CECL

CURRENT STATUS AND NEXT STEPS FOR FINANCIAL INSTITUTIONS

CRI CARR RIGGS & INGRAM
CPAs and Advisors

Doug Mims CPA

Doug Mims CPA
Partner
Financial Institutions Industry Line Leader

Doug has over 30 years' experience (10 years with PwC) providing assurance and advisory services to both private and publicly held financial institutions ranging in size from de novo status to regional bank holding companies. He has significant experience in Mergers & Acquisition (M&A), Sarbanes-Oxley Compliance (SOX) and Anti-money laundering (AML). Doug is currently leading the firm's sales and training efforts relative to Current Expected Credit Losses (CECL).

Doug has a BS in Accounting and MBA from the Sorrell College of Business at TROY University. He is a Certified Public Accountant (CPA), Certified Internal Auditor (CIA), Certified Anti-Money laundering Specialist (CAMS) and is Certified in Risk Management Assurance (CRMA).

Doug serves on the Board of Governors of the Atlanta Chapter of the IIA and is an Advisory Board Member for the Kennesaw State University Internal Audit Center. He is an active TROY alumni, serving in a variety of capacities, including as a member of the Board of Directors for the TROY University Foundation. Doug is also the current Chair-Elect of the Georgia Bankers Association Accountants Section Board.

CRI: Firm Facts

CRI CARR RIGGS & INGRAM CPAs and Advisors

FOUNDED IN 1997 • 10 STATES • 25+ MARKETS

1900+ PROFESSIONALS

300+ PARTNERS

TOP 25 CPA FIRM
(as ranked by Accounting Today)

100,000+ CLIENTS

in all 50 states

20+ YEARS OF CONSISTENT GROWTH SINCE FORMATION

SERVICES

- Accounting & Auditing
- Advisory
- Business Support & Transactions
- Business Tax
- Employee Benefit Plans
- Governance, Risk & Assurance
- Individual Tax & Planning
- IT Audits & Assurance

INDUSTRY EXPERTISE

- Captive Insurance
- Construction
- Financial Institutions
- Governments
- Healthcare
- Institutional Real Estate
- Insurance
- Manufacturing & Distribution
- Nonprofits

CRI FAMILY OF COMPANIES

- Auditwerx
- CRI Advanced Analytics
- CRI Capital Advisors
- CRI Solutions Group
- CRI TPA Services
- Level Four Advisory Services
- Paywerx
- Preferred Legacy Trust

CRI: Serving Financial Institutions

175+

with assets totaling nearly

$75+ billion

2 in 5

Banking clients

are subject to FDICIA

(Federal Deposit Insurance Corporation Improvement Act)

CRI'S FINANCIAL INSTITUTIONS EXPERTISE

CRI CARR RIGGS & INGRAM
CPAs and Advisors

Perform Bank Secrecy Act services for:

25% of Bank & Credit Union clients

Internal audit and compliance for approximately:

50% of Bank & Credit Union clients

Tax services for:

30% of Financial Institution clients

FFIEC IT review and penetration testing for:

25% of Financial Institution clients

Current Expected Credit Losses (CECL)

1. CECL to date…
2. Tools you can use…
3. Allowance for Credit Losses (good bye ALLL, hello ACL)
4. The more things change the more they stay the same…
5. Past events…
6. Current conditions aka “Q” factors
7. Looking ahead…
8. It’s getting WARM in here
9. Interagency Statement on ACLs - Overview
10. CECL Solutions

CECL to date…

CECL to date…

CECL timeline

- Initial exposure draft was issued in 2010.
- Revised exposure draft was then issued in 2012.
- Accounting Standards Update (ASU) No. 2016-13, Financial Instruments - Credit Losses was issued in June of 2016.
- Initial effective date for all SEC registrants Q1 of 2020, Non-SEC registrant Public Business Entities(PBEs) Q1 2021, and private companies Q1 2021.
- Largest SEC filers adopted Q1 2020, all others deferred to Q1 2023.

CECL to date…

CARES Act

- *Provided the opportunity to defer the adoption of CECL to the end of the state of emergency or 2021*
- *45 of 197 applicable banks chose to defer*
- *Less than $3B - 7*
- *$3B to $5B - 14*
- *$5B - $10B – 29*
- *Over $10B - 3*

CECL to date…

Impact of adoption:

Average Allowance to Loans (152 adopters)

- *December 31, 2019 - .89%*
- *January 1, 2020 – 1.21%*
- *March 31, 2020 – 1.47%*
- *June 30, 2020 – 1.66%*

