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FASB's Current Expected Credit Loss Model

Overview of the Proposed Accounting Standards Update
Financial Instruments – Credit Losses (Subtopic 825-15)

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Agenda

Current Expected Credit Loss (CECL) Overview

CECL – One Size Fits Most?

CECL Discussion – Gaps in the current ALLL Process

CECL Overview

What is the CECL Model?

CECL is defined as "An estimate of all contractual cash flows not expected to be collected from a recognized financial asset (or group of financial assets) or commitment to extend credit."

Key Principles

- **Single Model** - applies to all financial instruments measured at amortized cost.
- **Expected Loss Model** - removes the *incurred* concept and the *probable threshold*.
- **Life of Instrument Reserve** - requires a reasonable and supportable forecast of future conditions.
- **Risk Weighted -** must reflect a risk of loss, not a best estimate.
- **Time Value of Money** - if the estimate is based on a discounted cash flow model, the discount rate used in the model shall be the effective interest rate.

CECL Model – what is in scope?

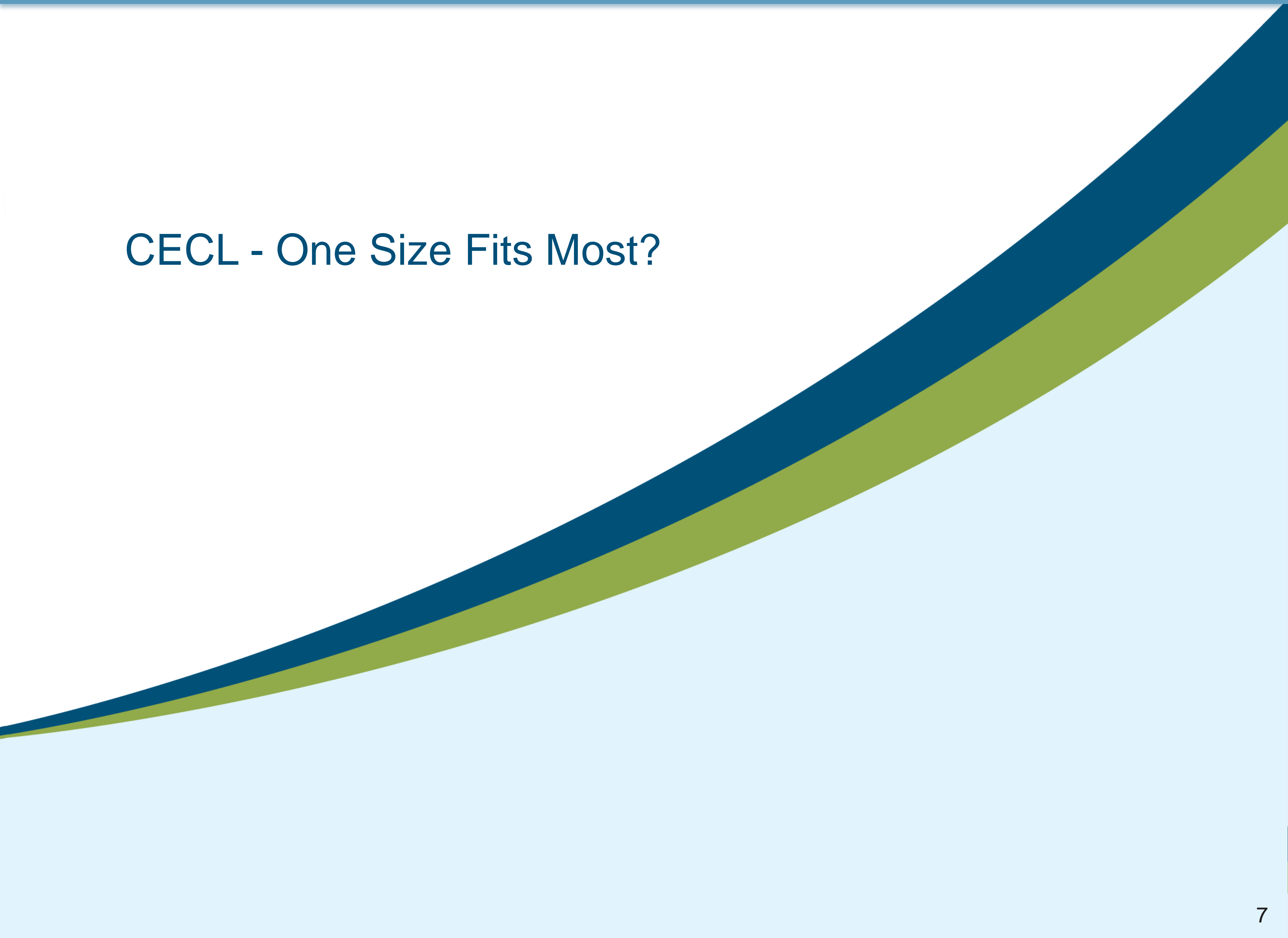
"An entity should apply the CECL model for financial assets measured at amortized cost."

