. Total (sum of items 1.a through 5)[4].........	JJ11		JJ19	

National RI-C Loss Rates as of 3/31/21

120 community banks completed Schedule RI-C, Part II, as of 3/31/21

Segment	Total Loans (in thousands)	ACL (in thousands)	Expected Loss Rate
RE - Construction	$20,965	$365	1.7407%
RE - Commercial	135,014	2,068	1.5314%
RE - Residential	79,220	652	0.8228%
Commercial	110,160	1,385	1.2572%
Credit Cards	15,305	1,842	12.0382%
Other Consumer	23,954	417	1.7409%
Totals	**$384,618**	**$6,729**	**1.7495%**

Note: Some numbers may not reconcile due to rounding.

SCALE Tool: Step 2 (continued)

From Schedule RI-C

Portfolio Segment	End of Period Loan Balance		Loans Assessed on Individual Basis (From Tab 2)		Loans Assessed on Pooled Basis (Calculated)	CECL ACL Lifetime Loss Rate		Adj. for Qualitative Factors (From Tab 3)		Life of Loan Loss Rate (Calculated)	CECL ACL (Calculated)
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Additional Segments	$ -	-	$ -	=	$ -	0.0000%		0.0000%	=	0.0000%	$ -
Total	$ 200,001				$ 198,489						$ 2,757

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SCALE Tool: Step 3

Step 3: Adjust for qualitative factors

- Make qualitative adjustments for information not already captured in the proxy expected lifetime loss rate, including any forward looking adjustments unique to the institution.

- See Interagency Policy Statement on the Allowances for Credit Losses for a list of some of the potential qualitative factors for management to consider.

⟹ **Similar to current process under incurred loss methodology**

SCALE Tool: Step 3 (continued)

Step 3: Adjust for qualitative factors

Loan Segment	Adjustment	Comments
Real Estate - Construction	0.0500%	[Enter summary comments and source of supporting analysis/narrative]
Real Estate - Commercial	0.0500%	
Real Estate - Residential	0.0500%	
Commercial	0.1000%	
Credit Cards	0.0000%	
Other Consumer	0.1000%	
Additional Segments [1]	0.0000%	

Additional Narrative:

[Enter additional explanatory narrative if warranted]

SCALE Tool: Step 3 (continued)

Step 3: Adjust for Qualitative Factors

	End of Period Loan Balance		Loans Assessed on Individual Basis *(From Tab 2)*		Loans Assessed on Pooled Basis *(Calculated)*	CECL ACL Lifetime Loss Rate		Adj. for Qualitative Factors *(From Tab 3)*	Life of Loan Loss Rate *(Calculated)*	CECL ACL *(Calculated)*
Portfolio Segment										
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								0.0000%		
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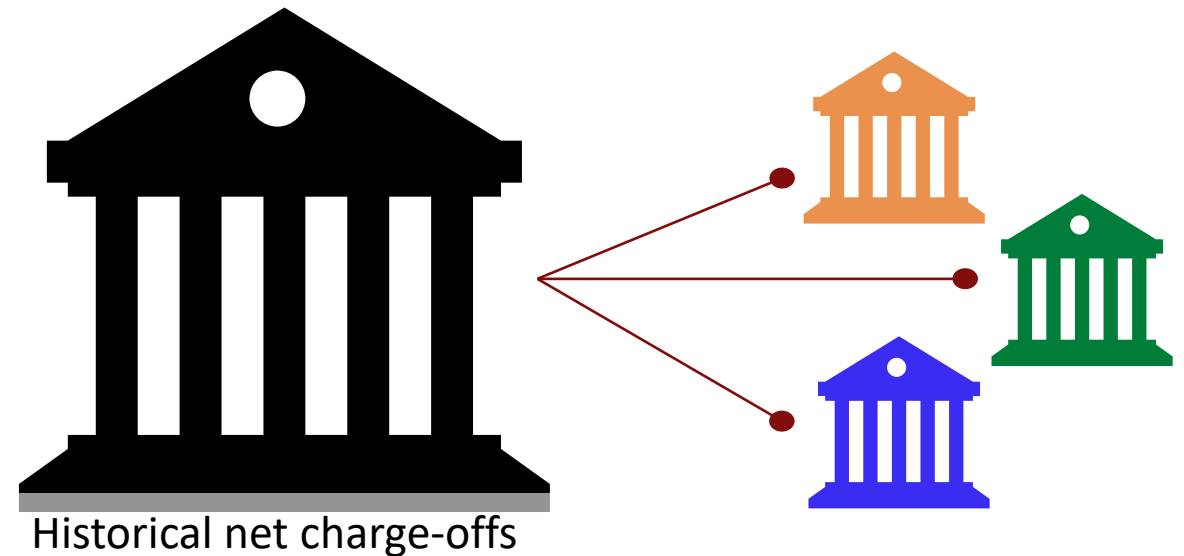Note: Some numbers may not reconcile due to rounding.

