



## CECL for Bank: Ready or Not

We have been talking about the Current Expected Credit Loss (CECL) accounting standard for almost 10 years, and the adoption date is fast approaching. On January 1, 2023, many financial institutions will adopt this standard. As your institution fine tunes its model, we invite you to watch this complimentary webinar. We cover last-minute considerations and answer your questions regarding adoption.

Find additional resources on our event page: <https://www.claconnect.com/en/events/2022/cecl-for-banks-ready-or-not.com>

Here is a transcription of this session:

David Heneke:

All right. Hello everybody. This is David Heneke from CLA and thank you very much for joining us today for this CECL presentation. We're here today to go through a number of things that you see in regards to CECL and getting you ready to start. If you haven't started already implementing, we've got some information for you about what's going on in the industry, as well as some updates on methodologies that have occurred over the last few months. And then we'll also talk about the qualitative and forecasting piece related to CECL as we get going here and go through our slides. And so to get started, I'll just do some brief introductions here. My name is David Heneke. I'm a principal with the financial institutions group here at CLA. I've been working with community institutions here over the past couple of years now, getting them ready for CECL adoption. And so hopefully we have some information here that will be relevant to you today and as we go through our presentation and so Tessa, I will turn it over to you.

Tessa Brockie:

Thanks. My name is Tessa Brockie. I am a manager with CLA in our financial institutions group. We do have a third presenter with us today. You will see him hop on in a little bit. His name is Josh Juergensen. He is also a principal with our financial institutions group, and I will just get into it now. So CECL is coming. You have to adopt CECL on January 1st of 2023. That is less than six months away from now. So if you have not already selected your methodology, it is very important to get that taken care of ASAP. You'll hear about some of those methodologies today.

Tessa Brockie:

If you have any questions and you've not started this process yet, please reach out to any of the three of us presenting today. I know all of our contact information is on the last slide and you can take a screenshot and reach out to us at any time. Because the adoption is less than six months away, we have been able to look at early adopters and what they've been doing so far, and I know David will be touching on that next. And right now, since we are in Q3, we should be running parallel with our current allowance methodology. This allows you to fine tune anything, make any adjustments, as you should know, you should be able to adapt and make any changes. The state of the world is evolving. The economic conditions are evolving, and so should your CECL methodology.

David Heneke:



And I would add to that, Tessa, as you kind of alluded to, I think the main point or one of the main points we want to get across here is the fact that if January 1 of 2023 for your December year ends being the date of initial adoption, that's really for lack of a better way to say it kind of the starting point of all this, so to speak, because there's going to be new guidance. Things will evolve over time as people begin to implement and adopt methodologies. And I'm guessing you'll start to see some best practices, start to hone in on what regulatory and auditor expectations are after people have adopted. Right now, it seems like the kind of the common stance is just really good faith effort to get something going and get something started and showing you're putting your best foot forward to come up with your calculation, but knowing that you are going to need to adapt because the unique thing about CECL that I'm sure all of you know, is the fact that Tessa and myself, we can go into five different institutions.

David Heneke:

All five institutions can be doing a different calculation and all of them could be correct, and all of them can comply with the standard. So that's something to be cognizant of when you're going through this, that things will evolve. Things will adapt and more guidance will be released as we move forward through adoption. So as Tessa mentioned, so with that, what I'm going to do now is, let's take a few minutes here and talk about what we're seeing from those early adopters. So the early adopters are primarily the publicly traded institutions that were required to adopt either as of January 1st of 2020, or given the CARES Act, it was delayed for some adopters until January 1st of 2022, but we do now start to have some data to see what the results of CECL implementation are in regards to those who have adopted.

David Heneke:

And so what you're going to see, we've got a few charts and graphs here, and I'll go through some of the details underlying that information of why we're seeing what we're seeing at the various asset sizes and for the various institutions in regards to those who have adopted. This population represents about 300 institutions that have adopted. And the interesting thing about it, of those 300 institutions that represents about 85% of the assets in the financial system. So it's kind of interesting that just the disparity amongst the community institutions and the larger institutions of how much of the asset base they actually make up as a total percentage of all the assets in the financial system. But so [inaudible 00:06:10] a different way, the vast majority of loans that are in the financial system today are actually already under CECL from a standpoint of allowance methodology, but let's look at some of the information that has come up from call reports that have been filed.

David Heneke:

And so this first chart that you see, this is for the early adopters that have adopted through March 31st of 2022. And on the bottom, you see the asset stratification of the asset size of those institutions. And then what you see here is the percentage of the increase in the allowance based on those various asset strata, a couple of things to point out here, first of which is keep in mind as you will see on another chart that will show a little bit later, keep in mind that as you look at this and you see these percentages, I know the initial reaction could be, oh my gosh, that's a lot larger than I was maybe anticipating. Well, there's a couple of things to note. The first of which is the vast majority of institutions in this population had a lower allowance to loan loss percentage as a percentage of their loans going into CECL.

David Heneke:



So if you took just the allowance divided by loans, that was a lot lower than I would say, the average or typical community institution. The other thing to note here that within this population is there were a lot of serial acquirers that did a lot of acquisitions over the last few years, that as a part of the adoption of CECL, you get to transfer some of the loan discount that was recognized upon acquisition. Because when you do an acquisition, all the assets and liabilities need to be marked to fair value. And so you would see a discount get applied to the loans related to that. Well, as a part of CECL implementation, a big chunk of that discount can get transferred to the allowance as a part of adoption. And so that's another reason why you're seeing some of these increases in numbers.