- Replaces FAS 5, FAS 114, and SOP 0-3 for Loans Held for Investment
- Replaces EITF 99-20 for Debt Securities Held to Maturity

* Available for Sale Debt Securities were removed from the scope of CECL and will retain the other than temporary impairment (OTTI) model. The OTTI model will be updated to allow reversal of previous impairment. *Tentative Board Decisions – August 13, 2014.*

The Measurement of Expected Credit Losses Should . . .

- Consider all contractual cash flows
  - including expected prepayments
  - excluding extensions, renewals, and modifications unless a TDR is expected.
- Required to evaluate assets on a collective basis where similar risk characteristics exist.
- Consider past events, current conditions, and reasonable and supportable forecasts.
- Always reflect the risk of loss, even when remote; however, will not be required to recognize a loss when the risk of nonpayment is greater than zero yet the amount of loss would be zero.
- Revert to historical average loss experiences for future periods beyond which the entity is able to make or obtain reasonable and supportable forecasts over
  - the estimated life on a straight-line basis
  - a period and in a pattern that reflects the entity's assumptions about expected credit losses over that period.
- Consider qualitative and quantitative factors and relevant internal and external information.


CECL - One Size Fits Most?

Implementation Considerations

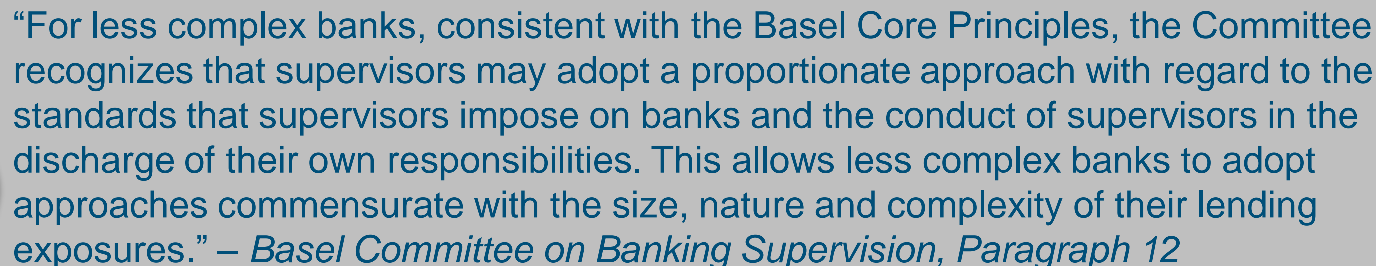
- Auditor and regulator enforcement
- Asset size
- Ownership structure
- Previous experience with forward-looking loss models

FASB's CECL represents a move from rules based to principles based accounting guidance. Therefore, FASB's CECL is less prescriptive than current U.S. GAAP. How individual institutions implement CECL will be dependent upon auditor and regulator enforcement.

