Current Expected Credit Loss (CECL) Model: Answers to Your Questions

Live from Eagle Bank and Trust
Little Rock, Arkansas

November 16, 2015
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Today’s Presenters

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Federal Reserve Bank of St. Louis

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*Senior Examiner*  
Federal Reserve Bank of St. Louis

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*Senior Examiner*  
Federal Reserve Bank of St. Louis
Objectives

• Continue recent discussions on the Current Expected Credit Loss (CECL) model
• Follow up on the October 22 Ask the Fed® session with focus on the St. Louis Federal Reserve District
• Review key timelines briefly
• Highlight key elements of the standard and some things to consider at this time
• Go over an additional example
• Take your questions
Rule Makers’ Due Diligence / Estimated Timeframe

- Financial Crisis Advisory Group formed (2008)
- FASB Exposure Draft (December 2012)
- FASB Reactions to IASB “three bucket model” (July 2012)
- Outreach efforts begin (Fall 2015)
- Final Standard Issued (early 2016)
- Implementation (2018-2020)
CECL Impact

- CECL implementation is, in many ways, a project management challenge that will affect most parts of your business to one degree or another.
• Considerations for previous slide
  – CECL is likely to impact business metrics you use to evaluate both your own success and risk you are encountering in the market.
  – We encourage you to develop a process that coordinates and manages the relevant units of your bank, assigns responsibility and resources, and keeps your board of directors informed.
  – You should ask questions of data providers, external accountants, vendors, consultants, and of course, regulators.
  – We are early in this process – so you have time – but data gathering appears to be a good place to start.
Inherent (Old) vs. Expected (New)

<table>
<thead>
<tr>
<th>Incurred Loss Model</th>
<th>Expected Loss Model</th>
</tr>
</thead>
<tbody>
<tr>
<td>• Two standards to scope credit losses were required for most firms.</td>
<td>• One standard will cover vast majority of community banking organization credit transactions.</td>
</tr>
<tr>
<td>• Losses were recognized when “probable” (appeared reactive during last crisis).</td>
<td>• Quicker recognition of loss provisions is expected.</td>
</tr>
<tr>
<td>• The practice evolved over many, many economic cycles.</td>
<td>• Firms can leverage existing systems.</td>
</tr>
<tr>
<td>• Historical performance was focused on heavily.</td>
<td>• Forward-looking information is considered.</td>
</tr>
</tbody>
</table>
CECL Scope

CECL covers loans, debt securities, trade receivables, reinsurance receivables, lease receivables, and loan commitments carried at amortized cost.

Losses are estimated and measured over the full life of the covered asset.

Purchased credit-impaired assets would follow the same approach with the initial estimate of cash flows shown as an adjustment to cost.

Expected credit losses are defined as “current estimate of all contractual cash flows not expected to be collected.”

As a practical expedient for collateral-dependent financial assets, a comparison of amortized cost with fair value of collateral less estimated costs to sell may be used.

Financial assets will be carried on balance sheet at cost less a contra-account (i.e., Allowance).

Income statement will reflect credit deterioration (or improvement) that occurred during the reporting period.
CECL Things to Consider

• A variety of loss methodologies are allowed to support a firm’s historical loss factors:
  – Historical loss experience / vintage analysis averages
    • this was the example from October 22nd Ask the Fed® session
  – Migration loss experience
    • this is the example for this session
  – Loan-by-loan Discounted Cash Flow
  – Probability of default and loss given default
  – Combination or matrix methods
CECL Things to Consider (continued)

- Two standards to one for recognition of loan credit losses

**Incurred Loss Model**

\[
\begin{align*}
\text{ASC 450 (FAS* 5)} & \quad + \quad \text{ASC 310 (FAS 114)} & \quad = & \quad \text{Allowance for loan and lease losses (ALLL)}
\end{align*}
\]

**Expected Loss Model**

\[
\begin{align*}
\text{Applying CECL to loans} & \quad = \quad \text{ALLL}
\end{align*}
\]

*FAS: Financial Accounting Standards*
Inputs needed to estimate the Allowance will expand compared to existing model.

**Common 8th District Bank Approach**

- Historical annual loss experience
- Adjustments for current environment
- ASC 450 portion of the ALLL
- ASC 310 portion of the ALLL

**New Approach?**

- Historical lifetime loss experience
- Adjustments for current environment
- Adjustments for reasonable and supportable forecasts
- “Collateral dependent”
So, what are some early sticking points?

