The CECL Workshop Series.

Part I: Crafting your implementation plan

January 21, 2016

PRESENTED BY

Todd Sprang
CliftonLarsonAllen

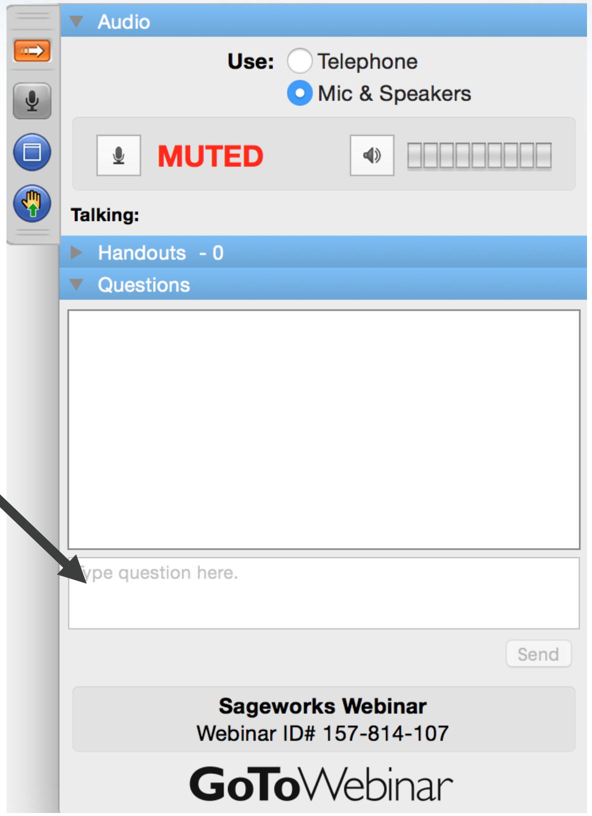
Tom Danielson
CliftonLarsonAllen

Tim McPeak
Sageworks

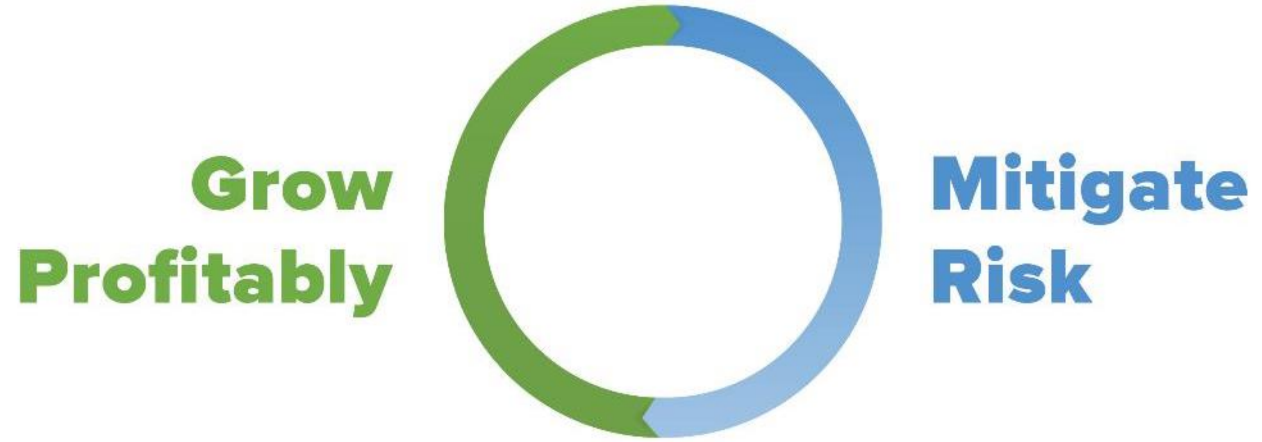
About the Webinar.

- Ask questions throughout the session using the GoToWebinar control panel

- We will answer as many questions as we can at the end of the presentation



About Sageworks.



- Loan portfolio and risk management solutions
- More than 1,000 financial institution clients
- Founded in 1998

- Risk management thought leader for institutions and examiners
- Featured in national and trade media

THE WALL STREET JOURNAL. CNBC AMERICAN BANKER.

About CliftonLarsonAllen.