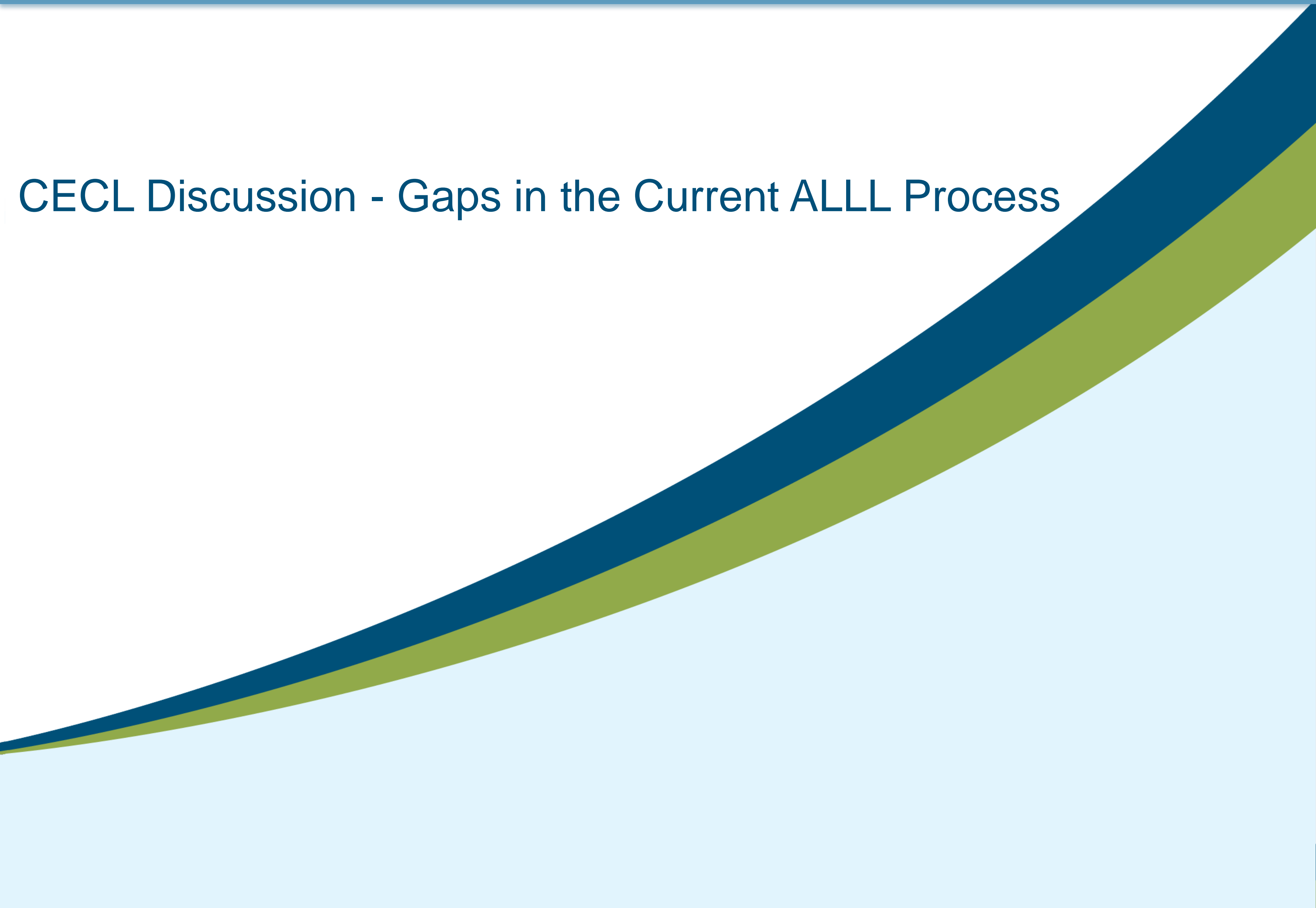
Guidance on Accounting for Expected Credit Losses

Basel Committee on Banking Supervision – Consultative Document

- Issued February 2, 2015.
- Open for comment through April 30, 2015.
- Provides practical guidelines for credit risk practices used for the expected credit loss measurement.
- Replaces 2006 Sound Credit Risk Assessment and Valuation for Loans (SCRAVL).
- Updated for expected credit loss (ECL) models - *IFRS 9 and FASB's CECL.*
- Applies to sophisticated internationally active banks; however, . . .



"For less complex banks, consistent with the Basel Core Principles, the Committee recognizes that supervisors may adopt a proportionate approach with regard to the standards that supervisors impose on banks and the conduct of supervisors in the discharge of their own responsibilities. This allows less complex banks to adopt approaches commensurate with the size, nature and complexity of their lending exposures." – *Basel Committee on Banking Supervision, Paragraph 12*



CECL Discussion - Gaps in the Current ALLL Process

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CECL Discussion - Data Gaps

CECL	Requires
Expected life of instrument loss for all financial instruments measured at amortized cost.	• Prepayment rates • TDR events
Evaluate on a collective basis where shared risk characteristics exist.	• Population identification and segregation • Reconciliation • Loan level credit attributes
Consider *past events, current conditions*, and reasonable and supportable forecasts.	• Historical loss rates • Current credit quality indicators
Credit quality disclosures by vintage.*	• Track loan originations

General Data Challenges

- Synchronization of risk and finance applications
- Support multiple views and ad-hoc analysis
- “Application-ready” data
- Reconciliations and timing differences

Addressing the data challenge successfully requires addressing sourcing, applications, and back-end reporting holistically.

