

The CECL Workshop Series.

CECL Finalization & Methodologies

June 7, 2016

PRESENTED BY



Todd Sprang
CliftonLarsonAllen



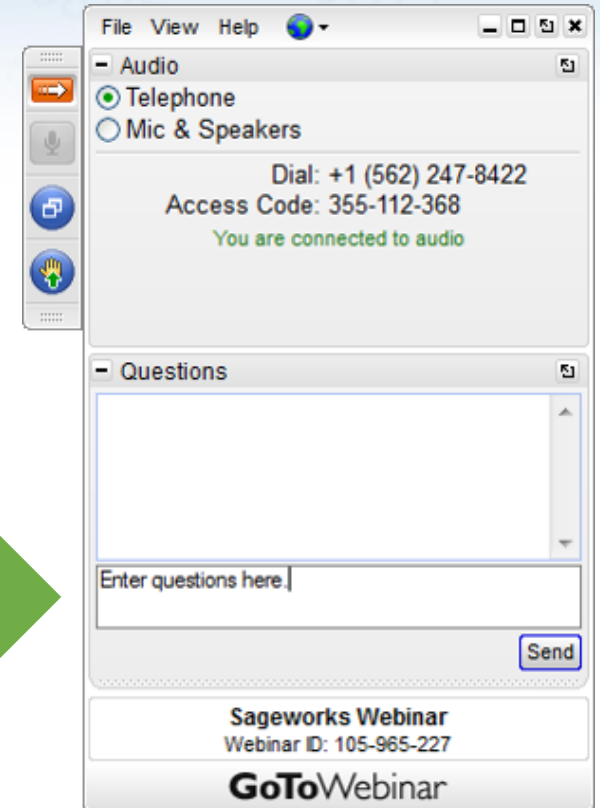
Tom Danielson
CliftonLarsonAllen



Tim McPeak
Sageworks

About the Webinar.

- Ask questions throughout the session using the GoToWebinar questions panel
- We will answer as many questions as we can at the end of the presentation



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- Founded in 1998
- Risk management thought leader for institutions and examiners
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THE WALL STREET JOURNAL.



AMERICAN BANKER.

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Investment advisory services are offered through CliftonLarsonAllen Wealth Advisors, LLC.

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About Today's Presenters.



TODD SPRANG

Principal
CliftonLarsonAllen



TOM DANIELSON

Principal
CliftonLarsonAllen



TIM MCPEAK

Exec. Risk Management Consultant
Sageworks

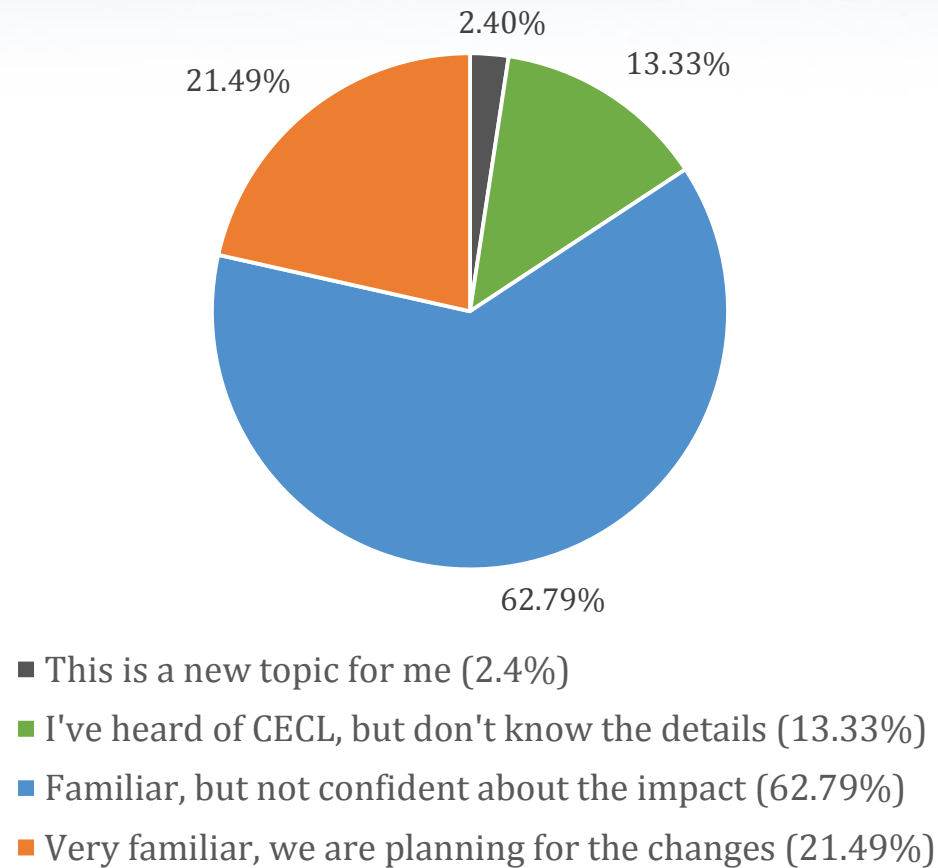
Agenda.