David Heneke:

The next chart shows, this is the count of institutions that showed recognition of the various percentage levels as far as that increase is concerned. And so this is not by asset size, but just to give you a better flavor for where did you see the most institutions landing when it came to the increase in their CECL calculation? And so a couple of things to note here is that you can see the vast majority of them were at 50% or less. You can also see that when you add them up, another subset of it about actually half of those institutions had an increase that was 25% or less. And the interesting thing that you see here is that 51 institutions actually showed a reduction of their allowance as a result of adopting CECL. And so a couple of things to note there, first of which is generally speaking as a part of CECL adoption, you would expect your allowance to go up.

David Heneke:

And the reason for that is we're moving from an incurred loss methodology to a lifetime loss methodology. So the amount of time that we have to reserve for is longer. Under the incurred loss methodology, typically you would say the incurred loss period is maybe between 12 and 24 months. And so therefore in your reserve, you should have only the losses book that are incurred, which means the loss exists today. And then that means you're probably going to take that loss at some time over the next 12 to 24 months. So if you start from that premise of thinking that we would generally expect the allowance to go up, well, what were these 51 institutions doing? There's really only a couple of explanations. And I'll say the first explanation is a place you do not want to find yourself in realistically as an institution.

David Heneke:

The first of which is if you're conceding that your allowance calculation should go up under CECL, but yet you're showing a reduction. That basically means you're saying your allowance right now under the incurred loss method is overstated. And that's a place you really don't want to find yourself at. You want to find yourself in a place where your allowance is appropriately stated under current gap, so that then you can reflect the appropriate adjustment on day one for the adoption of CECL. And so there may be institutions in here that are quote, unquote, "cleaning up their reserve" as a part of this adoption, which is not really the appropriate thing you want to be doing as a part of implementation of this standard under gap. The other way that this can happen, which is a reasonable way under gap, is that technically under CECL, you are allowed to include recoveries as a part of your methodology on a forward looking basis, or what does that mean?

David Heneke:

That means that if I have a loan, let's say where it's, maybe I've got a 100, let's say I've got a \$100,000 of principal that I could still collect contractually, but I've charged that whole amount off. So it's on my

books at zero. If you, as a part of your analysis are forecasting or you have the support to justify, then let's say you're going to recover a half million dollars of that loan or excuse me, \$50,000 of that loan, \$50,000 of that 100,000, you can book that \$50,000 on a present value basis as kind of a contra asset to your allowance. So you kind of have a receivable hidden in your allowance figure that will reduce the amount that you need to carry. So when you take that recovery in, you've already theoretically accounted for it in your allowance. So you debit cash and you'd credit your allowance and your allowance would go up.

David Heneke:

So that is one thing to be cognizant of. And you can see this in the inter-agency guidance, as well as the OCC's ACL handbook, where they talk about this. And it's also noted specifically in the standard that recoveries of that nature, you can quantify in your allowance as a receivable within your allowance as a part of the adoption of CECL. And so that could be a situation where if you're, as an institution, if you have a lot of charge-offs and you're forecasting a lot of recoveries where you could see a situation where your allowance would be smaller under CECL than it is under the incurred loss model.

David Heneke:

Now, that being said, if you're going that route and you see that you have these recoveries that you want to include in there, you want to make sure your documentation is really strong and you have really good support as to why you think these recoveries are going to be realized as a part of your documentation, because that could be something that could easily be challenged by either a regulator or an auditor based on what assumptions you're using to quantify that number. So just be cognizant of that. So next we're moving on to where I kind of alluded to this before of where allowance levels as a percentage of loans was prior to adoption and then after adoption.

David Heneke:

And one of the things I found interesting in kind of parsing out this data is the fact that if you look at kind of, I'll say the middle section of the banks in between 500 million and we'll say 25 billion, they're pretty consistent. I mean, they had allowance levels that were below 1% generally speaking, and they all kind of moved up to around 1.3 or 1.4%. And that's typically, I would say where we see most community institutions today on just kind of an average basis, our allowance levels are around there already. And so that's why I wanted to reiterate that size matters as well as whether you are a public filer or a privately held institution matters because you see it in the numbers that where some of these larger institutions are moving is pretty consistent with where privately held community banks are already at as a percentage of allowance to loans.

David Heneke:

The one thing you may notice at 500 million, the less than 500 million, that is a sample of I believe two. So there are only two institutions of that size that actually adopted. So it's not very statistically relevant to what you're seeing across the board when you look at it on a more, on a broader level in regards to where allowance levels are at. So if you're kind of consistent with what you're seeing, here you can see where these CECL numbers are at. We will also take a moment here to look at this chart, which has, this is the current allowance level of CECL adopters by asset stratification for those that are over a billion dollars in assets. And the reason for this chart is to show you that when you get to a billion dollars, CECL filer or CECL adopters have to disclose the amount of allowance they have by these six categories as a percentage of those loans.