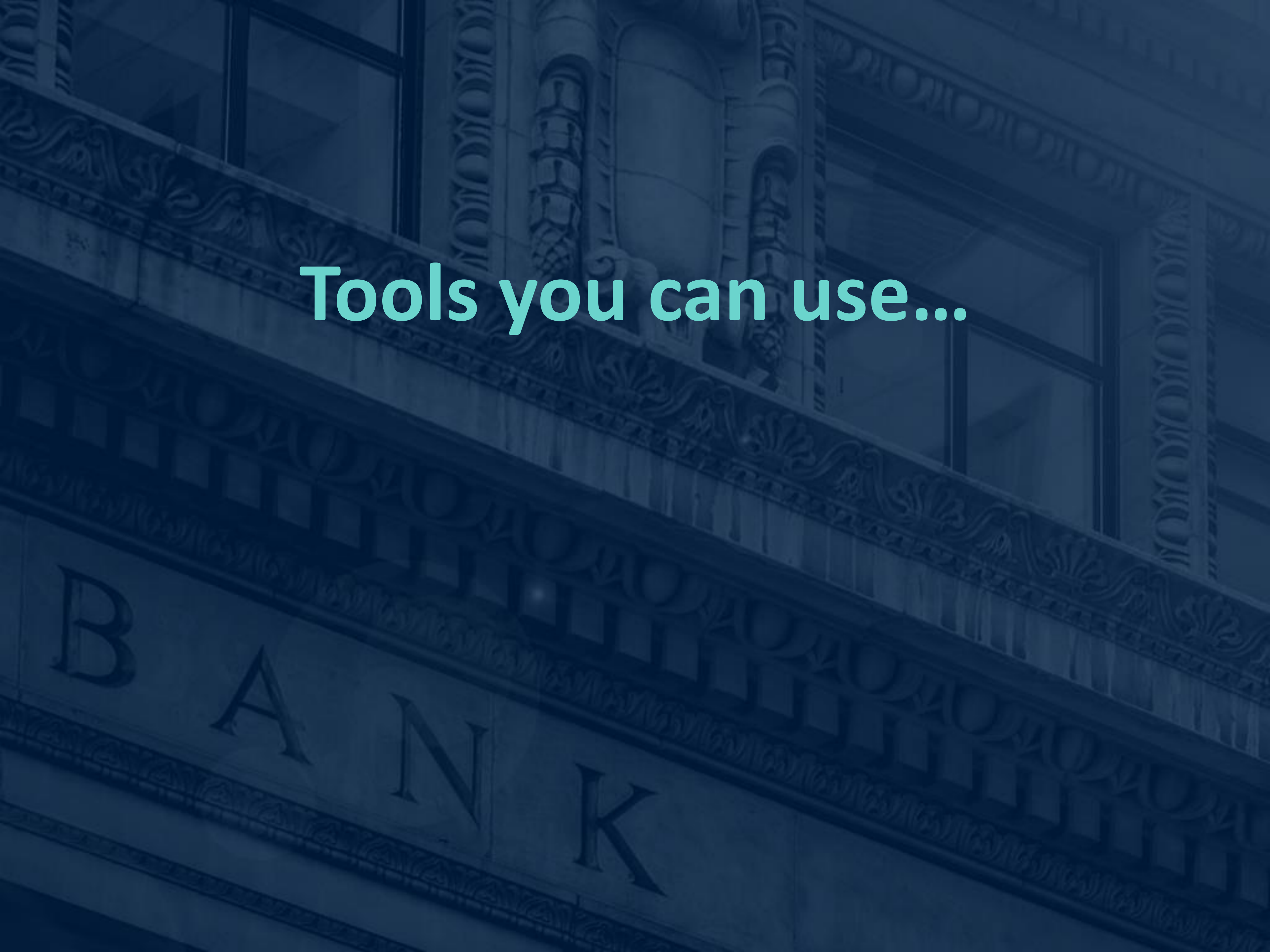
**Average increase of 36.4% at adoption*

CECL to date…

Impact of Adoption, continued

- Adopters provision to average loans was .44% and .15% for Q1 and Q2, respectively
- Those opting to defer were .35% and .15%, comparatively
- 2020 adopters asset size ranged from $1.3B to $3.1T
- 45 institutions presumably to adopt in 2021
- Approximately 5,100 community banks scheduled to adopt in 2023, along with all credit unions (over 5,100 as well)