- A professional services firm with three, distinct business lines
  - » Wealth Advisory
  - » Outsourcing
  - » Audit, Tax, and Consulting
- Nearly 4,000 employees
- Offices coast to coast
- Serve more than 1,450 financial institutions

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

Executive Risk Management Consultant
Sageworks

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Agenda.

CRAFTING YOUR IMPLEMENTATION PLAN

- Factors your institution should consider when crafting a CECL implementation plan
- Example timelines for CECL implementation planning
- Important data components, and how to future-proof your ALLL
- The pitfalls of repurposing historical loss calculations for CECL
- Auditor concerns

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)

Implementation Resources.

When it comes time for implementation, institutions will have a number of resources to consider:

- Regulators, industry experts, thought leadership
- All institutions will be going through the same process, your institution is not alone
- Leverage in-house knowledge in your committee
- External assistance from consultants and vendors

Scope of CECL Implementation.

"CECL implementation is, in many ways, a project management challenge that will affect most parts of your business to one degree or another." ("Fed Quarterly Conversations," 2015)

"The CECL model represents the biggest change – ever – to bank accounting." ("ABA Letter to the FASB - CECL," 2016)

Operational
- IT Systems
- Vendor Management

Credit
- Credit Business Lines
- Mergers & Acquisitions
- Counter-parties

Legal/Compliance
- Regulatory Reporting
- Tax
- Financial Reporting

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

Forming 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

Defining Roles in Your Committee.

- Must first evaluate your current process and methodology
  - » From data gathering to reporting/disclosures
  - » Often a few key individuals perform most of the work
- CECL will require significant collaboration across functional areas
  - » Committee members must understand the role their areas will play going forward
  - » Assumptions used for ALLL will need to be consistent across other bank functions and models (ALM & Stress Testing)
  - » Active committee creates checks and balances
- Opportunity to improve the ALLL process
  - » Not starting from scratch, but close to it

Factors for Your Committee to Consider.

Methodology Changes	Historic loss to migration, PD/LGD, vintage analysis
Data Requirements	"Reasonable and supportable forecasts"
Capital Adjustment	Life of loan expected loss versus one year incurred loss
Communication	Model validation
Projected Impact	Internal controls
	External provider

Factors for Your Committee to Consider.

Methodology Changes	Building and maintaining a data warehouse (new storage device / server)
Data Requirements	Assessing availability and quality of historical data
Capital Adjustment	Determining key data needed for calculation
Communication	Data validation process
Projected Impact	Report building process

Factors for Your Committee to Consider.

- Methodology Changes
- Data Requirements
- **Capital Adjustment**
- Communication
- Projected Impact

Need to raise additional capital?

Timing consideration

Shareholder communication

Regulatory communication

Factors for Your Committee to Consider.

Methodology Changes

Data Requirements

Capital Adjustment

Communication

Projected Impact

- Socialization of CECL with board and senior management
- Periodic meetings
- Documents read into the minutes

Factors for Your Committee to Consider.

Methodology Changes	Earnings projection due to changes in provision
Data Requirements	Peer comparisons will change
Capital Adjustment	Asset and liability management
Communication	Stress testing
Projected Impact	Loan pricing
	Underwriting guidelines
	Segment lending limits