David Heneke:

And so you can see off to the right side there the asset on the very, very far right column, the percentage of allowance to loans varies quite greatly, depending on asset size, where you see the smallest institutions, the 1 to 5 billion are at a lower level. Once you get up to 5 to 10, they're at 1.65, so on and so forth. And that's where you see kind of on an average basis, the allowance levels range anywhere between 1.3 and I'll say 1.6% for what I would consider to be a community institution. And you could also see that the portfolio makeup really matters. Because if you look at your typical real estate and commercial loans, those allowance levels I would say are fairly consistent with what we're seeing in the community institution space, the 1 to maybe 1.2, 1.3% where those are secured by real estate.

David Heneke:

It's the consumer and the credit card portfolios that really drive a lot of the higher reserve levels you may see in a specific institution, because those are where they're typically seeing more loss. So it's just something to be cognizant of in regards to where the allowance levels are at. The other interesting thing that has come up as a part of the allowance levels is just looking at the trends of the allowance percentages since CECL adoption, to where we're at today. And that's what you're seeing here is these are the allowance levels as a percentage of loans from March 31st, 2020, going all the way through March 31st, 2022. Couple things to point out here, this was obviously during the COVID wave.

David Heneke:

And you could see what institutions did. Generally speaking, the larger institutions started ramping up their reserves as a part of COVID for credit losses they thought they were going to take. And then started to negative provision those down when it became apparent that there were going to be not as many credit losses taken as a part of COVID as a result of all the government stimulus that was put into place and shoring up balance sheets of companies, whether it was through PPP or many of the other governmental funds that were available, you could see the increase and decrease and all of that wasn't really through charge-off or recovery.

David Heneke:

It was through provisioning and negative provisioning. And another thing to draw from this is these are some of the largest, most sophisticated institutions in the world. And if I was going to be very flippant about this, I would say all of their forecasts were wrong. And these are the banks that have the most sophistication and the most personnel dedicated to forecasting this correctly and they were wrong. And it's obviously the caveat to that as we went through something we'd never went through before in regards to what the COVID pandemic did, but it can just show you that these institutions are also struggling with that qualitative and forecasting piece, just like a lot of community institutions we've begin to, or we have been helping have struggled as well, as far as kind of coming up with what they want to monitor in how they want to set aside qualitative and forecast adjustments.

David Heneke:

But the final thing I'll point out here is if you look at that 1 to \$5 billion tranche there, the thing to see there is that allowance level is a percentage of loans. Really didn't fluctuate all that significantly throughout the COVID pandemic, where you solve more volatility at the larger levels. And I think for most community institutions, that's something that community institutions want to try to get across is that we're going to reserve what we think is necessary. We probably aren't going to experience losses as



volatile as some of the larger institutions. So you probably wouldn't expect to see that level of volatility in the smaller community banks that you're seeing in some of those larger institutions when we look at this data. And so with that, I'm now going to turn it over to Mr. Josh Juergensen, to speak to us about some of these other questions we've been getting and from high level things of how we can help you in regards to dealing with Q factors amongst other things. So Josh, I will turn it over to you.

Josh Juergensen:

Awesome. Thanks David. Just to confirm, can you hear me okay here?

David Heneke:

Yes, we hear you. You're all good.

Josh Juergensen:

Awesome. My apologies, everybody. I had some technical difficulties, right, as we were logging on here this morning. So, as David mentioned we've been working with a large number of institutions, I think we're over 300 institutions now that we're assisting in some form of CECL capacity, whether it's the current models that they're using or technical questions as we creep up an implementation here. And so, one of the things we wanted to cover today was just some of those common questions of things that we are regularly talking with clients about. Just some of those things that continue to come up in all of our conversations. And the first one that we wanted to address here today is just in regards to Q factors, because as the vast majority of institutions have experienced for last decade there really is minimal to no losses that institutions have experienced.

Josh Juergensen:

And in many cases, we've even seen institutions that are in net recovery position over the last 7 to 10 years. And so the significant portion of the reserve that the institution is using on their CECL analysis is going to continue to be driven by those Q factor adjustments. I know we've got a slide coming up here and a little bit on some of the various methodologies that are out there and when, what we're seeing and hearing from clients in that regard, but regardless of what methodology you're using, the crux of those are driven off of those historical losses in some way, shape or form. And if those losses just aren't there, which I guess is a good thing, but it's going to continue to drive the importance of these Q factors. And so, one of the common questions that we're getting from clients is where do we begin?

Josh Juergensen:

And the good news is the regulators have continued to support that we don't need to recreate the wheel when it comes to what those Q factor adjustments are. In many cases, the same Q factor adjustments that you've been using for the last decade plus under the current incurred method are going to continue to be able to be utilized. And as we're working with clients, we continue to see many of the same types of Q factor adjustments, whether it's local and economic conditions, maybe it's the experience or staff levels that you have within your institutions, specific concentrations, the same typical 8 to 10 Q factors that we see. But like I said, the good news is we don't need to recreate the wheel. The biggest thing that we're going to need to look at as we migrate into the future is really what the most important part of CECL is.

Josh Juergensen:



And it's that forecasting component. Now, the challenge that we have there, as David mentioned, even some of the most sophisticated institutions that have plenty of resources available, weren't able to forecast the COVID pandemic and the results of what's happened and transpired since then. Now that being said, we still do need and still do have the expectation under CECL to utilize the best forecasting that we can and to continue on with that comment, how do we support the adjustments, it's another common question that we're getting, or where do we get the information from to support the Q factor adjustments? Like I said, the good news is a lot of that's going to continue to migrate over. And so a lot of the same tools that you're utilizing today, and the same analysis that you're utilizing today is going to be very applicable and very relevant.