– *What kind of data do I need, exactly?*
– *How far back do I need to go?*
– *Which methodology should I choose?*
– *What will this thing look like at the date of transition?*
– *What will the examiners be telling me?*
CECL Example (from Exposure Draft)

• Bank A provides five-year amortizing commercial mortgage loans.
  – Step A: The bank estimates expected credit losses for pools of similar asset types by:
    • Segregating into credit risk ratings
    • Applying a current estimated loss rate specific to the amortized cost basis of the assets in that category
  – Step B: Bank A develops historical loss rates on the basis of its historical loss data for five-year commercial mortgage loans:
    • Form static pools by grouping borrowers by risk rating at beginning of year
    • Follow each pool from that point forward through the life of assets within the pool
    • Determine a historical loss rate applicable to the risk rating for each pool
CECL Example (from Exposure Draft) (continued)

• To develop its current expected loss rate, Bank A updates historical data (Step B in previous slide) to reflect:
  – Changes in current conditions
  – Reasonable and supportable forecasts that differ from historical experience

• Bank A has now developed current expected loss rates by risk rating based on its historical loss rates and has adjusted for current conditions and reasonable and supportable forecasts about the future.

• For the example, we assume the bank computed the following loss factors:
  – 0.5 percent for loans in Pass category “1”
  – 3.0 percent for loans in Pass category “2”
  – 8.0 percent for loans in Watch category
**Bank A – Expected Credit Loss Estimates (in 000’s)**

<table>
<thead>
<tr>
<th></th>
<th>Pass “1”</th>
<th>Pass “2”</th>
<th>Watch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected loss rates</td>
<td>0.50%</td>
<td>3.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$27,500</td>
<td>$10,000</td>
<td>$2,500</td>
</tr>
<tr>
<td>Expected credit loss</td>
<td>$138</td>
<td>$300</td>
<td>$200</td>
</tr>
</tbody>
</table>

*$638/$40,000 = 1.59 percent and an ALLL of $638,000
CECL Example (from Exposure Draft) (continued)

• Assume that in the following quarter, Bank A expects the loss rates to be the same as they were for the current quarter, because conditions remain consistent.

• Also, assume that various activities have occurred such as payments, and that some credits have deteriorated.
CECL Example (from Exposure Draft) (continued)

Bank A – Expected Credit Loss Estimates (in 000’s)  
March 31, 201X

<table>
<thead>
<tr>
<th></th>
<th>Pass “1”</th>
<th>Pass “2”</th>
<th>Watch</th>
</tr>
</thead>
<tbody>
<tr>
<td>Expected loss rates</td>
<td>.50%</td>
<td>3.00%</td>
<td>8.00%</td>
</tr>
<tr>
<td>Beginning balance</td>
<td>$27,500</td>
<td>$10,000</td>
<td>$2,500</td>
</tr>
<tr>
<td>New originations</td>
<td>2,300</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Paydowns</td>
<td>(1,510)</td>
<td>(560)</td>
<td>(130)</td>
</tr>
<tr>
<td>Credit migration</td>
<td>(320)</td>
<td>115</td>
<td>205</td>
</tr>
<tr>
<td>Ending balance</td>
<td>$27,970</td>
<td>$9,555</td>
<td>$2,566</td>
</tr>
<tr>
<td>Expected credit loss estimation</td>
<td>$140</td>
<td>$287</td>
<td>$205</td>
</tr>
</tbody>
</table>

*$632/$40,091 = 1.58 percent
## CECL Example (from Exposure Draft) (continued)

<table>
<thead>
<tr>
<th>ALLL Reconciliation to Example</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>December 31, 201X</td>
<td>$638</td>
</tr>
<tr>
<td>Charge-offs 1Q1X</td>
<td>(9)</td>
</tr>
<tr>
<td>Provision</td>
<td>3</td>
</tr>
<tr>
<td>March 31, 201X</td>
<td>$632</td>
</tr>
</tbody>
</table>
CECL Summary

• Early pitfalls to avoid:
  – Delaying action because you hope it will go away.
  – Not adopting a process to manage it.

• Day One Transition will be a capital event; it will not run through earnings.
  – “Ramping up” the ALLL approaching Day One Transition will not be permitted.
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Questions?
You have two ways to ask a question:

• By webinar via the “Ask Question” button
• By email: rapid@stls.frb.org
Thank you!