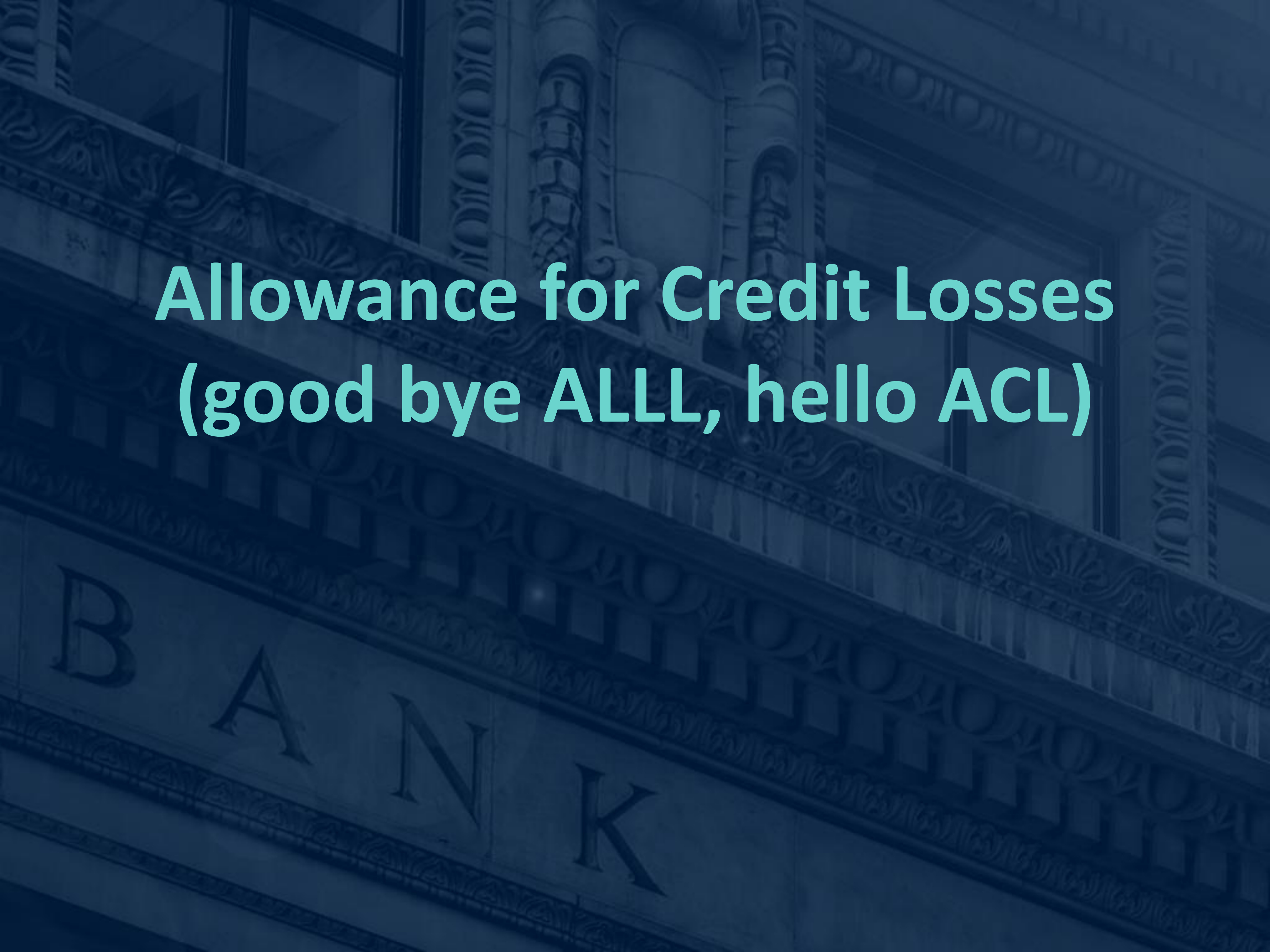
Tools you can use…



Tools you can use…

- ASU 2016 – 18
  Pg 109-123
- FFIEC Webinars 2018
  2/27/18, 7/30/18, 9/27/18
- FASB Staff Q&A on WARM
  1/2019
- FFIEC CECL Frequently Asked Questions
  updated 4/3/19
- Center for Audit Quality
  CECL tool for Audit Committees
  5/19
- AICPA CECL Practice Aid
  9/19
- FFIEC interagency guidance on Allowance for Credit Losses 3/20

Allowance for Credit Losses (good bye ALLL, hello ACL)



Allowance for Credit Losses

- A valuation account
- Deducted from amortized cost basis of financial assets
- Used to present “net amount expected to be collected”
- Changes flow through net income

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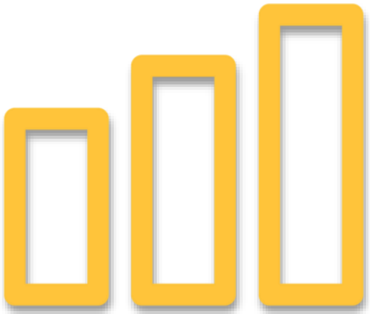

Allowance for Credit Losses

A + B = C

A: amortized cost is the unpaid principal balance (UPB) lent to a customer that has been adjusted for loan fees and origination expenses, repayments, write offs, nonaccrual practices, and certain hedging transactions

B: book the difference as allowance

C: the remaining amounts expected to be collected

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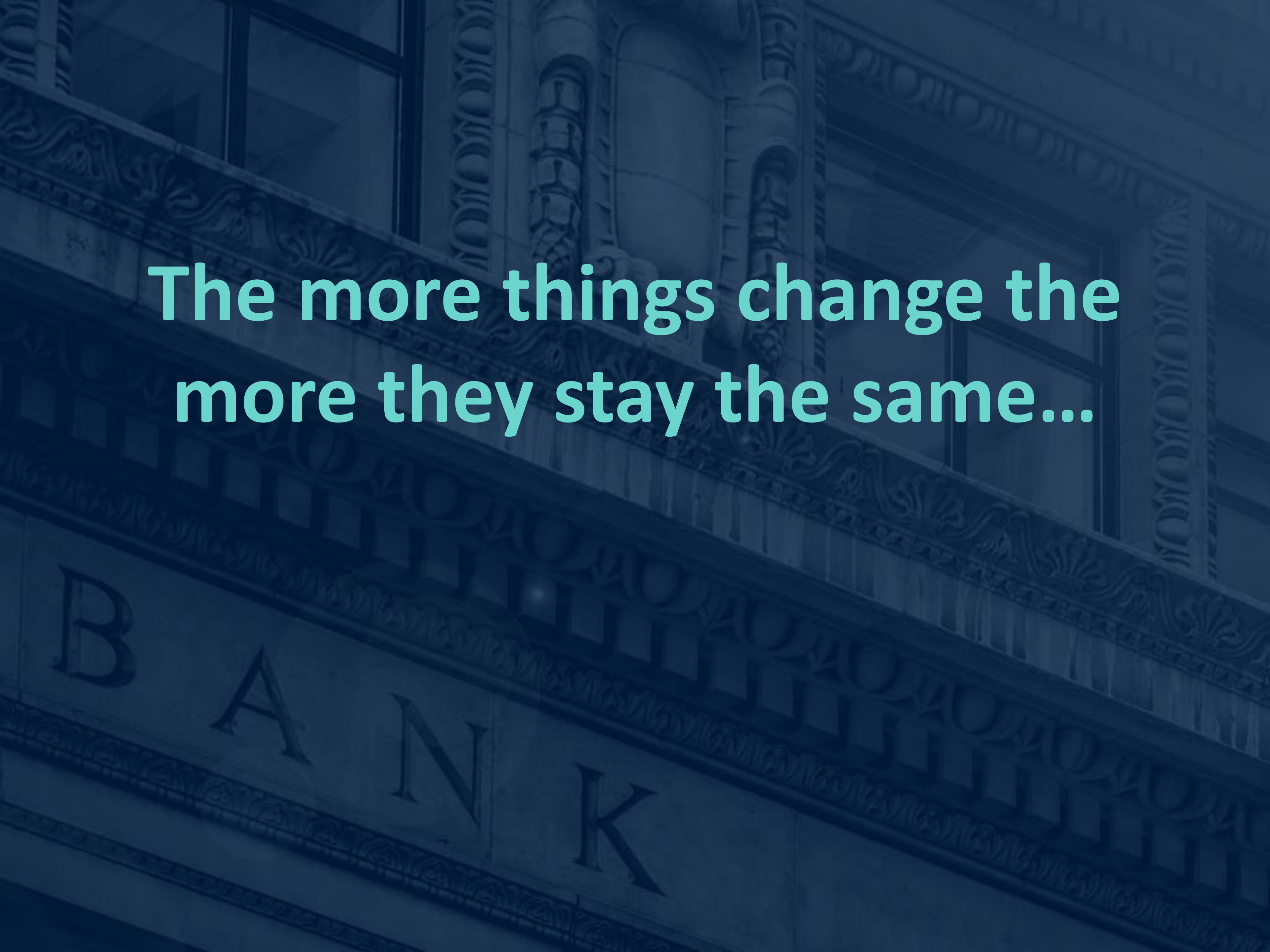