CECL FINALIZATION & METHODOLOGIES

- Overview of CECL
- Recap of Parts I and II
- News and updates
- Revisions to the standard and what they mean
- Example CECL calculations reviewed by the TRG
- Expected release and next steps for your institution

Registration Poll Question.

What is your familiarity with the FASB's CECL model?



What is CECL?

- FASB released proposal December 2012
- Current expected credit losses (CECL)
- What's changed from Incurred Loss Model?
 - » Forward-looking requirements
 - » "Probable loss" threshold removed
 - "No triggers, no thresholds" (["Fed Perspectives," 2015](#))
 - » Need for accessible, loan-level data
 - » Longer loss horizon
 - » Makes ALLL more institution-wide calculation
- Purpose: Quicker recognition of losses. Changes in ALLL reserve balances will reflect changes in credit quality and flow through bank earnings (["Fed Perspectives," 2015](#))

"Current Expected Credit Loss Model (CECL) and Supervisory Expectations with Steve Merriett the Fed's Chief Accountant". FedPerspectives. October 30, 2015. <https://bsr.stlouisfed.org/perspectives/>

Part I Recap: The CECL Workshop Series.

Crafting your implementation plan – January 21, 2016

- Understand the potential scope of implementing CECL
- Consider forming a cross-departmental implementation committee
- Understand the data components your institution may need to future-proof your ALLL