* *Tentative decision, February 11, 2015 Board Meeting.*

General CECL Data Requirements

Servicing System Data:

1. Loan characteristics

   Term – renewals, modifications and extension dates

   Rate – fixed, variable, and index

2. Loan "credit enhancements“
3. TDR events
4. Collateral fair values
5. Transaction codes in loan servicing systems
6. Loan geography
7. Contractual cash flows for each loan or pool of loans

Risk System Data:

1. Loan classes and grades
2. Modification history by loan class
3. Loan renewal and funding history by loan class
4. Loan prepayments history by loan class
5. Loan cash flows not collected
6. Loan grade LGD and PD rates
7. Loan grade charge-off history
8. Loan grade migration history
9. External historical loss rate by loan class

Discussion – Operational Complexity

CECL	Requires
Consider past events, current conditions, and *reasonable and supportable forecasts*.	• Assumptions around future conditions • Translation to accounting
In addition to discounted cash flows an entity would not be prohibited from using loss-rate methods, probability-of-default methods, or a provision matrix.	• Forward-looking loss estimate • Consider the time-value of money • Reflect the risk of loss
Reflect the risk of loss even when remote and reflect the time value of money.	• Probability of default • Assess collectively • Effective yield

General Operational Challenges

- Coordination between risk and finance
- Controlled SOX process

Discussion – CECL Status and Next Steps

- **Transition** - cumulative-effect adjustment as of the beginning of the first period in which the guidance is effective (offset to retained earnings).
- **Issue Date** – expected to be issued during 2015.
- **Effective Date** – none proposed.

- **What can / are Community Banks do / doing to prepare for CECL?**
  - Assign roles and responsibilities
  - Gather data
  - Leverage capital planning exercises
  - Integrate applications
  - Add / document controls

"Give me six hours to chop down a tree and I will spend the first four sharpening the axe." - Abraham Lincoln

Appendix

- Frequently Asked Questions
- Proposed Disclosure Requirements

Frequently Asked Questions

1. **How will I forecast for commitments and credit cards?**

   The funded portion of loan commitments will be estimated in the same manner as other loans. The expected credit loss for the unfunded loan commitment should reflect the full contractual period over which the entity is exposed to the credit risk unless unconditionally cancellable by the issuer. The estimate must consider the likelihood that funding will occur and an estimate of expected credit losses on commitments expected to be funded. The estimate of expected credit losses on unfunded loan commitments will be presented on the statement of financial position as a liability.

2. **Do I have to recognize a loss if the estimated collateral value is greater than the exposure?**

   No. According to the February 19, 2014 Tentative Board Decisions, "the estimate of expected credit losses should always reflect the risk of loss, even when that risk is remote. However, an entity would not be required to recognize a loss on a financial asset in which the risk of nonpayment is greater than zero yet the amount of the loss would be zero." Note that the final standard will not explicitly state for which financial assets a zero allowance of expected credit losses would be appropriate. However, a scenario where the estimated collateral value is greater than the loan balance fits this description.

   Note: The definition of collateral dependent will be updated to "A financial asset for which the repayment is expected to be provided primarily or substantially through the operation or sale of the collateral." Primarily or substantially will replace solely

Frequently Asked Questions *(continued)*

3. What are the disclosure requirements?

The disclosure requirements are extensive with the goal of enabling investors to understand the drivers of changes in the allowance estimate. Explaining how assumptions underlying the economic forecast and changes in the portfolio composition impacts the allowance will be challenging.

As of the February 11, 2015 Board Meeting, the amortized cost basis roll forward was removed from the proposed disclosure requirements. The vintage (year of origination) for the last 5 years will be added to the current Credit Quality Disclosures. Entities may find it challenging to disaggregate the ending balance by year of origination.

* *Proposed disclosure requirements are located in the appendix.*

4. Do I need to use a discounted cash flow model?

The guidance does not mandate a specific method for estimating the current expected credit loss. However, a discounted cash flow model represents the best practice.

According to the September 17, 2013 Tentative Board Decisions, “In addition to discounted cash flow modeling, an entity would not be prohibited from using loss-rate methods, probability-of-default methods, or a provision matrix using loss factors.”