The more things change the more they stay the same…

The more things change…

Today

- Asset classes have required estimation methods
- Pooling permitted but not required
- Recognize losses when probable

CECL

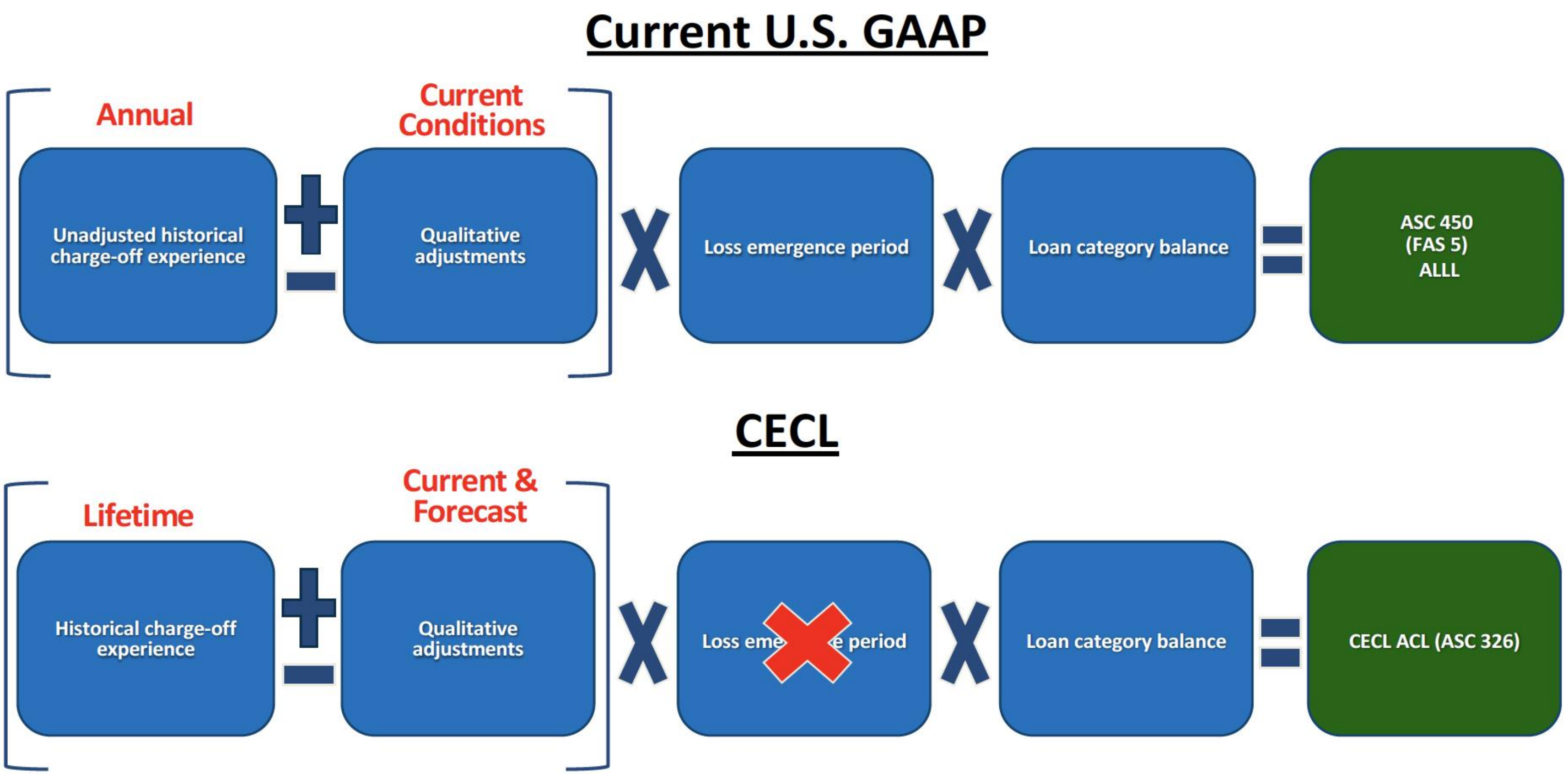
- Single impairment mode
- Pooling is required when assets have similar risk characteristics
- Reasonable and supportable forecasts
- No threshold to recognize losses

The more things change…

- No complex estimation models required for loans
- Consider past events and current conditions
- Requires judgement

CECL only changes the timing of loss recognition, not the amount lost.