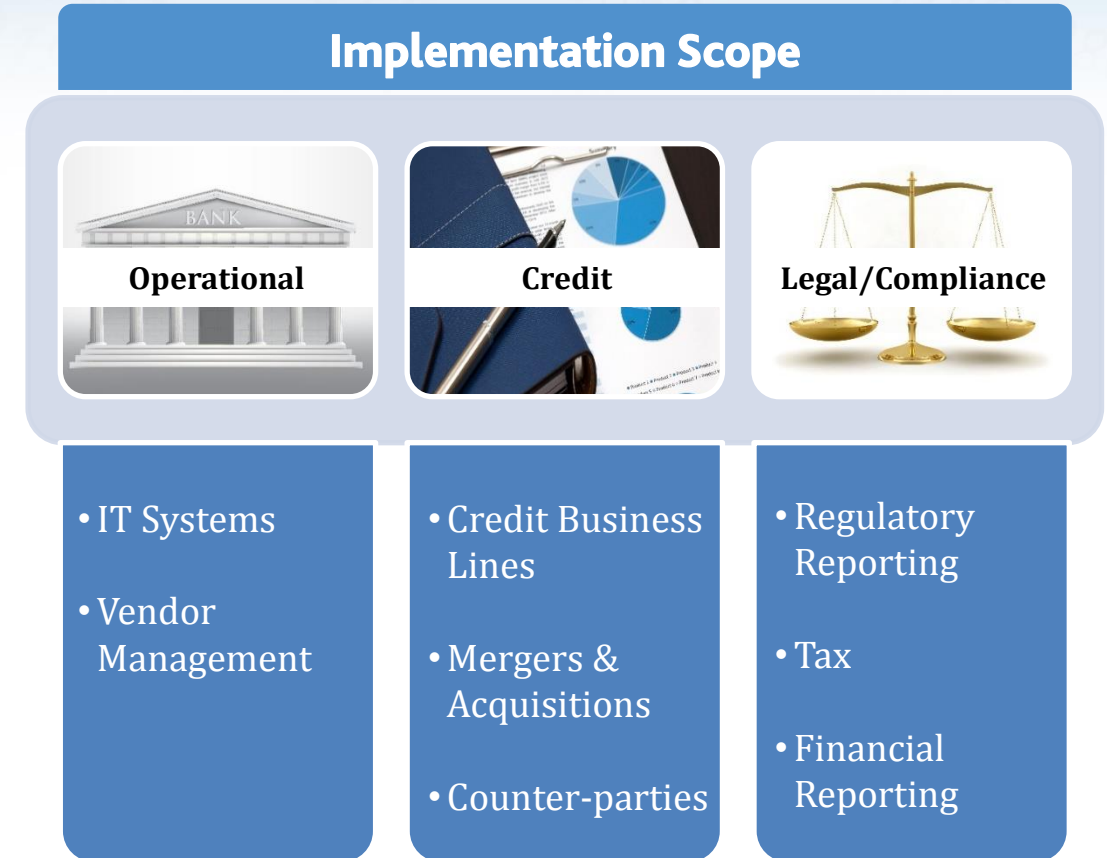


Figure adapted from "Current Expected Credit Loss (CECL) Model: Answers to Your Questions," by the Federal Reserve Bank of St Louis, 2015, *Quarterly Conversations, Live from Eagle Bank and Trust Little Rock, AR*. Retrieved from: [https://bsr.stlouisfed.org/conversations/includes/resources/November%202015%20Quarterly%20Conversations%20\(CECL\)_FINAL.pdf](https://bsr.stlouisfed.org/conversations/includes/resources/November%202015%20Quarterly%20Conversations%20(CECL)_FINAL.pdf)

Part I Recap: Your Implementation Committee.

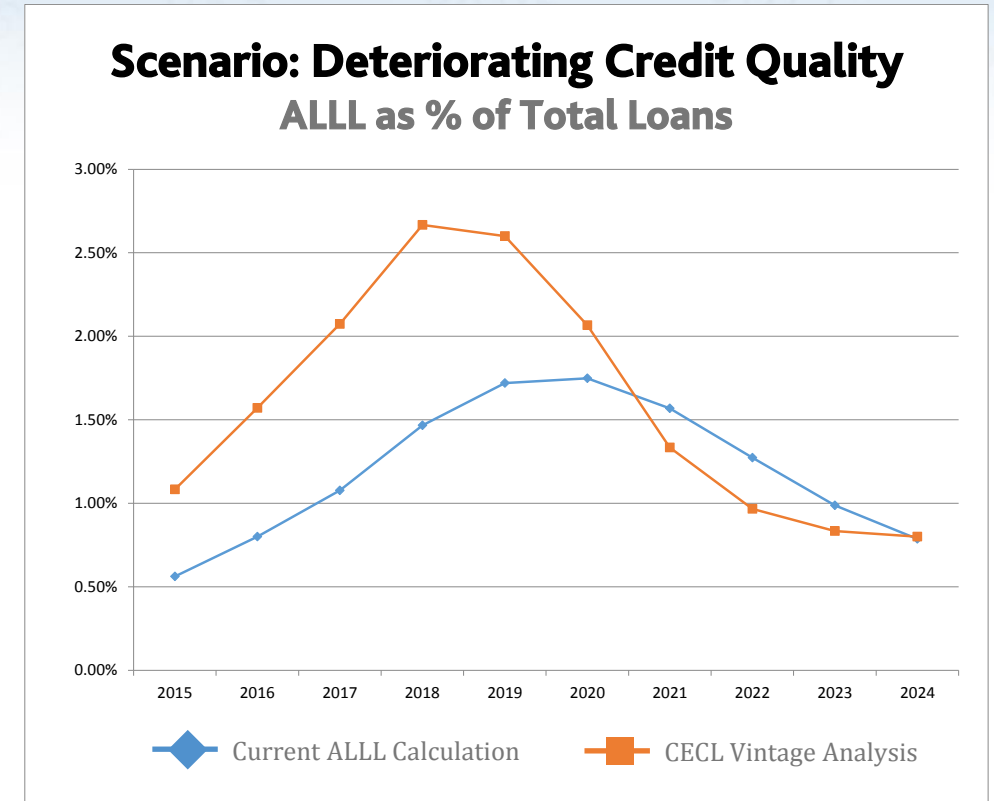
- Forming your committee:
 - » Look at how the allowance calculation flows through your institution and how many business areas touch it
 - » Strive for senior level representation across all departments
- Define the roles of the committee
 - » Set initial objectives and timelines
 - » Determine responsibilities and scope out resource requirements
 - » Provide regular updates to senior management and board
- Create project plan
 - » Document your roadmap as well as possible
 - » Meet regularly, as defined by the plan
- Factors for your committee to consider:
 - » Methodology changes, data requirements, capital adjustment, communication, projected impact



Part II Recap: The CECL Workshop Series.