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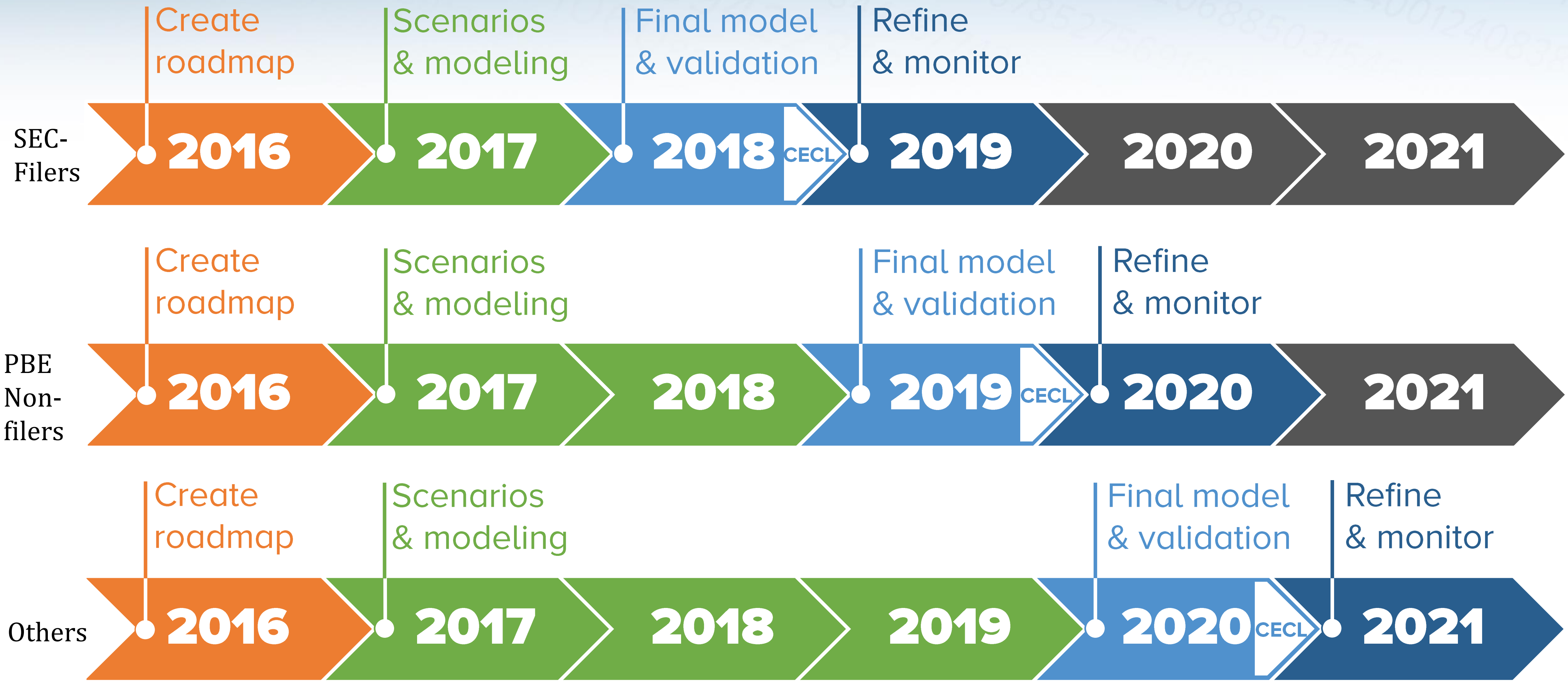
CECL Implementation Example Timelines.



Example Implementation Timeline.

SEC-Filing institution

CECL Implementation Example (SEC filer).

2016: Create Roadmap.

Key Action Items

- Build committee
- Set project plan
- Review final CECL language
- Inform board & management of committee/ALLL changes
- Examine data/current processes

- Determine data requirements
  - » Build and house data (warehouse, report builder, data tools, reports)
  - » Work with core provider to extract data
  - » Start gathering and storing data
  - » Data validation
- CECL
  - » Review finalized CECL language / leverage available resources
  - » Review potential loss methodologies versus available data
  - » Begin modeling potential CECL scenarios

2017: Scenarios & Modeling.

Create roadmap — 2016

Scenarios & modeling — 2017

Final model & validation — 2018

CECL

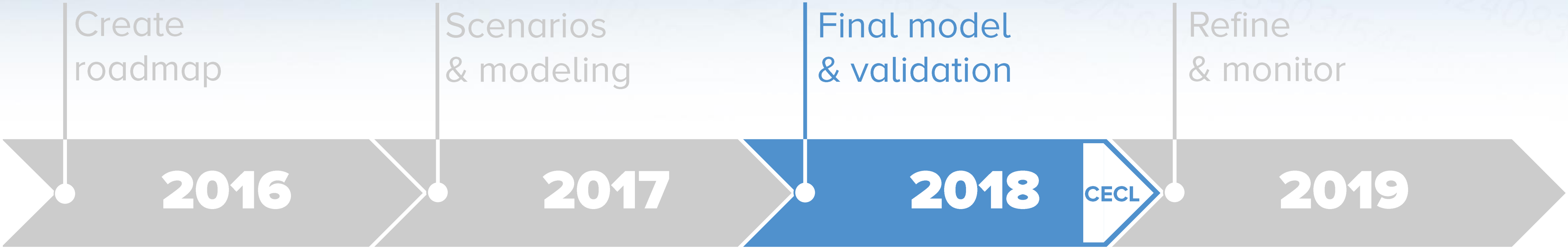
Refine & monitor — 2019

Key Action Items

- CECL scenario modeling
- Test methodologies
- Develop data validation process
- Identify any capital issues
- Update board/management