Josh Juergensen:

But it is that forecasting piece that comes into play that we do need to look out into the future. One of the things that I'll frequently discuss with clients is it's not an expectation that we're going to need to look 5 years out or 10 years out because that's just not really a realistic approach. What we're really talking about with clients is as we look into the next 12 months or 18 months, or even out 24 months on the long end, where do we see things going within your individual portfolio.

Josh Juergensen:

As we talked about things going on in the environment today, some kind of recessionary environment that's talked about regularly these days looking at your portfolio, maybe now is a time where we talk about increasing some of the key factors related to trends and past dues, because we are starting to see and hear from clients that we are seeing trends in that regard, probably not surprising as some nerdy CPAs on this deal here [inaudible 00:23:20] pretty excited and anxious to see what's going to be coming out with the Q, Q call report information's coming out in the next couple of weeks here to see where things are trending in that regard with some of that data and how we can best utilize and capture that data to support the Q factors adjustments as we go forward.

Josh Juergensen:

One of the tools that we're regularly using and regularly talking about, and if you haven't used this, I would strongly encourage you to do so. I'm guessing we've got some fellow nerdy data people and numbers people on this call here this morning that you can get lost for days on this tool here with all the vast amount of data that they have, but the federal reserve economic data tool that's out there, it's through the St. Louis Federal Reserve, but it is a phenomenal tool here when it goes to, or when it relates to tracking information and historical data, that's out there.

Josh Juergensen:

And I've got a couple of screenshots here, but if you go out into Google or whatever your search function is, and just search for FRED or federal reserve economic data, this is what will pop up. And you can search in this little search box here, or some of the, they've got the quick trending items that you can click on there. But what you can do is you can go into this tool here and pull up a wide variety of data. And I've got a couple just snips and screenshots here as an example. But if you wanted to go back and look at the unemployment rate over the last, in this case, it's almost the last 20 years, this will go back and give you that ability to do so and show how things have transpired over an extended period of time.

Josh Juergensen:





You've also got the ability to modify and go even further back. You'll notice kind of in the bottom right corner of this graphic here, we've got this trimmed just to show from about 2005 on, but we have all the unemployment data that goes back even prior to the 1950s in that regard. And so you've got the ability then to layer on and say, okay, when the unemployment rate changes, what is the correlation to charge-offs? Now, in this case, the screenshot here, we've got a projection of what the unemployment rate will be over the next couple of years, but I've got another couple of slides coming up here that will show what that layering out looks like to kind of give you an example of how we can utilize historical data to try to forecast out into the future.

Josh Juergensen:

Another one we've got here just as an example is just showing what the treasury rate is. And again, we can layer on some other data points to show, okay, as the treasury rate moves and migrates in certain directions, how does that impact whether it's charge-offs or other kind of economic factors? Here's an example where it's kind of showing how we can layer on multiple data points. And again, you can layer on as many of these as you want. And one of the cool functions about this tool is it really does have the ability to allow you to get as granular or as broad as you want it to be. It allows you to drill down into city levels, into county levels, states, or regional or national levels. So you can really drill down into your own individual specific institution, but what we've got here is showing as the unemployment rate changes.

Josh Juergensen:

Now, in this case, COVID kind of threw everything for a funk, as you can see, there's maybe a little blip in the radar of the delinquency rates at the beginning of 2020. And then I think all the federal stimulus packages hit. So maybe isn't the best correlation as we maybe scale out or take out the pandemic side of things. But this, I think is a great example of as the unemployment rate changes, the correlation between that and the delinquency rates in our loan portfolios, as you look at the last recession around 2010, the significant increase in unemployment rates and the very correlating increase in the delinquency rates of our loan portfolio. So just an example of, as you're trying to forecast out into the future, looking at things that have happened, historically speaking in the environment that we're in today gives you some ability to provide more context is what your Q factor adjustments will be in that regard.

Josh Juergensen:

And then one other one that I just thought was interesting here as inflation changes, what are the charge upgrades on the loan portfolios? And again, this is for all commercial banks across the entire country, but you do have the ability to get more granular with that as well. So again, just another example of showing, okay, as inflation migrates and inflation changes, what is the impact that it has on our loan portfolios and charge-offs specifically? So again, if you haven't had a chance to go out there and play around with the FRED tool, there's also an Excel add-in that you can go out and add it into Excel, it really allows you the ability to get the raw data that's out there as well.

Josh Juergensen:

But yeah, like I mentioned, if you have all your extra free time, or if you're somebody that really wants to get into the data, I think there's over 800,000 data points that they've got out there within this tool. So really gives you a great ability to go out there and look into, and drill down into various things that are going on within the economy or within your own institution as well, so.





David Heneke:

So Josh, if I could add a couple of quick bits to what you talked about, which I thought was all like really great information. And I think the thing that we want to also continue to impress on the community institutions is like you said, Josh, is that the qualitative factors that are identified and the inter-agency guidance for CECL, as well as the staff accounting bulletin 119 for public filers, as well as the OCCS guide. They're basically the exact same as the nine factors we're looking at today, as far as the things that the regulators will expect that you're evaluating. I think the main thing in regards to the difference will be the language that you're using to justify why you think things are going to be better or worse than what your history is telling you from your CECL calculation and make sure that that language is forward looking.