Methodology deep dive: Vintage Analysis -
February 18, 2016

- Forecasting expected credit losses and the loss curve
- Understanding vintage analysis
 - » ECL Calculations account for losses sooner
- Importance of scenario analysis



Poll.

Please select an option

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News & Updates.

What's new since the last webinar in this series

Transition Resource Group (TRG) for Credit Losses.

- Purpose
 - » To solicit, analyze, and discuss stakeholder issues arising from implementation of the new guidance
 - » To inform the FASB about those implementation issues, which will help the Board determine what, if any, action will be needed to address those issues
 - » To provide a forum for stakeholders to learn about the new guidance from others involved with implementation
- Members
 - » Chair = Larry Smith, FASB
 - » TRG members include financial statement preparers (including community banks and credit unions), auditors, users, and financial services regulators.
- There most recent meeting was held on April 1, 2016 and future meetings have not yet been scheduled.

New Effective Dates.

1 SEC-Filing Institutions
December 15, 2019

2 PBE Non-Filers
December 15, 2020

3 Others
December 15, 2021

Optional: All Entities
December 15, 2018 – Early CECL Adoption

New Implementation Timelines.

1. SEC Filing Institutions.



2. Non-SEC Filing Public Business Entities.



3. All Other Entities + Not-For-Profit Organizations.



Early Adoption Timeline.

Early CECL Adoption.



Discussion:

- Who will adopt the standard early?

Implementation Timing & Discussion.

- Greater loss reserves during a weak economy
 - » If we enter a recession as effective dates near, reserves could already be higher
 - » This may increase bankers' expectations for losses in the future, possibly resulting in a greater one-time increase?
- Impact of BASEL III
- Understand the impact to your institution early – perform modeling and scenarios to assess the impact
- Stress assumptions around the model to understand what the impact may be given economic factors
- Institutions rushing for additional capital at the same time?

Recent Revisions: “Added Flexibility.”

- Internal and external information available without undo cost and effort
- Clarifications
 - » Use multiple methods
 - » Forecast periods and reverting to mean
- Day 1 flexibility
- Language is broader and less specific/prescriptive
 - » May come back to the TRG
 - » Simplified examples
- Vintage disclosures

Poll.

Please select an option

Methodology Examples.

Examples reviewed by the Transition Resource Group (TRG)

Ex. 1: Loss-Rate Approach (Collective Evaluation).

This Example illustrates one way an entity may estimate expected credit losses on a portfolio of loans with similar risk characteristics using a loss-rate approach.

- **Community Bank A** provides 10-year amortizing loans to customers; loans managed on a collective basis based on similar risk characteristics.
- The loan portfolio was originated over the last 10 years and has an amortized cost of **\$3,000,000**.
- After comparing historical, the bank believes that its most recent 10-year period is a reasonable period on which to base its expected credit loss-rate calculation.
 - » Cumulative historical lifetime credit loss rate for most recent 10-year period: **1.5 percent**.
 - » The historical credit loss rate already factors in prepayment history, which it expects to remain unchanged.
- Significant factors are considered that could affect the expected collectability of the amortized cost basis of the portfolio.
 - » Based on current conditions and reasonable and supportable forecasts, the bank expects:
 - An additional decrease in real estate values over the next 1-2 years / Unemployment rates are expected to increase further over the next 1-2 years.
 - » The historical loss rate is adjusted to reflect the differences in current conditions and forecasted changes:
 - An incremental **10-basis-point increase** due to the expected decrease in real estate values.
 - A **5-basis-point increase** due to expected deterioration in unemployment rates.
 - » Management estimates the incremental 15 basis-point increase based on its knowledge of historical loss experience during past years. Management is unable to support its estimate of expectations for real estate values and unemployment beyond Year 2 of the forecast and decides to immediately revert to the historical credit loss experience after Year 2.
- The historical loss rate is adjusted by an incremental 15 basis points to **1.65 percent**.
- The allowance for expected credit losses for the reporting period date would be **\$49,500**.