- Continue modeling CECL scenarios / run multiple scenarios
  - » Begin running potential CECL models in parallel with current calculation
  - » IT testing (test data, validation, etc.)
  - » Internal and external audit review of ongoing model building
- Ensure accurate data by developing formal data validation process
- Identify if CECL calculations will require capital adjustment
- Provide management with regular reporting showing comparison of current ALLL versus proposed CECL calculation, as well as whether additional capital will be needed

2018: Final Model & Validation.



Key Action Items

- Identify final CECL model
- Incorporate model & reserve data into current portfolio management
- Capital adjustment
- Update board/management

- Identify final CECL model
  - » Audit approval, regulatory feedback, board approval
- Regular management and board reporting showing differences between ALLL and CECL
  - » Potential impact on ratios, earnings, capital purchase, shareholders and investor relations
- Incorporate model and reserve data into current portfolio management
  - » Pricing, reporting, stress testing

2019: Implement Final Model.

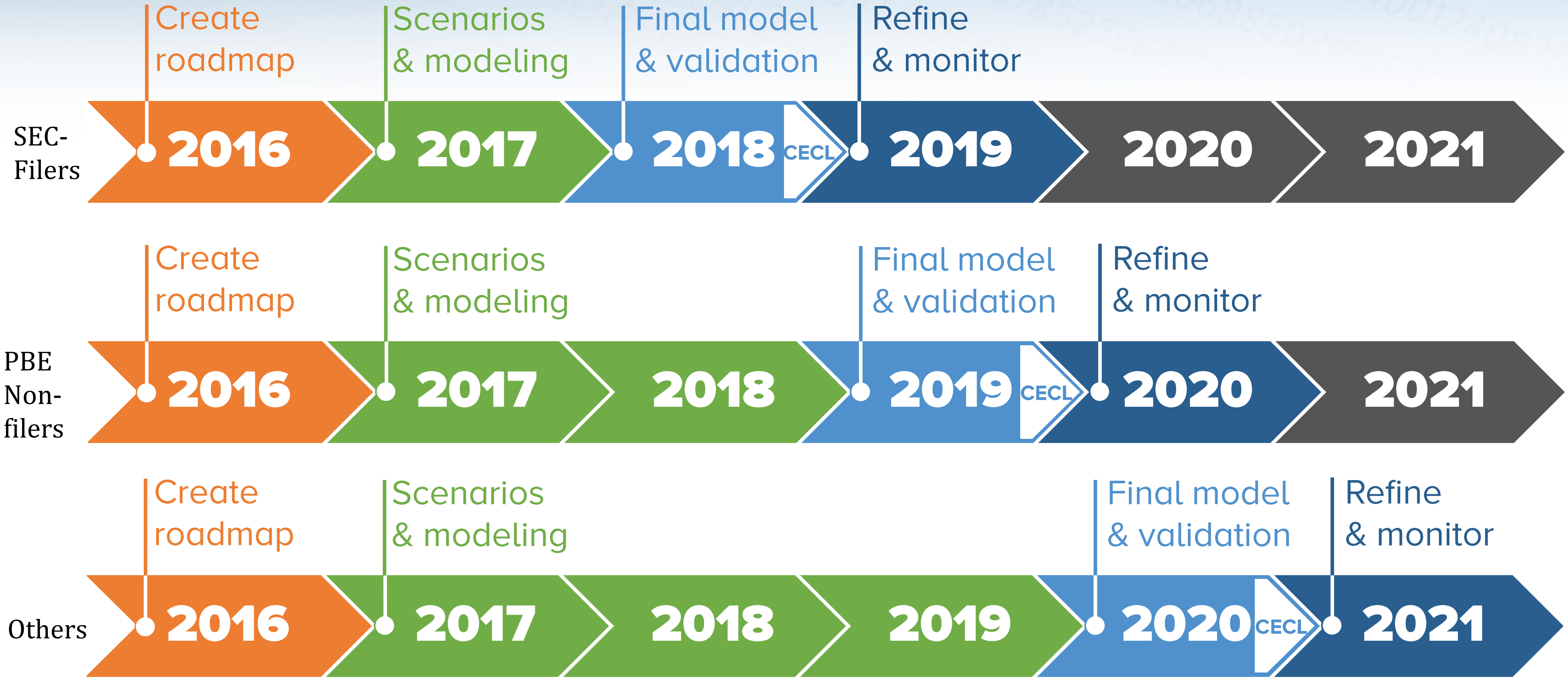
Create roadmap | Scenarios & modeling | Final model & validation | Refine & monitor