David Heneke:

Tessa, Josh and I joke quite frequently about some of our current clients and their allowance calculations in regards to how they document their qualitative factors to where under the incurred loss model, we'll see things like, and we'll say in the economic section, they'll say the economy's improving [inaudible 00:29:17] the economy's stable. And then they're adding 50 basis points to the calculation, even though management's saying they don't expect anymore. They don't expect a higher inherent risk of charge-offs on their portfolio based on their evaluation of the economic factors, but yet they're still adding. And that's where with CECL, that type of documentation is going to need to be more directionally consistent in regards to what you as a management team feel is going to happen from a standpoint of risk of loss in the various portfolios, and whether you're adding or subtracting.

David Heneke:

And so that really gets down to kind of the first question is when you sit back and think about your forecasting adjustments and your qualitative adjustments, you look at your history and what your history's telling you, and then it becomes a question of, well, do you think things are going to be better or worse going forward based on what economic data or what data points you're looking at [inaudible 00:30:13] based on your portfolio to whether or not you think things are going to be better or worse. And then as Josh mentioned, if you read the regulatory guidance, there doesn't seem to be an expectation in regards to you as a community institution coming up with some sophisticated methodology, such as a regression analysis to say, if unemployment goes up X, that means our charge-offs go up Y. Primarily, it's because you as a community bank do not have the robust amount of data necessary to draw those statistical conclusions.

David Heneke:

So you're probably going to see qualitative factors done similarly to how they're done today. Meaning we're doing an evaluation. Do we think things are better or worse, then we're going to add some percentage or subtract some percentage from the Q factor, but I wanted to make sure, we reiterated that as you're going through this analysis that it's probably going to, the way you come up with the number will probably be fairly similar, but you need to make sure when you're doing your documentation, you're incorporating that forward looking language as to why you, as a management team are forecasting. You think things are going to be better or worse. What data are you looking at to tell you that?

Josh Juergensen:



Yeah, David, that's a great point. And one thing that I wanted to add onto that as well, you talked about the documentation and whatnot. Most of the institutions that we work with do a pretty decent job of having some kind of narrative to support their reserve and the justification for why they're reserving what they are. Our expectation is that, and we're going to learn more on this as we go forward in the coming months and couple next, first couple years of implementation here, but really the expectation is needing to beef up that narrative to make sure that we are able to support what that Q factor adjustments are. We did a presentation on CECL, I think it was about a year ago or so, or maybe the fall of 21 and had a polling question asking all the attendees of that webinar, how long is your narrative to support your reserve?

Josh Juergensen:

And the significant majority was pretty short in nature, kind of that one to three to four pages range, not saying you need to go out of here and write a novel by any means, but needing to make sure that, especially for institutions as you get more larger and more complicated and more of a diverse portfolio, that you do have proper documentation to be able to support what that justification for those reserves are. So if there's anything you're doing between now and the end of the year, if you've already got your model selected or your methodology selected, and you're kind of running that parallel, use that time between now and implementation to make sure that narrative that you have is able to support and justify whichever direction your reserve is going. With that, I'm going to turn it back over to Tessa, to talk about some kind of updates on methodology.

Tessa Brockie:

Awesome. Thank you, Josh. So as many of you are probably aware, one of the other common questions we get is what methodologies are we seeing the most. On this slide, we've got probably the six most common methodologies we see with remaining, maturity analysis being the least complex and discount cash flow being the most complex out of these six. But what's important when you're selecting a methodology is to select one that's right for you and your institution. What I mean by that is you want to be able to explain your methodology to management, to regulators. You really need to make sure that you understand the inputs of it, and that it's not just something you have in order to meet the standards. If you can't explain it, you probably need to change your methodology or look at getting some help so that you can fully support it.

Tessa Brockie:

And again, that just goes back to that documentation that Josh was just talking about and making sure that it's thorough and ready for auditors, regulators, anyone that's involved. The other thing that we want to mention when it comes to selecting a methodology is what you really need to think about is that forecasting piece and forecasting the charge-offs as David was talking about. So the methodology you're picking needs to most accurately predict your charge-offs that you might have in the future. Those are difficult, especially as a community bank, as we noted earlier, even the big banks, those large public institutions were getting it wrong when COVID started. So odds are, there's going to be a lot of flux and a lot of volatility with this, that's expected. But what you probably want to think about is why are loans charged off? When we ask that question to our clients, we get three common answers.

Tessa Brockie:

One is divorce. That's not easy to predict in any manner. And so it's not anything we can add into our CECL calculation. The next one is the death of the borrower. That again, is very difficult to predict. It's



probably going to consider an actuarial analysis, which we're not saying you need to go out and get for the CECL calculation. It's just something that we see. It's, again, very difficult and not anything that is going to add a ton of value when it comes to your CECL calculation. But the third one is something that we do expect to see in all CECL calculations and that's if the borrower loses their job. And so using the FRED tool that Josh just pointed out or any other resources you may have, it's very important to have that unemployment aspect in your queue factors so that you can make sure that you are properly forecasting for that charge-off, because that's probably the most predictive measurement you can have in terms of your CECL calculation.

Tessa Brockie:

And like I mentioned, all six of these are the ones we see the most. We also do see a blend of approaches as well. And so we can see more than one methodology used based off of the loan pools and how they are broken out. For real estate, we often see real estate or commercial real estate using maybe a different methodology just based off of the complexity of that loan pool. The one thing I do want to mention in terms of those loan pools is don't break them down so small that it's only five loans in the pool, because that's not going to give you a accurate analysis within your overall CECL calculation. And you want to make sure that that's being considered in a large pool of loans that makes sense.