Financial Accounting Standards Board—Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments, Transition Resource group (TRG) Meeting, April 1, 2016. Subtopics 326-20-55-18, 326-20-55-19, 326-20-55-20, 326-20-55-21. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168024855

Ex. 1: Loss-Rate Approach (Collective Evaluation).

| Community Bank A | |
|--|---------------|
| Total Loans – 10 year amortized loan portfolio | 3,000,000 |
| 10-year cumulative historical lifetime loss rate | 1.50% |
| Significant factors that could affect expected collectability: | |
| Decrease in real estate value | + 0.1% |
| Deterioration in unemployment rates | + 0.05% |
| Loss Rate – adjusted for expected credit losses | 1.65% |
| Total Reserve | 49,500 |

- **Discussion:**
 - » Points “assumed away”
 - Seasoning, stable portfolio, little growth/shrinkage, no change in underwriting standards, no change in staff
 - » What this doesn’t tell us
 - A year from now, how do you decide if the 10-year rate is still applicable?
 - How do you assess what you need at the beginning of year two?

Financial Accounting Standards Board—Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments, Transition Resource group (TRG) Meeting, April 1, 2016. Subtopics 326-20-55-18, 326-20-55-19, 326-20-55-20, 326-20-55-21. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168024855

Ex. 2: Loss-Rate Approach (Individual Evaluation).

This illustrates one way to estimate expected credit losses on an individual loan using a loss-rate approach when no loans with similar risk characteristics exist.

- **Community Bank B** provides residential real estate loans to borrowers in the community.
- In the current year, the bank started a program to originate commercial loans. The bank has one commercial loan outstanding at period end and because the commercial loan does not share similar risk characteristics, the bank does not believe it is appropriate to pool the commercial loan for purposes of determining its allowance for credit losses. The bank's commercial loan has an amortized cost of **\$1,000,000**.
- Historical loss information for commercial loans in the community with similar risk characteristics show a **0.50 percent** loss rate over the contractual term.
- Relevant current conditions and reasonable and supportable forecasts are considered. The bank determines that the significant factors affecting the performance are borrower specific operating results and local unemployment rates.
 - » Other qualitative factors including national macroeconomic conditions are determined to not be significant inputs to the loss estimates for to this loan.
 - » The bank is able to reasonably forecast local unemployment rates and borrower specific financial results for one year only. The reasonable and supportable forecasts of those factors indicate that local unemployment rates are expected to remain stable (based on the main employer in the community continuing to operate normally) and there will be a deterioration in the borrower's financial results (based on an evaluation of rent rolls).
 - » Management determines that no adjustment is necessary for local unemployment rates because they are expected to be consistent with the conditions in the 0.50 percent loss rate estimate. However, the current and forecasted conditions related to borrower specific financial results are different from the conditions in the 0.50 percent loss rate estimate, based on borrower specific information.
 - » The bank determines that an **upward adjustment of 10 basis points** to the historical loss information is appropriate based on those factors. Management estimates the 0.10 percent adjustment based on its knowledge of commercial loan loss history in the community when borrowers exhibit similar declines in financial performance.
- The historical loss rate to apply to the amortized cost basis of the individual loan would then be adjusted an incremental 10 basis points to **0.60 percent**.
- The allowance for expected credit losses for the reporting period date would be **\$6,000**.

Financial Accounting Standards Board—Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments, Transition Resource group (TRG) Meeting, April 1, 2016. Subtopics 326-20-55-23, 326-20-55-24, 326-20-55-25, 326-20-55-26, 326-20-55-27. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168024855

Ex. 2: Loss-Rate Approach (Individual Evaluation).

| Community Bank B | |
|--|--------------|
| Amortized cost of commercial loan | 1,000,000 |
| Historical loss for similar comm loans in the community | 0.5% |
| Significant factors that could affect expected collectability: | |
| Borrower-specific financial results adjustment | 0.1% |
| Loss Rate – adjusted for expected credit losses | 0.6% |
| Total Reserve | 6,000 |

- **Discussion:**
 - » Points “assumed away”
 - Underwriting standards compared to other banks, staff depth and experience
 - » What this doesn’t tell us
 - Lottery ticket difficulties – not CECL related
 - With a pool of one, any loss would likely be more than \$6,000
 - Concept of similar risk characteristics – 2, 4 or 6 loans?

Financial Accounting Standards Board—Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments, Transition Resource group (TRG) Meeting, April 1, 2016. Subtopics 326-20-55-23, 326-20-55-24, 326-20-55-25, 326-20-55-26, 326-20-55-27. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168024855

Ex. 3: ECL on a Vintage-Year Basis.