2016 | 2017 | 2018 | CECL | 2019

Key Action Items
• Fine-tune new process
• Monitor ALLL levels
• Fine-tune risk ratings
• Fine-tune loan pricing
• Update board/management

- Fine-tune the new ALLL process and other related processes
  - » Ensure everyone is performing their duties
  - » Refine risk ratings
  - » Fine-tune loan pricing
- Regular management and board reporting for strategic planning to include new CECL numbers

CECL Implementation Example Timelines.



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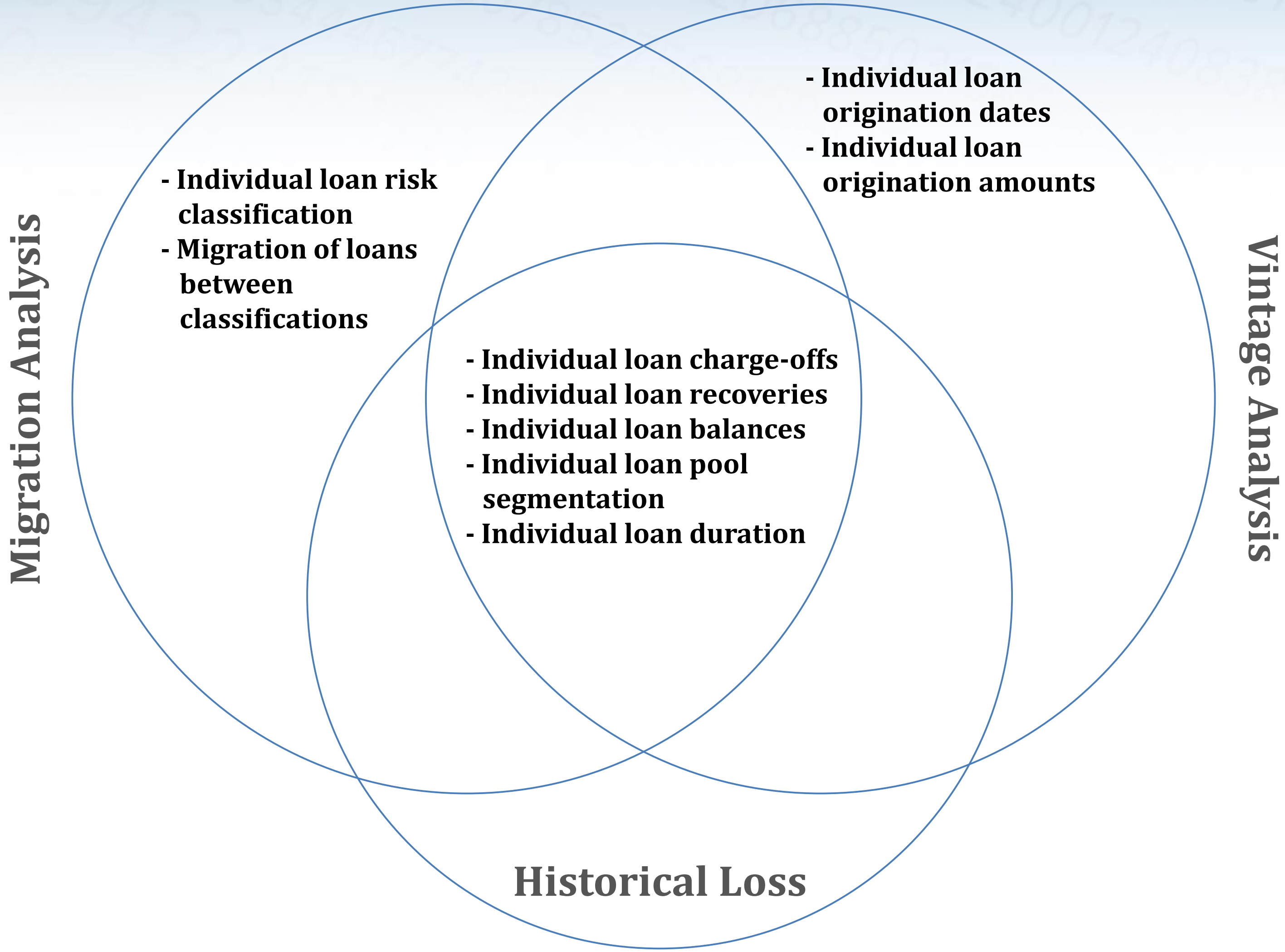
Future-Proofing Your ALLL.