Josh Juergensen:

Yeah. Tessa, you brought up a great point in regards to the size of those loan pools and one of the reasons why I think CECL is able to work for larger institutions and why we've seen them go through that implementation process already, it's just due to the large amount of data points that they have, right? It's relatively easy for them to have some kind of forecasted component that they're able to back up and justify or support. Whereas some of the things that Tessa alluded to, the death or divorce or losing of a job, it's pretty difficult though, to do from a community bank perspective, just due to the size of the portfolios that you have. There's not that vast amount of data points that are out there. And so, one of the things that we've been consistent on, even dating back to, if you go back into the archives of our CECL presentations back in 2018 and 2019 is really trying to keep this as simple as we possibly can.

Josh Juergensen:

And Tessa brought up a great point as well when it comes to making sure that you've got the ability to explain and support and justify why you're using methodology that you are and why it's appropriate for your own institution. And so, as we're working with community banks across the country, the most common that we are seeing is the weighted average remaining maturity. And we've a couple examples here that I'll show you and put on the screen. What we've got here right now is an example of if you wanted to build it on your own and utilize Excel, the WARM methodology, the weighted average remaining maturity for those of you, if you're not familiar with that yet is really just taking a lifetime look at the existing portfolio that you have and trying to anticipate and amortize out the losses over the remaining life of that portfolio.

Josh Juergensen:

If we go way back in the early conversations on CECL, there were some concerns that this methodology would not be appropriate or would not be blessed if you will, by the regulators, but they've continued to support this. And now I would say that with the community banks that we work with, this is easily the most common that we are utilizing. I think a lot of that has to do with the easiness of understanding the portfolio and giving your arms around it and being able to explain it. We did a demo of some CECL

support that we were providing to a client and had a CFO of an institution to tell us that she had sat in on seven different models and seven different software providers. And the way that average domain of maturity was the first one that she'd been able to truly get her arms around when it comes to the understanding of how the math works, how the calculation itself works and how they arrive at the overall reserve levels that they need to have under CECL.

Josh Juergensen:

So, again, as I mentioned, this is an example of what it could look like with an Excel. We've got it broken out here by the various loan pools on the left, and then calculating what kind of remaining maturity that portfolio has. One of the things that we are seeing and having conversations with clients about one of the challenges that they're running into is how to come up with what that remaining maturity actually is for each and for an institution, because that maybe not sure where best to get that information and how to segment that out. One of the ways that is somewhat easy to do. It does take a little bit of work to get it set up on the front end, but taking a detailed loan trial balance and being able to calculate what is the remaining maturity, the contractual maturity for each loan, and then segmenting those out.

Josh Juergensen:

Now, the one important thing to keep in mind is we are talking about contractual maturity. Okay, so this isn't intended to be the amortization schedule or amortization period of alone. We'd expect that to be adjusted via some kind of Q factor adjustment. But if you have questions on how best to calculate what that remaining maturity is by the each individual loan portfolio, feel free to reach out to any of us. We're happy to kind of talk through some of the things that we've been doing with institutions and how best we can help in that regard. Also, a common question that we're getting when we're talking about the remaining maturity methodology specifically is how often do I need to be recalculating this? And how often do I need to be updating that? I'll generally take a little bit of a cop out answer and say it really is up to you at your own institution on what is most appropriate.

Josh Juergensen:

But from a practicality perspective, generally speaking, we are not seeing at least in those institutions that we've been working with for a couple of years now on this, we are not seeing a lot of volatility in the remaining maturity on a quarter by quarter basis. So I would say on the high end, take a look at this on a quarterly basis. I know there are some institutions that I'm working with that they're planning to update that on an annual basis and making sure that's updated prior to year end to make sure that there's no significant changes in the remaining maturity there. So again, this is an example from an Excel perspective on how you could do that. There are some tools out there and one common one that we have clients that we're working with they're utilizing is the bank trends CECL calculator that they have, if you're familiar with that group.

Josh Juergensen:

This is just a couple of screenshots from that and what that looks like, but it really gives you the ability to utilize the call report data. And it automatically pulls that call report data on a quarterly basis. And then it gives you the ability then to go in and enter in as this screenshot on the right shows, what is the percentage of the portfolio that's interest only, what are the other lifetime inputs that you've got in there, right? And how you want to modify that for your own individual institution?

Josh Juergensen:



On the left side shows some of that market data or market information that's out there, whether it's net charge-off analysis, and you've got the ability to go into there and layer on and customize that for your own specific institution that flows right into the calculation as well. So this is an example of one of the softwares that's out there from a third party vendor that we are seeing commonly across the industry and makes it a pretty easy to use tool as well. So, in addition to that, I know we've got a couple other methodologies that the regulators have put out recently. David, you want to touch on these couple here?

David Heneke:

Yeah, that sounds good. Josh. So before we jump into that, I had a couple of comments I wanted to make on the methodologies, just so everybody's aware also to kind of piggyback off of what Tessa and Josh were saying is one thing to understand when you look at that listing of methodologies, and this goes back to what Josh and Tessa were saying about complexity versus the sophistication of what you'll need based in your portfolio is every one of those methodologies, the math to come up with the history of what your historical lifetime loss rate is. You effectively end at the same formula, and that is charge-offs divided by principle. Each methodology just kind of has a different way of getting there. Whereas vintage analysis, you're organizing the portfolio by year of origination. With the cohort/snapshot methodology, you're organizing by points in time is things like that.