The following Example illustrates one way an entity might estimate the expected credit losses on a vintage-year basis.

- **Community Bank C** is a lending institution that provides financing to consumers purchasing new or used farm equipment throughout the local area.
- Originates approximately the same amount of loans each year.
 - » Four-year amortizing loans are secured using a relatively consistent range of loan-to-collateral-value ratios at origination.
 - » The underlying farm equipment collateral is repossessed and sold at auction when the borrower becomes 90-days past due.
- The bank tracks those loans on the basis of the calendar-year of origination. The following pattern of credit loss experience has been developed based on the amount of amortized cost in each vintage that was written off as a result of credit losses:
 - » In estimating expected credit losses on the remaining outstanding loans at December 31, 20X9, the bank considers its historical loss experience. It notes that the majority of losses historically emerge in Year 2 and Year 3 of the loans.
 - » It notes that historical loss experience has worsened since 20X3 and that loss experience for loans originated in 20X6 has already equaled the loss experience for loans originated in 20X5 despite the fact that the 20X6 loans will be outstanding for one additional year as compared with those originated in 20X5.
 - » In considering current conditions and reasonable and supportable forecasts, the bank notes that there is an oversupply of used farm equipment in the resale market that is expected to continue, thereby putting downward pressure on the resulting collateral value of equipment. It also notes that severe weather in recent years has increased the cost of crop insurance and this trend is expected to continue.
- On the basis of these factors, the entity determines the remaining expected losses (represented by the shaded cells in the table in each respective year – *next slide*), and arrives at expected losses of \$60, \$260, \$430, and \$510 for loans originated in 20X6, 20X7, 20X8, and 20X9, respectively.

Financial Accounting Standards Board—Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments, Transition Resource group (TRG) Meeting, April 1, 2016. Subtopics 326-20-55-28, 326-20-55-29, 326-20-55-30, 326-20-55-31. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168024855

Ex. 3: ECL on a Vintage-Year Basis.