The importance of data

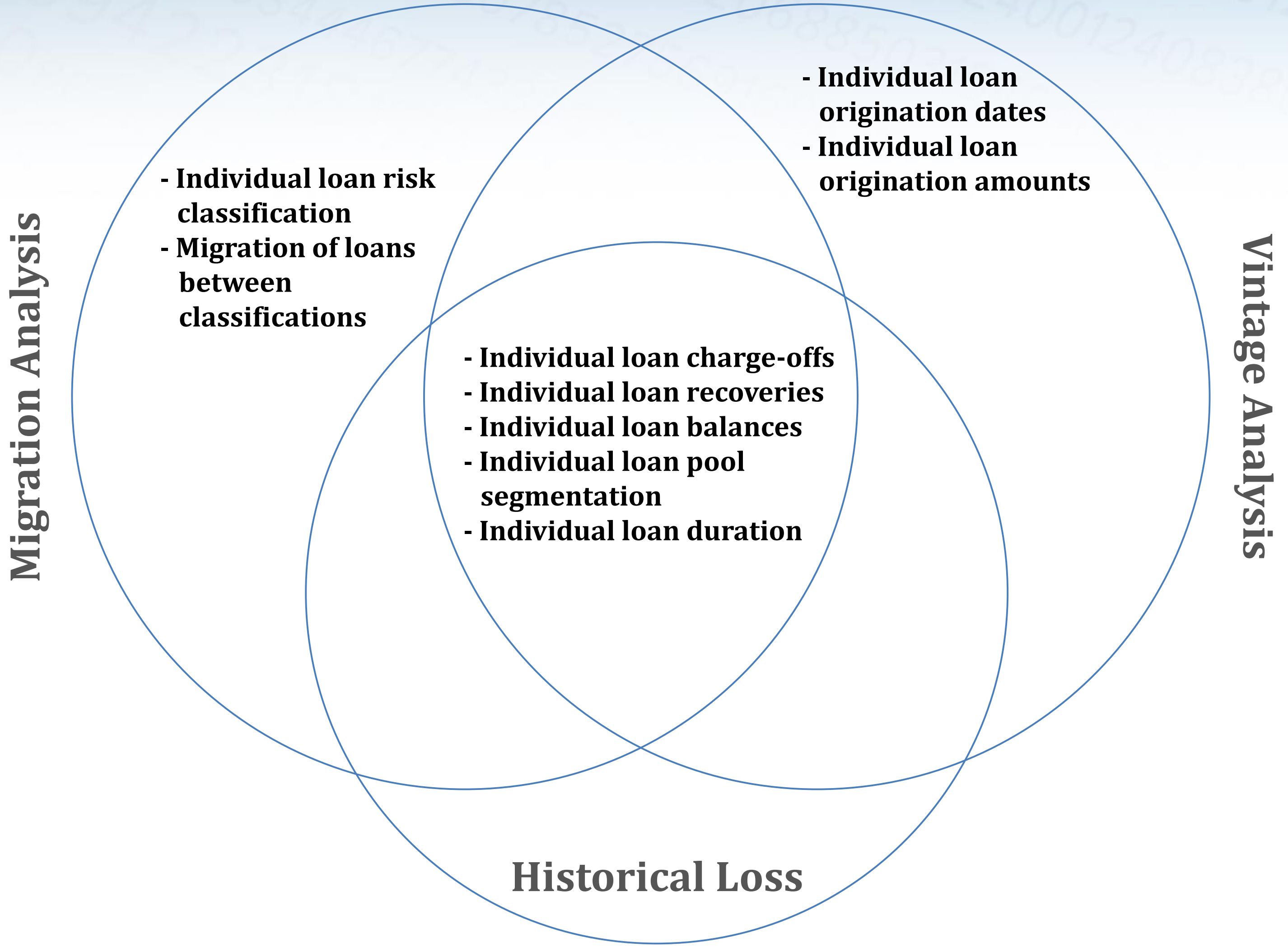
Data Components by Methodology.