Frequently Asked Questions *(continued)*

5. **What about Troubled Debt Restructurings?**

Troubled Debt Restructurings (TDR) are still relevant from an identification and reporting perspective. However, a basis adjustment (rather than an allowance) will be recorded at the time of modification in order to bring the cost basis of the loan equal to the present value of the modified contractual cash flows discounted by the pre-modification effective yield

According to the February 19, 2014 Tentative Board Decisions, this may result in an increase to the cost basis with a corresponding credit to the allowance.

6. **Can you speak to the forecasting process for variable rate loans? To what extent will there be an expectation of rate forecasting?**

The proposed guidance specifically mentions forecasting prepayments and excluding renewals (unless a TDR is expected); however, it does not specifically mention forecasting rate changes for variable rate loans. According to ASC 310-20-35-20 (FAS 91) "In a period in which the independent factor on a variable rate loan changes, the constant effective yield is recalculated not from the inception of the loan but from the time of the change." Therefore, because the yield is held constant until the factor changes, the projection should not reflect changes in the rate until the factor is updated. There should be consistency between the discount yield and the expected cash flows used to calculate the allowance.

This is consistent with the practice under ASC 310-10-35 (FAS 114) and ASC 310-30 (SOP 03-3) today.

Frequently Asked Questions *(continued)*

7. Can you comment on the public comments made by examiners (Federal Reserve, OCC, FDIC) that the reserve is supposed to go up by 40% - 60% from the reserves today?

The short answer . . . *it depends upon the assumptions*.

The long answer . . . Two entities can start with the same set of facts, make different assumptions, and arrive at very different answers. Case in point, Primatics performed a CECL analysis with the American Bankers Association (ABA) where the life of loan loss was applied to a portfolio of loans increasing the reserve as of the balance sheet date by roughly 30%. At the same time, another institution performed an analysis on the same population making different assumptions and their reserve increased by 60%. This study highlights the role that assumptions will play, their impact on the allowance, and the unavoidable challenges to comparability between financial statements. Assumptions must be made around borrower behavior and the forecast of future conditions.

It depends upon the economic cycle - For example, heading into the ’08 financial crisis the outlook for the reserves would be quite high, but as the financial crisis passes reserves would be released.

We should also clarify that when we say that the amount of the allowance will increase, this is *as of the balance sheet date*. Ultimately, over the long run the reserve will be the same as under US GAAP, but removing the incurred and probable threshold will results in earlier recognition under CECL.

Frequently Asked Questions *(continued)*

8. Can the collateral value be used to calculate the impairment?

There is a practical expedient for collateral dependent assets. The reserve can be measured by the difference between the collateral's fair value (less selling costs) and the amortized cost basis of the asset. The definition of collateral dependent will be updated to - *A financial asset for which the repayment is expected to be provided* ***primarily or substantially*** *through the operation (by the lender) or sale of the collateral, based on an entity's assessment as of the reporting date.* ***Primarily or substantially*** will replace ***solely***. Many believe that this expands the definition of collateral dependent and increases the number of assets for which this practical expedient can be applied.

9. Can I use historical averages?

According to the proposed model and the tentative decisions confirmed during the August 13, 2014 board meeting, the entity must consider past events, current conditions, and reasonable and supportable forecasts when developing the expected loss estimate. An entity should revert to unadjusted historical credit loss experience for future periods beyond which the entity is able to make reasonable forecasts over a.) the financial asset's estimated life on a straight-line basis or b.) a period and in a pattern that reflects the entity's assumptions about expected credit losses over that period.

Frequently Asked Questions *(continued)*

10. How will I forecast for loans?

According to the guidance, an entity should consider all contractual cash flows over the life of the related financial assets. An entity should consider expected prepayments and should not consider expected extensions, renewals, and modifications unless it reasonably expects to execute a troubled debt restructuring with the borrower.

An entity should consider relevant qualitative and quantitative factors as well as internal and external information specific to the borrower and related to the environment in which the entity operates. Note that this does not require that discounted cash flows be used to estimate the loss, only that the method used reflect all the remaining contractual cash flows.

11. Will the loss need to be evaluated for assets individually?

According to the tentative board decisions confirmed August 13, 2014, entities will be required to evaluate financial assets on a collective basis when similar risk characteristics exist. If an entity determines that a financial asset does not share similar risk characteristics with other financial assets of the entity, the entity would evaluate the financial asset on an individual basis.