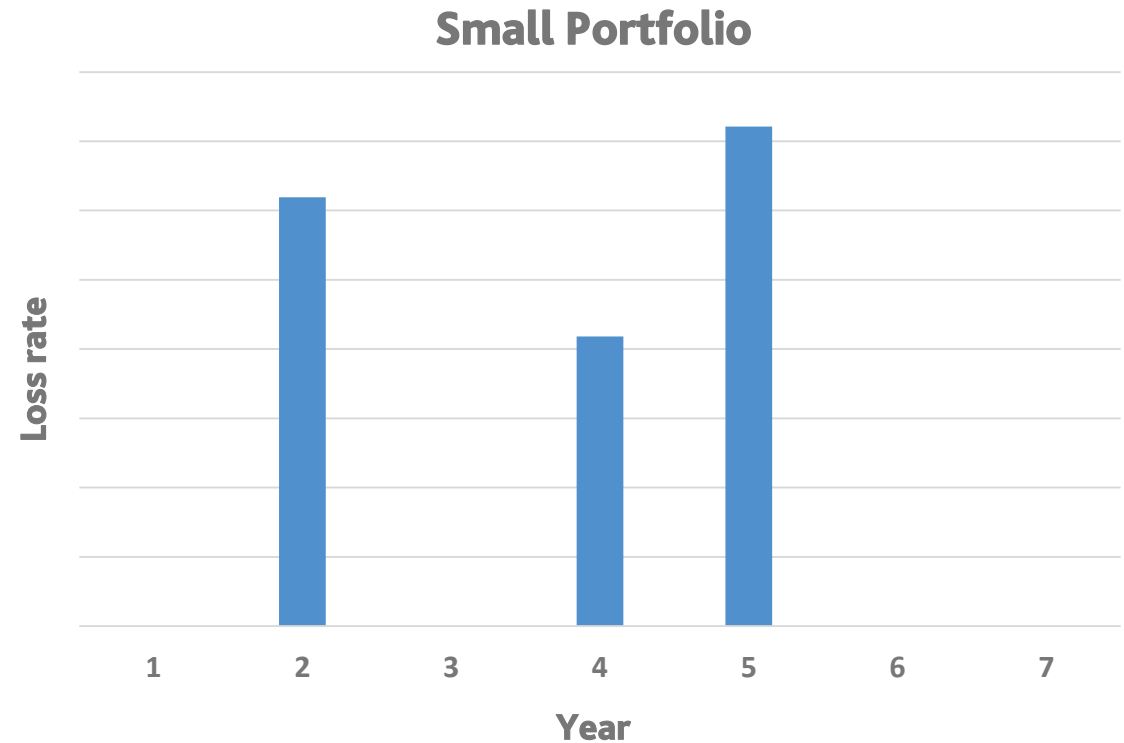
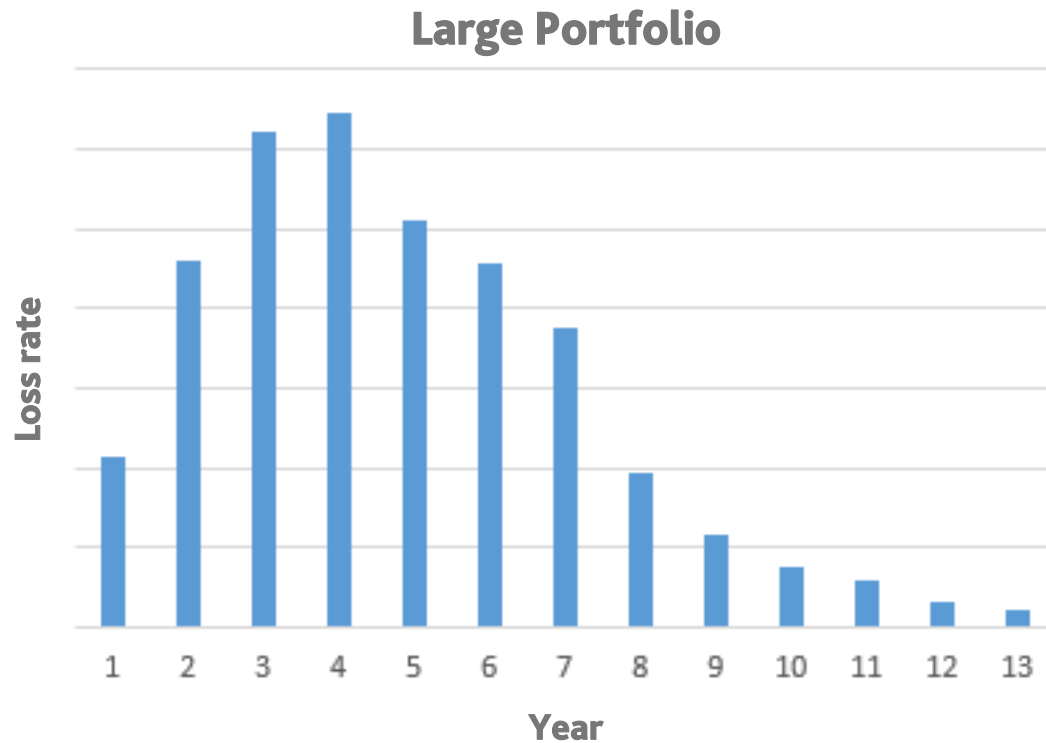
| Community Bank C | | | | | | |
|---------------------|--|--------|--------|--------|-------|----------------|
| Year of Origination | Loss Experience in Years Following Origination | | | | | |
| | Year 1 | Year 2 | Year 3 | Year 4 | Total | Total Expected |
| 20X1 | \$50 | \$120 | \$140 | \$30 | \$340 | - |
| 20X2 | \$60 | \$120 | \$160 | \$50 | \$390 | - |
| 20X3 | \$40 | \$110 | \$150 | \$30 | \$330 | - |
| 20X4 | \$60 | \$110 | \$150 | \$40 | \$360 | - |
| 20X5 | \$50 | \$130 | \$170 | \$50 | \$400 | - |
| 20X6 | \$70 | \$150 | \$180 | \$60 | \$460 | \$60 |
| 20X7 | \$80 | \$140 | \$190 | \$70 | \$480 | \$260 |
| 20X8 | \$70 | \$150 | \$200 | \$80 | \$500 | \$430 |
| 20X9 | \$70 | \$160 | \$200 | \$80 | \$510 | \$510 |

- **Discussion:**
 - » Points “assumed away”
 - » What this doesn’t tell us
 - Prepayments higher, faster, slower than expected, etc. / Day 2 adjustments
 - » What happens when the loss curve is not normalized?

Financial Accounting Standards Board—Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments, Transition Resource group (TRG) Meeting, April 1, 2016. Subtopics 326-20-55-28, 326-20-55-29, 326-20-55-30, 326-20-55-31. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168024855

Data Challenges.

