Quarterly Conversations with the Federal Reserve Bank of St. Louis
Live from Arvest Bank
Bentonville, Arkansas

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Today’s Presenters

• **Julie Stackhouse**, *Senior Vice President*, Federal Reserve Bank of St. Louis

• **Steve Merriett**, *Deputy Associate Director and Chief Accountant*, Federal Reserve Board of Governors
Agenda

• Current allowance for loan and lease losses (ALLL) trends and issues
• Early thoughts on implementation of the Current Expected Credit Loss (CECL) Model
• Other accounting hot topics
ALLL Trends

Loan Loss Reserve Coverage Ratio
All Commercial Banks in AR, IL, IN, KY, MO, MS, TN

Loan loss reserve: (LLR); nonperforming total loans (NPTL); total loans (TL)
Source: Consolidated Reports of Condition and Income
ALLL Trends (continued)

Nonperforming Loans to Total Loans
All Commercial Banks in AR, IL, IN, KY, MO, MS, TN

Source: Consolidated Reports of Condition and Income
Perceptions

• Credit quality is back to normal?
• Examiners are disallowing negative or zero provisions?
• Accounting firms and the Securities and Exchange Commission (SEC) are pushing banks to release allowances?
Reality

• Certain credit quality indicators show improvement, but risks remain elevated.
• SEC and Public Company Accounting Oversight Board comments to banks and auditors only relate to adequacy of documentation, not the amount of the allowance.
Supervisory Positions on ALLL

- Should be based on a comprehensive, well-documented, and consistently applied analysis
- Should take into consideration all existing available information, including environmental factors
- Should use judgment and incorporate qualitative / environmental factors
  - Historical data is only the starting basis.
  - Methodology incorporates all internal and external factors affecting collectability, not just historical charge-offs.
  - Banks should consider whether the methodology is producing the right number.
Supervisory Positions on ALLL (continued)

• “Unallocated” loan loss allowance is appropriate when it reflects an estimate of probable losses and is properly supported and documented.

• Communication between examiners and external auditors is encouraged, as appropriate.
Proposed Changes to ALLL

• Recognize credit losses earlier
  – Remove “probable” thresholds

• Broaden the information set considered
  – Internally and externally available information
  – Past events, current conditions, and **reasonable and supportable assumptions** about the future
  – Quantitative and qualitative factors specific to borrowers and the economic environment, including underwriting standards

• Replace numerous impairment standards
  – CECL applicable to all debt instruments carried at amortized cost
  – A modified impairment model for available-for-sale debt securities
Current Expected Credit Loss (CECL) Model

• Key elements:
  – CECL
    • All contractual cash flows not expected to be collected
    • Allowance = CECL
  – All contractual cash flows ~ Life of loan or lifetime ~ Cumulative loss rates
  – Preference for pooling of like instruments
  – No thresholds ("probable," "incurred") for recognition
Measurement of Expected Credit Losses

• Choice of methods available include:
  – Loss-rate
  – Roll-rate
  – Probability of default
  – Discounted cash flow
  – Provision matrix using loss factors
• May need to change inputs and assumptions
  – Annual → lifetime loss rates
• Entities should leverage current internal credit risk management approach and system.
Transition Impact on the Allowance

• Allowance levels most likely to increase upon transition from current incurred loss model to CECL
  – New standard expected to be finalized in late 2015; earliest implementation January 2018

• Actual impact upon transition will depend on:
  – Level of allowances
  – Portfolio composition
    • Asset mix, seasoning, loan features, risk characteristics
  – Model specifications
  – Economic conditions expected
Supervisory Approach

• Institutions are encouraged to:
  – Become familiar with the proposed accounting standard
  – Discuss the proposed accounting changes with external auditors, industry peers, and regulators
  – Develop cross-functional (credit, loan system/information technology, accounting) teams in preparation for implementation
  – Review current ALLL and credit risk management practices to identify processes that might be leveraged
  – Consider data availability for inputs that might be used in a lifetime expected credit loss model (such as origination and maturity dates, initial and subsequent charge-off dates and amounts, and lifetime loss amounts)
  – Begin drafting an initial, high-level plan for CECL implementation
Questions?

You have three ways to ask a question:

1. By webinar: Select the **Ask Question** button
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3. By email: [rapid@stls.frb.org](mailto:rapid@stls.frb.org)
Thank you!