Frequently Asked Questions *(continued)*

12. What about Purchased Credit Impaired (PCI) Assets?

There is a significant shift from current GAAP for PCI Assets under ASC 310-30 (formerly SOP 03-3). An allowance is established at the time of purchase, and a non-credit mark must be allocated to each asset. The amortized cost basis is *grossed-up* to the purchase price plus the allowance at the time of purchase. Increases in expected cash flows are recognized through the reserve rather than through the yield (symmetrical to decreases in expectations). Interest income is based on contractual cash flows, and nonaccrual rules would be applicable.

As determined during the March 11, 2015 Board Meeting, assets currently accounted for as PCI (including assets for which Subtopic 310-30 has been applied by analogy) will be classified as PCI assets at the date of CECL adoption. Entities will be required to gross up the allowance for expected credit losses for all PCI assets at the date of adoption and will continue to recognize interest income based on the yield of such assets as of the adoption date.

As determined during the April 22, 2015 Board Meeting, the definition of a PCI Asset was updated to a*ssets with more than insignificant credit deterioration since origination* which is expected to increase the number of assets that qualify for PCI treatment. The gross-up approach will be applied to assets qualifying as PCI only. There are no changes to the current accounting practice for non-PCI assets acquired in a business combination.

Proposed Disclosure Requirements

Disclosure	Description	Difficulty
Changes in Economic Forecasts and Portfolio Composition	• Method and information used to calculate the allowance. • How the current and projected forecasts drive the estimate. • Past events, current conditions, and reasonable supportable forecasts. • Changes in the factors and the reason for the change.	**Challenging** • The forecast of future economic circumstances, is a new and challenging element. • The potential for expected credit loss volatility is high. • Collaboration between the credit and accounting groups will be necessary. • Forecasts of future economic conditions are highly judgmental.
Credit Quality Disclosures by Vintage*	• Credit quality indicators disclosed under current GAAP disaggregated by year of the asset's origination.	**Challenging** • New requirement for all institutions. • Entities may find it challenging to disaggregate the ending balance by year of origination.
Purchased Credit Impaired Financial Assets	• Reconciliation between the fair value and the face value. • Purchase fair value, Discount attributable to expected credit losses, Non-credit related discount/premium, Unpaid principal balance	**Challenging** • Amortized cost basis is equal to the purchased fair value gross of the allowance. • The difference between the fair value and principal balance is segregated by a credit mark and an non-credit mark.
Transition	• Cumulative-effect adjustment to the statement of financial position.	**Challenging**
Allowance for Expected Credit Loss Roll Forward	• Beginning balance, provision, write- offs, recoveries, and the ending balance of the allowance for the period.	**Medium** • Requires that the roll forward be disaggregated at the portfolio level, and include all charge-off and recovery activity for the period.

** As of the February 11, 2015 Board Meeting. Replaces the amortized cost basis roll forward in the original exposure draft.*

Proposed Disclosure Requirements *(continued)*

Disclosure	Description	Difficulty
Credit Quality Information	• Enable the user to understand the credit quality of the portfolio. • Amortized cost basis disaggregated by credit quality indicators.	**Medium** • Credit quality disclosures in ASC 310 (ASU 2010-20) effective in December 2010 for public companies. • Inherent risk associated with combining accounting balances and risk classifications from multiple source systems.
Past Due Status	• Aging analysis of the amortized cost for debt instruments that are past due.	**Medium** • Similar to the current disclosure requirement for nonaccrual and past due financing receivables in ASC 310-10.
Nonaccrual Status	Provide the following by portfolio segment: - Beginning and ending amortized cost in nonaccrual - 90 days past due and accruing status - Nonaccrual status but no related expected credit losses due to full collateralization - Interest income on the cash basis.	**Medium** • Covers a broad range of information including the estimated allowance, interest income, collateral values, and the amortized cost basis of nonperforming loans. • A roll forward of loans on nonaccrual status is ideal when providing the nonaccrual balance at the beginning and end of the period.
Collateralized Financial Assets	• Collateral type by class of financial asset for collateral dependent loans. • Explain by class changes in the extent to which collateral secures an entity's financial assets.	**Medium** • Updated appraisals, loan-to-value (LTV) ratios, and the house price index (HPI) will be needed to convey the extent to which the financial collateral dependent financial assets are secured. • This will require coordination between the accounting and credit groups.

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