- Understand the limitations of your institution's data
- Applying one methodology to all segments may not work well
- Example: Vintage analysis & loss curves



Poll.

Please select an option

Looking Forward.

CECL Finalization and next steps

Expected Release.

- The FASB plans to issue the final standard draft in June 2016
- For most users, this will be the first updated document they will read since the December 2012 Exposure Draft
- We don't expect any large changes, from the language discussed at the April TRG meeting, except:
 - » The Board decided that public business entities that are not SEC filers would be permitted to provide their vintage disclosures using a phase-in transition approach. The phase-in transition approach would require three origination years to be disclosed (including the originations during the first year of adoption), and then an incremental year for every fiscal year thereafter until five separate fiscal years are disclosed, consistent with SEC filers.
 - » The Board decided that all other entities, including not-for-profit organizations and employee benefit plans, would not be required to disaggregate credit quality indicators by the year of origination.
- What will happen next?
 - » Regulators
 - » Auditors
 - » Industry Groups

Next Steps For Your Institution.

- **Transition planning**
 - » Establish an implementation committee, get the right people involved
 - » Create a project plan, set goals with specific deadlines
 - » Determine initial data shortfalls
- **Experiment with various methods**
 - » Know how your portfolio reacts under the various methodologies
 - » Uncover data shortfalls as you work through the various calculations
 - » Run parallels and gain insight into the potential impact to earnings/capital
- **Evaluate costs and synergies**
 - » Track the true cost of performing the calculation internally
 - » With the right method, output and format the model can be more than just a standard reserve calculation
 - Underwriting/credit
 - Pricing/ALM
 - Stress testing/forecasting

Poll.

Please select an option

2016 Risk Management Summit.

- Topics include:
 - » CECL
 - » Current ALLL best practices
 - » Stress Testing
- Speakers from CliftonLarsonAllen, Grant Thornton, Sageworks and more
- sageworks.com/summit



Q&A, Contact Information.



TODD SPRANG

Principal
CliftonLarsonAllen
todd.sprang@CLAconnect.com
Ph. 630.954.8175



TOM DANIELSON

Principal
CliftonLarsonAllen
thomas.danielson@CLAconnect.com
Ph. 612.376.4795



TIM MCPEAK

Executive Risk Management Consultant
Sageworks
tim.mcpeak@sageworks.com
Ph. 919.242.2642

**Join us for a webinar after finalization
The Final CECL Standard.**
Panel-style discussion with industry professionals

*A review of the final standard, insights from
industry professionals, what it means for bankers
and next steps for making a smooth transition.*

July 7th, 2016
2:00 p.m. – 3:00 p.m. (ET)

Register now:
<http://web.sageworks.com/cecl/>

Additional Resources.

- CLAconnect.com – Learn more about CliftonLarsonAllen
- Sageworksanalyst.com – Learn about Sageworks
- ALLL.com – Everything ALLL, including news articles, whitepapers and peer discussions
- ALLL Forum for Bankers – LinkedIn group for ALLL news & discussion
- [CECL Post-release webinar](#) - panel-style webinar with thought leaders
- Interested in talking with a specialist?
 - » Email us now: sales@sageworks.com

Endnotes.

- “Current Expected Credit Loss (CECL) Model: Answers to Your Questions,” by the Federal Reserve Bank of St Louis, 2015, Quarterly Conversations, Live from Eagle Bank and Trust Little Rock, AR. Retrieved from: [https://bsr.stlouisfed.org/conversations/includes/resources/November%202015%20Quarterly%20Conversations%20\(CECL\)_FINAL.pdf](https://bsr.stlouisfed.org/conversations/includes/resources/November%202015%20Quarterly%20Conversations%20(CECL)_FINAL.pdf)
- “Current Expected Credit Loss Model (CECL) and Supervisory Expectations with Steve Merriett the Fed's Chief Accountant”. FedPerspectives. October 30, 2015. <https://bsr.stlouisfed.org/perspectives/>
- Financial Accounting Standards Board—Financial Instruments—Credit Losses, Measurement of Credit Losses on Financial Instruments, Transition Resource group (TRG) Meeting, April 1, 2016. http://www.fasb.org/cs/ContentServer?c=Document_C&pagename=FASB%2FDocument_C%2FDocumentPage&cid=1176168024855

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