The more things change…



FASB FINANCIAL ACCOUNTING STANDARDS BOARD

POLL QUESTION

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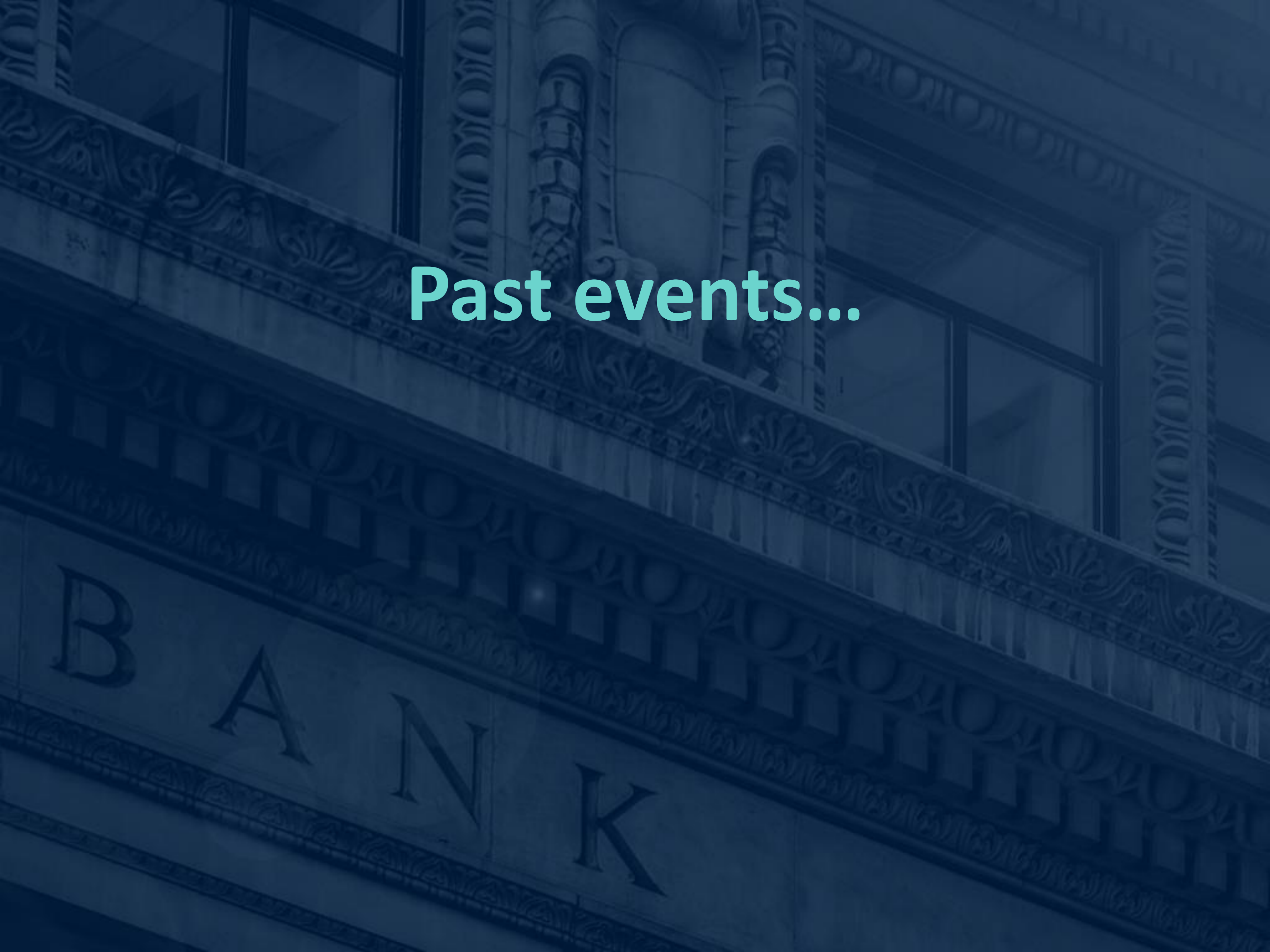
Past events…



Past events…

Historical credit loss information (“past events”)

- “Generally provides a basis” for assessing expected credit losses
- “Shall consider adjustments” for differences in
  - Current asset specific risk characteristics (within a pool)
  - Contractual term (individual or pool)
  - Different economic conditions
- Common adjustments to historical credit loss information:
  - Changes in underwriting
  - Historical losses from a different point in the credit cycle

326-20-30-7 to 8

Current conditions aka “Q” factors

Current conditions aka "Q" factors

- Qualitative adjustments **are permitted** under CECL to capture current conditions and reasonable and supportable forecasts.
  - *Potential to change in number and magnitude under CECL*
- Identifies information relevant to assessing the collectability of cash flows.
  - Internal, external, or a combination of both
  - Internal information may be sufficient and/or more appropriate
- Available information may relate to
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts

Include forward-looking information.
Do not need to forecast factors that are not relevant.