- Ensuring that you are capturing the proper data will give you more flexibility in the methodologies you can consider



Future-Proofing Data.

- This is a data-driven exercise
- Don't cheat yourself out of using a methodology due to a lack of information
- Gather industry information
  - » Shape of loss curves
  - » Prepayment assumptions
  - » Projected lifetime losses for various types of loans by loan vintage



May I Adapt My Current ALLL Model?

- Not technically prohibited
- ‘It typically would be inappropriate’ for long-term assets according to the exposure draft
- Ease seems to be the only advantage
- May create unwanted results for long-term assets
- May be appropriate for short-term loans

Excerpt from Exposure Draft.

825-15-55-24 It typically would be inappropriate to estimate the expected credit losses for a long-term asset by multiplying an annual loss rate (that is, the net amount written off in a 12-month period divided by the average amortized cost) by the remaining years of the asset's contractual term because loss experience is often not linear. That is, for certain types of lending, credit losses are low shortly after origination, rise rapidly in the early years of a loan, and then taper to a lower rate until maturity. When estimating expected credit losses under this Subtopic, the loss rate should be commensurate with the current credit risk of the financial asset.

Comparison for Long-Term Loans.

Example: Commercial real estate portfolio with a remaining life of four years

Existing Calculation

Loan Type	Loan Balance	Historical Factors	Q Factors	Allocation for Historical Losses	Allocation for Q Factors	Total Allocation
Commercial Real Estate	$100,000,000	1.25%	0.25%	$1,250,000	$250,000	$1,500,000

CECL Calculation

Date	Year End Loan Balance	Avg Balance	Loss Rate + Q Factors	ALLL
12/31/X0	$100,000,000			
12/31/X1	75,000,000	87,500,000	1.50%	1,312,500
12/31/X2	50,000,000	62,500,000	1.50%	937,500
12/31/X3	25,000,000	37,500,000	1.50%	562,500
12/31/X4	-	12,500,000	1.50%	187,500
				$3,000,000

Increase of 100%

Problems With Adapting Current Model.

- Depending on the shape of the loss curve, the necessary reserves might be 25% less than the $3 million shown on the previous slide
- Large increase in reserves for long-lived assets
- Discourages making long-term loans
- Doesn't account for loss curves
  - » Low losses early
  - » Losses rise quickly
  - » Losses tail off as loans season
- Discouraged by standard setters

Advantages of Adapting Current Model.

- Familiarity
- Ease
- Information is readily available
  - » Still need to gather information on expected life of loan

Recommendations.

- Avoid the temptation of simply adapting your current methodology
- CECL seems to encourage other methods
- CECL expressly allows financial institutions to use multiple methods
- Learn about other methods
- Start gathering information needed

Auditor Concerns.

- Reasonable and supportable forecast
  - » Time period the forecast covers
  - » Documenting forecast assumptions
- Documenting the economic cycle
  - » Cycle term
  - » Current point on the cycle
- Evaluating assumptions
  - » What is the definition of a default?
  - » Is the financial institution’s probability of default reasonable?
  - » Is the financial institution’s loss given default assumption reasonable?
- Proper use of industry data (when allowed)
  - » Everyone thinks they are above average
  - » Applying national data to a regional/local portfolio

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2016 Risk Management Summit.

- Topics include:
  - » CECL
  - » Current ALLL best practices
  - » Stress Testing

- Speakers from CliftonLarsonAllen, Grant Thornton, Sageworks and more

- sageworks.com/summit

2016
Risk Management Summit
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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

Additional Resources.

- CLAconnect.com – Learn more about CliftonLarsonAllen
- Sageworksanalyst.com – Learn about Sageworks risk management suite
- 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 from top accounting firms
- Interested in talking with a specialist?
  - Email us now: sales@sageworks.com

Endnotes.

- Federal Reserve Bank of St Louis, (2015). Current Expected Credit Loss (CECL) Model: Answers to Your Questions. *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
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