SCALE Tool: Step 4

Step 4: Adjust proxy expected lifetime loss rate to reflect the institution's insight on portfolio performance

Example approach: Compare institution's net loss rate to its peers' rate as reported in the Uniform Bank Performance Report (UBPR)

NOTE: Other approaches may be more appropriate based on institution's management judgment

Historical net charge-offs

SCALE Tool: Step 4 (continued)

Bank	
Net Loss to Average Total LNLS	
[from page 7 of UBPR]	
Year	**Ratio**
2007	0.0200%
2008	0.2400%
2009	0.1900%
2010	0.1300%
2011	0.1500%
2012	0.2400%
2013	0.4000%
2014	0.5600%
2015	0.2500%
2016	0.1500%
2017	0.0300%
2018	0.0400%
2019	-0.0200%
2020	0.0300%

Peer	
Net Loss to Average Total LNLS	
[from page 7 of UBPR]	
Year	**Ratio**
2007	0.1700%
2008	0.4000%
2009	0.8000%
2010	0.7400%
2011	0.5900%
2012	0.4000%
2013	0.2500%
2014	0.1600%
2015	0.1100%
2016	0.1100%
2017	0.1100%
2018	0.0900%
2019	0.1000%
2020	0.0800%

Average through-the-cycle net loss rate for target bank

Average through-the-cycle net loss rate for banks nationwide

Average	0.1721%

Average	0.2936%

Calculated
Adjustment
-0.1214%

SCALE Tool: Step 4 (continued)

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SCALE Tool: Example Recap

Portfolio Segment	End of Period Loan Balance		Loans Assessed on Individual Basis (From Tab 2)		Loans Assessed on Pooled Basis (Calculated)	CECL ACL Lifetime Loss Rate		Adj. for Qualitative Factors (From Tab 3)		Life of Loan Loss Rate (Calculated)	CECL ACL (Calculated)
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Total $ 200,001 $ 198,489 $ 2,757

Adjustment for Historical Loss Experience	From Tab 4	-0.1214%	$ (241)
Expected Losses on Loans Assessed on Individual Basis		From Tab 2	$ 429
Total Expected Losses on Loans			$ 2,945
ACL/Total Loans			1.47%

Ending Loss Rate (1.47%)

Note: Some numbers may not reconcile due to rounding.

What is your current role at your institution?

1. Chief Financial Officer/Accounting specialist

2. Credit specialist

3. External auditor

4. Other

SCALE Method: Common Questions

What are the key management inputs for the SCALE Method?

- Proxy expected lifetime loss rates from Schedule RI-C or other data sources

- Adjustments to expected lifetime loss rates

- Other qualitative adjustments

SCALE Method: Common Questions (continued)

Are qualitative adjustments still relevant under the SCALE Method?

- Similar to incurred loss methodology and other methods of applying CECL, qualitative adjustments are <u>required</u> under the SCALE Method to capture expected future losses not quantitatively reflected.

  – May increase or decrease management's estimate of expected credit losses

SCALE Method: Common Questions (continued)

Can you give an example of a qualitative adjustment relevant under the SCALE Method?

- Adjustments to proxy expected lifetime loss rates bridge the gap between loans in the institution's portfolio and loans in the peer group.

- Examples:

  - The bank's market footprint is affected by the oil and gas industry, which is experiencing stress.

  - The bank has experienced a staff turnover in its real estate lending department.

SCALE Method: Key Reminders

- ASC 326 was developed to be operably scalable and flexible.

- The SCALE Method may be appropriate for smaller, less complex institutions. The SCALE tool is limited to institutions with assets less than $1 billion.

  – Not mandatory nor preferred by regulators.

- The SCALE tool should be used with appropriate caution, and the Federal Reserve is providing the SCALE tool template "as-is."

- An institution's management is responsible for ensuring that the ACLs conform with U.S. GAAP and adequately cover credit risk.

SCALE Method: Supervisory Expectations

Interagency Policy Statement on ACLs addresses

- Supervisory expectations for designing, documenting, and validating expected credit loss estimation methodologies

- Internal controls over ACL

- Management's responsibilities for the allowance estimation process, including the need to appropriately support and document the institution's allowance estimates

- The board of directors' responsibilities for overseeing management's processes

- The role of examiners in reviewing the appropriateness of an institution's ACL as part of their supervisory activities

SCALE Method: Supervisory Expectations (continued)

<u>Interagency Policy Statement on ACLs addresses</u>

- Examiner review of the ACL components assesses:

  – Appropriateness of management's loss estimation processes

  – Adequacy of the institution's ACL balances

  – Adequacy of supporting documentation

- The CECL assessment builds on asset quality and credit risk determinations made within existing supervisory review plans.

Based on today's presentation, do you think the SCALE tool would be useful in measuring and reporting your ACLs?

1. Yes
2. No
3. Not sure

Resources

- **FASB:**
  - [Transition Resources Group for Credit Losses](#)
- **Federal Reserve:**
  - [CECL Resource Center](#)
  - [Ask the Regulators: Practical Methods Smaller, Less Complex Community Banks Can Use as a Starting Point for CECL (March 2018)](#)
  - [Interagency Policy Statement on Allowances for Credit Losses](#)
  - [Frequently Asked Questions on the Current Expected Credit Losses Methodology (CECL)](#)

Acronyms

ACL: allowances for credit losses

ALLL: allowance for loan and lease losses

ASC Topic 326: FASB Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*

CECL: current expected credit losses

FAS: Financial Accounting Standard

FASB: Financial Accounting Standards Board

FRB: Federal Reserve Board of Governors

GAAP: generally accepted accounting principles

IPS: interagency policy statement

SCALE: Scaled CECL Allowance Loss Estimator

Schedule RI-C: Disaggregated Data on the Allowance for Loan and Lease Losses

UBPR: Uniform Bank Performance Report

To ask a question:

- **Email your question to:** asktheregulators@stls.frb.org

- **Use the "Ask Question" button in the webinar tool**

Thanks for joining us