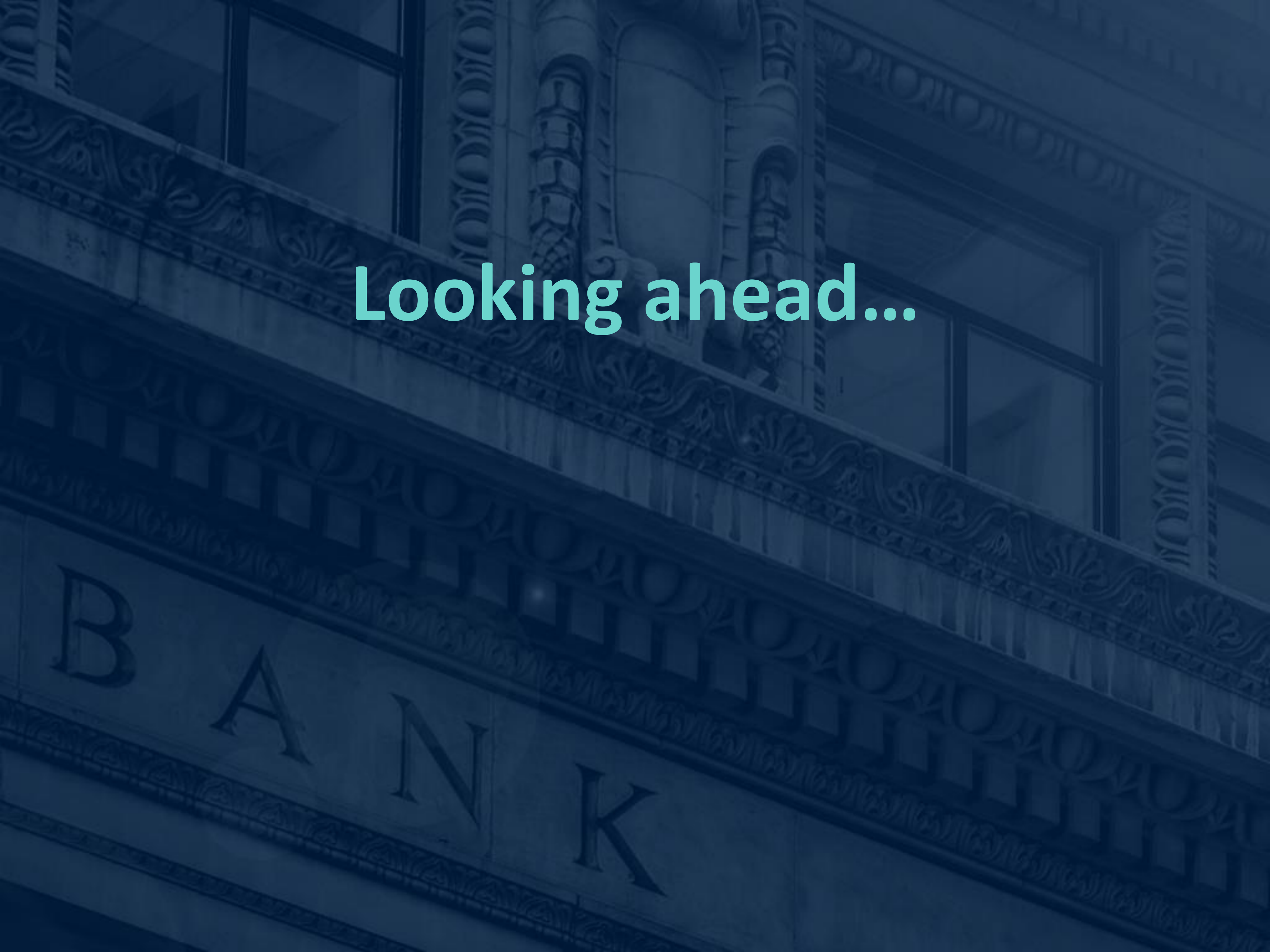
Current conditions aka "Q" factors

- Adjustments to historical data or charge-off rates bridge the gap between loans in the current portfolio as of the reporting date and loans in historical data sets.

326-20-55-4

- For example:
    - The financial institution's historical losses reflect loans originated under stricter underwriting standards.
    - Loans in the financial institution's current portfolio reflect loosened underwriting standards when compared with historical periods.

Looking ahead…



Looking ahead…

Developing Forecasts

- Consider relevant quantitative and qualitative information to assessing collectability

"Information" includes <u>internal, external, or a combination</u>

- "Past events, current conditions, and reasonable and supportable forecasts"
- "Not required to search all possible information…not reasonably available"
- "May find… internal information is sufficient"

Looking ahead…

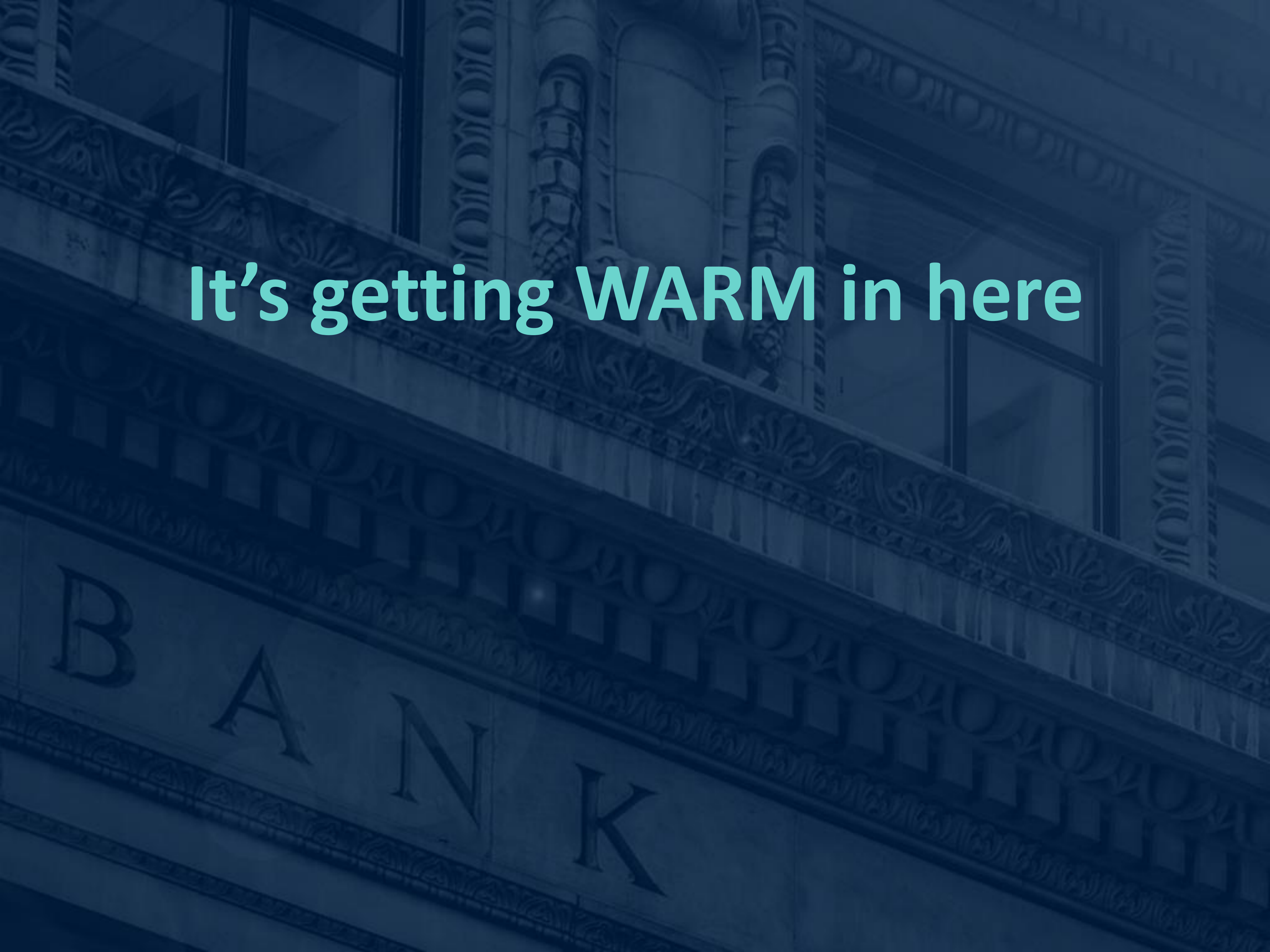
Developing Forecasts, continued

- Not required to develop forecasts over the entire contractual term
- Not required to correlate or reconcile reasonable and supportable forecasts to macroeconomic data
- Consider refining future estimates based on actual experience