David Heneke:

And so to that point, the one thing to reiterate is if that numerator, meaning the charge-off is either volatile or non-existent, you're going to get volatile or non-existent results, regardless of what methodology you select. And that goes back to Josh's point about the selection of potentially a more simplified methodology given what you may see in your portfolio based on what your charge-offs tell you, because reminder and Tessa brought this up, we're trying to forecast charge-offs. And if charge-offs are nonexistent or volatile, that data element is going to be very hard to predict because that's another thing you see in community institutions is as Tesla alluded to those three items that we typically get the common answers for why loans are charged off, is in a community bank the charge-off of a loan is much more singular to that individual credit than it is a broad reflection of that entire portfolio.

David Heneke:

Whereas when you're dealing with the large say national institution and they're charging off thousands of loans a month or thousands of loans a quarter, you can draw conclusions on the entire portfolio based on that data, which just makes it very hard to do as a community institution. So I wanted to layer that on to what Josh and Tessa said, as well as you begin to think about what methodology you select, because just going more complex doesn't mean you're going to get necessarily a more accurate answer depending on what your charge-offs history actually looks like. All right. So as Josh alluded to, I'm going to take a minute here to talk briefly about the two methodologies that have recently been released by the regulatory agencies, specifically the federal reserve. So you can go out and Google for these two items, if you haven't already seen them or sat in on the presentations done by the regulators for these.

David Heneke:

But the first one they did was scale and scale effectively leverages the loss rates of CECL adopters for over a billion dollars, because that goes back to that data I showed you earlier, of pulling down those loss ratios by category and using those as your starting point. So you're not using your historical data as your starting point for your CECL calculation. You're using the data of CECL adopters between a billion

and 10 billion as your starting point because that's what the regulators are putting together and providing to you as it relates to what those loss rates are. You will then also compare your loss history, so your annual loss history to that, of your peers and the UBPR and then you would increase or decrease your allowance based on what your loss history was compared to your peer. Now what makes this one challenging is that third bullet of the qualitative adjustment.

David Heneke:

So now as we've always been doing it, we've been qualitatively adjusting our history, our loss data to that of what we think is going to happen based on what we know going on in the industry. While under scale, you're conceptually adjusting the industry back to what you think your losses are compared to that industry. Because remember what I said was, we're starting with loss data and loss rates of banks between a billion and 10 billion as our starting point. And so then you, as a management team, would need to look at that data and say, well, what are, say, unemployment rates for the nation compared to where my bank locations are, what are real estate levels, real estate prices, whatever you decide as your data element as your metric to look at how you relate compared to what those institutions in that data are showing you.

David Heneke:

So the qualitative assessment is a completely different mindset than it would be on any other methodology. Now, that being said, this is a very simplified approach. And I'll say that it doesn't appear to have gained, I'll say significant traction in the industry from both a regulatory and auditor perspective for institutions that have some size to them. This seems to be a method that's really reserved for the smallest of the small community institutions in the country to where there's probably never going to be a point in which they'd ever be subject to a financial statement audit, or carry a lot of complexities within their portfolio. The much more common direction we're seeing institutions go like Josh and Tessa alluded to is more of the weighted average remaining maturity method to where that starts with your own data and then can qualitatively adjust from there.

David Heneke:

And that just seems to have a lot more wider acceptance as a simplified methodology for banks of all asset sizes, because you're also seeing some of the large publicly traded financial institutions using WARM for at least a subset of their portfolio and disclosing such in their 10Ks and their 10Qs. Now, having said that the Fed did just recently release a tool within the last few weeks here, which they call the expected loss estimator, otherwise known as the Ellie tool. And this is a weighted average remaining maturity method tool where you key in some data from your loan portfolio on a loan by loan level basis, you put in some inputs and it spits out the loss amount for you. This seems to be a much more, this method seems to be one that could be a lot more usable to institutions of various sizes.

David Heneke:

And it's something to explore as maybe if you're getting started and want to look at a tool that may give you some information. Now, there are some inputs to it that you'll need to look at pretty significantly as your institution related to amortization periods. The maturity dates, if you want to include dynamic loss rates or dynamic prepayment speeds in there, there's spots for those. So it is a little bit more sophisticated than I'll say the most simplified version of WARM, but it does at least give you that option and opportunity to key in some of those data input.



David Heneke:

So it's a good tool to go out and explore and look at and see if that may make sense for your institution. Otherwise, as we've already talked about, there are other options and methodologies and tools out there for WARM, as well as all these other methodologies, depending on what you think is right for you as an organization. So with that in our last few minutes, here we have together, I'm going to turn it back over to Tessa as she's going to bring us home here with some other items to consider [inaudible 00:51:04] beyond the loan portfolio and to be aware of in regards to CECL adoption. So Tessa, I'll turn it over to you.