Looking ahead…

- Focus on the factors ***relevant*** to collectability
- Adjustments do not have to be macroeconomic in nature
- Acceptable forecast specific events (e.g., factory foreclosure) even if other forward looking information is only reasonable and supportable for a shorter period of time

It’s getting WARM in here



CECL Methodology Options

WARM	• Uses average annual charge-off rates and remaining life of loan to estimate credit losses
Snapshot/Open Pool	• Point in time view of portfolio that tracks loan performance until disposition
Vintage	• Tracks charge-offs associated with a specific year of loan origination
PD/LGD	• Uses default probability x loss at default x exposure to estimate credit losses
Discounted Cash Flow	• Translates expected future cash flows into present values to determine allowance levels

It’s getting WARM in here

- Remaining life method utilizes average annual charge-off rates and remaining life to estimate the allowance for credit losses.
- For amortizing assets, remaining contractual life is adjusted by the expected scheduled payments and prepayments (i.e., paydowns).
- Average annual charge-off rate is applied to the amortization adjusted remaining life to determine the unadjusted lifetime historical charge-off rate.
- A. Average annual charge off rate x B. Amortization adjusted remaining life = C. Lifetime historical charge-off rate

A × B = C

It’s getting WARM in here

What factors should an entity consider when determining whether to use the WARM method?

- How complex is the pool of assets?
- What is the contractual term of the pool?
- What extent of the loss history is available?
- Are the losses sporadic with no predictive patterns?
- How many loans are in the pool?
- Does the composition of the pool vary significantly from historical pools of financial assets?

It's getting WARM in here

Step 1: Calculate annual charge-off rate

Table 1: Calculate Average Annual Charge-off Rate				
		A	B	C = B/A
Year	Amortized Cost	Average Balance	Actual Annual Net Charge-offs	Annual Charge-off Rate
2015	$ 5,126			
2016	8,969	7,048	21	0.30%
2017	11,220	10,094	51	0.51%
2018	12,312	11,766	42	0.36%
2019	12,936	12,624	32	0.25%
2020	13,980	13,458	49	0.37%
Balances are in thousands except charge-off rate data				
			Average annual charge-off rate	**0.36%**

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Totals may not sum precisely due to rounding

It’s getting WARM in here

Step 2: Estimate the Allowance for Credit Losses

Table 2: Estimated Amortized Cost Basis				
		A	B	A*B
Year End	Est. Paydown	Projected Amort Cost	Avg Annual Charge-off Rate	Allowance for Credit Losses
2020 Actual Amortized Cost		$ 13,980	0.36%	$ 50
2021	$ 3,700	10,280	0.36%	37
2022	3,900	6,380	0.36%	23
2023	3,000	3,380	0.36%	12
2024	2,160	1,220	0.36%	4
2025	1,220	-	0.36%	-
Est. unadjusted charge-off amount for remaining balance				126
Paydown & amortized cost balances in thousands				
Unadjusted historical charge-off rate for remaining balance				0.90%
Qualitative Adjustment				0.25%
Total allowance for credit losses rate as of 2020				**1.15%**
Total allowance of credit losses as of 2020 ($13,980 x 1.15%)				**161**

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

Totals may not sum precisely due to rounding

POLL QUESTION

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Interagency Statement on ACLs - Overview

Overview - Scope

The CECL methodology ***does not*** apply to the following financial assets:

- Financial assets measured at fair value through net income, including those assets for which the fair value option has been elected
- Available-for-sale debt securities
- Loans held-for-sale
- Loan and receivables between entities under common control
- Receivables arising from operating leases.

Overview - ACLs

- Methods used to estimate ACLs generally should be applied consistently over time
- Changes to ACLs via periodic evaluations are recorded through increases or decreases to the provision for credit losses (PCLs)
- Specifically identified uncollectible amounts should be promptly written off against ACLs
- Estimation of ACLs involves a high degree of judgement and is inherently imprecise
- May result in a range of estimates with the “best estimate” being supported and recorded

Overview – Collective Evaluation

- Requires expected losses be evaluated on a collective or pool basis when financial assets share similar risk characteristics
- Examples could include, but not be limited to:
  - Internal or external credit scores or credit ratings
  - Risk ratings or classifications
  - Financial asset type
  - Collateral type
  - Size
  - Effective interest rate
  - Term
  - Geographic location
  - Industry of the borrower
  - Vintage

Overview – Collective Evaluation

- Other risk characteristics related to held-to-maturity (HTM) debt securities are also included in the Policy Statement
- Topic 326 does not prescribe a process for segmentation
  - Segmentation should be evaluated on an ongoing basis to ensure pooled assets continue to share similar risk characteristics
- Financial assets that do not share similar risk characteristics with other assets can be evaluated individually

Overview – Estimation Methods

- Topic 326 does not require the use of a specific loss estimate method
- Management is not precluded from selecting a different method if it results in a better estimate of ACLs
- The same loss estimation method does not have to be applied to all financial assets
- Acceptable methods include probability of default/loss given default method, roll-rate method, discounted cash flow method, a method that uses aging schedules, or other reasonable methods
- Method selected should be appropriate for the financial assets being evaluated and be consistent with the institutions size and complexity

Overview – Contractual Term

- Topic 326 requires an institution to measure estimated expected credit losses over the contractual term of its financial assets, ***considering expected prepayments***
- Renewals, extensions, and modifications are ***generally*** excluded from the contractual term of financial assets for estimating ACLs
- Exception would be if is a reasonable expectation of executing a TDR or the renewal and extension options are part of the contract and are not unconditionally cancellable by the institution (management must evaluate likelihood)

Overview - Forecasts

- May extend over the entire contractual term or a period shorting than the contractual term
- Forecasts may vary by portfolio segment or individual forecast input
- Not required to search all available information or incur undue cost and effort to collect data
- Multiple economic scenarios can be considered but are not required