Tessa Brockie:

Thanks, David. Yes, this is our last few minutes. If you have any additional questions that you did not get answered, please type them in and we will get back to you. I'm not quite sure we'll be able to answer them on air today, but we will do our best. So yes, model validation, we do expect all CECL calculations to have a model validation. Obviously we are less than six months away from adoption. The validation does not need to be done before you adopt, but it does need to be done before year end 2023, because that will obviously be the year that is audited for the first time with your CECL calculation. So work with management, figure out who will be conducting that validation and try and get it set up on the books. Also, for FASB items, TDRs do go away for your CECL calculation.

Tessa Brockie:

However, you still do want to take note of those loans you consider as TDRs so that you can disclose them within your financial statements. So again, not part of your CECL calculation, but you still need to maintain documentation for disclosure purposes. And with purchased loans, this actually gets easier with CECL because your discount for the credit drops into your allowance for this. And so it's much easier in terms of how you're calculating your purchased loans for under CECL than under your allowance methodology now. And then for unfunded commitments, so for this one, you need to look at your current calculation and come up with the average utilization of your current credit lines and consider how much will be advanced within what's outstanding at this time. So you're going to take your average utilization on your lines now and calculate that times your loss rate of what you expect to expend in the future. David, did you want to add anything to the unfunded commitments there?

David Heneke:

No, I think you summarized it well, Tessa, I would just say that there is more than one way to go about this, but what you described is what I would say is the most common methodology we're seeing our clients start with to where they're trying to get a gauge for the unfunded piece that's out there, how much they could potentially advance based on their history, like you said, and then applying those lifetime loss rates based on the category it's in. Usually that number for ones we've been working with has come up to be a pretty small number because if you think about it, conceptually, if you're taking a large, say a hundred million dollars of unfunded commitments, multiplying it by 5% potential advancement, and then by a 1% lifetime loss rate, the number gets pretty small, but you'll need to go through that analysis to justify to the regulator or an auditor that you've at least went through the process to say, this is what we think it is. It's not material, or if it is material, then book that liability accordingly.

Tessa Brockie:





And then lastly, investments. Investments are included within your CECL calculation. But what we've been seen with the early adopters and the large banks is most of them have already come to the conclusion that any adjustment for investments is not material to the calculation. So if you think about it, your investment consideration is for the unrealized loss that you would experience on bonds. And again, this is immaterial in most cases, and it can be treated at this point, very similar as if you are completing an OTTI memo simply because not a lot is being done. And that's what's being seen across the industry right now. As more information comes out around investments, this might change. But at this point in time, there's not a lot that this is actually impacting in your calculation.

David Heneke:

I would say if I could add to that Tessa, to clarify what you said is, Tessa was talking about looking at the unrealized loss, we're aware that probably all of you are sitting with bonds that are in significant unrealized loss positions right now, given the movement of interest rates. And so the starting point, typically for evaluation of whether there should be an allowance booked is if you have a bond and an unrealized loss position, but the unrealized loss position that would need to get booked as an allowance would specifically be related to, if you think there's going to be credit loss on that bond, if you are not going to recover the principle, if you hold it to maturity.

David Heneke:

So like Tessa said the old OTTI or the other than temporarily impaired concept, the point being is that then as Tessa mentioned, you can take some of these bonds that really have very little credit risk, like US treasuries or any bonds that are backed by a US government agency, kind of put those over to the side and say, the credit risk here is minimal. Any unrealized loss that we have right now is specifically given that interest rates have moved up. Whereas if you're looking at municipalities or private label mortgage backed securities or corporate bonds that you may have, there may need to be a little bit more thorough analysis to justify that you do not have any credit loss there, but this doesn't mean, like Tessa said, this isn't going to be near as robust as your loan loss allowance is going to be, because you'll be able to either point to rating agency ratings, cash flow coming from municipalities and like the projects where it's coming from [inaudible 00:57:40] things of that nature.

David Heneke:

So we do at this point, at least envision, if your bond portfolio is pretty plain vanilla is what you see at most community institutions that this will probably take the form of a memo and that you won't need to do any other, I'll say formal calculation. Because if you think about it conceptually, one of the things you can ask yourself is have you ever taken a credit loss on a bond before in your institution? Well, if the answer to that is no. Well then your historical loss is zero. And so no computation you do on that's going to change that. So that's just something to keep in mind that this will not be as robust as the loan side of things [inaudible 00:58:18].

Josh Juergensen:

Hey David, before we wrap up real quick, I know we had a question come in that I think one of us, one of you, you or Tessa answered in regards to the model validation that Tessa was referring to, and if there would be a cost to have this done. I would look at this very similar to what you're experiencing or seeing with any of your other significant models that you're using. And most commonly, we see that in your asset liability management process, your interest rate risk model that you're utilizing, really expecting to have very similar type of expectation from regulators when it comes to CECL as well. We also see many

clients that have their current methodology validated on an annual basis as well. So considering what's expected to be an increased depth of a calculation, increased complexity, really anticipating that is going to continue to be something that regulators are going to expect and something that should be on your radar, so.

Josh Juergensen:

And I think with that, that gets us to our time here. Big thanks everybody for attending, here's all of our contact information. And should there be more questions that you have that you want to follow up on, please feel free to reach out to David or Tessa, or I directly. Happy to be a resource as we navigate the next six months upon implementation. And then the next couple of years as we get past implementation day one and move on into the future, I think we're going to have a lot of clarity as we get 6, 12, 18, 24 months out from implementation when it comes to expectations and efficiencies and things like that, but more than happy to be your resource for you all as we go forward. So big thanks for attending. Have a great rest of your day and have a great week.

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