Overview – Q Factors

- **Historical credit losses generally do not, by themselves, form a sufficient basis to determine the appropriate level for ACLs**
- Should consider qualitative adjustments
- **May increase or decrease the estimate of loss**
- **Adjustments should not be made if information is already considered in loss estimation**

Should consider the following:

- **Nature and volume of financial assets**
- **Concentration of credit**

Overview – Q Factors

- Volume and severity of past due, nonaccrual, and adversely classified assets
- Value of underlying collateral (for loans, not collateral dependent)
- Lending policies and procedures (changes in underwriting, collections, write offs, and recoveries)
- Quality of credit review function
- Experience, ability, and depth of applicable management/staff
- External factors including regulatory, legal, technology, competition, and natural disasters

Overview – Q Factors

- **Actual and expected changes in economic and business conditions**

Additional Q Factors for HTM Securities:

- Changes in investment strategies and philosophies
- Loss allocation methods, definition of default, performance and market value triggers, credit, liquidity, etc.
- Structural subordination and collateral deterioration
- Quality of underwriting
- Legal covenants

Overview - Collateral-Dependent

- Financial asset for which repayment is **expected** to be provided substantially through the operation or sale of collateral when the borrower, based on managements assessment is experiencing financial difficulty
- **For regulatory reporting purposes, ACL is measured using the fair value of collateral regardless of whether foreclosure is probable**
- Valued at fair value less cost to sell
- Increases and decreases in fair value should be recorded through the ACL with any negative ACL capped at the amount previously written off

Overview - TDRs

- Expected credit losses on financial assets modified in TDRs or **reasonably expected** to be modified **in TDRs are estimated using the CECL methodology**
- Losses related **to collateral dependent TDRs should be estimated based on the fair value** of the underlying collateral
- The estimated effect of reasonably expected TDRs may be included in an institutions Q factor adjustments

Overview - Accrued Interest Receivable

- Included in amortized cost basis of financial assets under Topic 326
- Generally should be written off against ACLs

Three independent accounting elections at adoption <u>and may differ by class of financing receivable</u>:

- May elect not to measure via ACLs if uncollectible interest is written off timely
- May elect to write off by reversing interest income; use of PCLs or combination
- May elect to present accrued interest receivable separate from the financial assets on a net basis

Off-Balance Sheet Credit Exposures

- **Requires estimation of credit losses associated with off-balance sheet credit exposures**
- Estimates should take into account the likelihood of funding as well as the amount expected to be funded over the contractual term
- Should not record credit losses for off-balance sheet exposures that are unconditionally cancellable by the issuer
- Estimated credit losses are recorded as a liability rather than including in ACLs

Available-for-Sale (AFS) Debt Securities

- FASB ASC **Subtopic 326-30**-Financial Instruments-Credit Losses – AFS Debt Securities
- Credit losses for AFS debt securities are evaluated as of each reporting date when the fair value is less than amortized cost
- **Requires credit losses be calculated individually, rather than collectively, <u>using a discounted cash flow method</u>**
- Recognized via a charge to PCL
- Subsequent increases can be recognized through PCLs to the extent not previously written off
- ACLs are limited by the amount that the fair value is less than the amortized cost (fair value floor)

POLL QUESTION

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Overview - Documentation

Policies and procedures for the systems, processes, and controls necessary to maintain appropriate ACLs should address:

- Processes that support the determination and maintenance of ACLs
- Roles, responsibilities, and segregation of duties
- Processes for determination of historical period
- Processes for determination of reversion techniques
- Processes for segmentation
- Data capture and reporting systems

Overview - Documentation

- Description of systematic and logical loss estimation processes for determination and maintenance of ACLs
- Procedures for validating and independently reviewing the loss estimation process
- Polices and procedures for prompt write off of financial assets
- Systems of internal controls used to confirm that the ACL processes are maintained and periodically adjusted in accordance with GAAP

Overview – Internal Controls

- Provide reasonable assurance:
- Regarding the relevance, reliability and integrity of data
- Of compliance with laws, regulations and the institution's polices and procedures
- The institution's financial statements are in accordance with GAAP and regulatory reports are prepared in accordance with instructions
- Include a well defined and effective loan review and grading process
- Include a well defined process for monitoring credit quality or HTM securities

Overview – Analyzing and Validating ACLs

- **Management should perform ongoing, rigorous, and well-documented evaluations of ACL calculations**
- Such evaluations can include comparison of actual versus estimated write offs, ratio analyses, and peer group comparisons
- **Estimation process should also be periodically validated by a party with the appropriate knowledge, technical expertise, and experience who is independent of the credit approval and ACL estimation process (can not be FS auditor)**

Overview - Board of Directors

- Retain experienced and qualified management (ACL/PCL)
- Review management's assessment of loan review system
- Annually review and approve written loss estimation policies
- Review management's assessment of processes and controls for monitoring credit quality of investments
- Review management's assessments of and justifications for ACLs and PCLs
- Require management to periodically validate loss estimation methods
- Approve internal and external audit plans for ACLs
- Review ACL audit findings and monitor remediation

Overview - Management

- Adopt and adhere to written policies and procedures (as outlined in “Documentation Standards”)
- Maintain ACLs at appropriate levels and document in accordance with GAAP and regulatory requirements
- Establish and maintain appropriate governance activities
- **Periodically compare loss estimates to actual write-offs**
- **Periodically validate the loss estimation process**
- Engage in sound risk management of third parties

Overview - Examiner Review

- Evaluate ACL policies and procedures, and assess loss estimation methods, including supporting documentation
- Assess effectiveness of board oversight and management’s effectiveness in managing credit risk
- Review appropriateness of overall levels of ACLs, which can include independent qualitative analysis
- Review ACLs reported in regulatory and other reports and reconcile to ACL estimates
- Verify models are subject to initial and ongoing validation
- Assess effectiveness of third party risk management

CECL Solutions

CECL Solutions – Practical Considerations

- Denial is not a river in Eqypt and divine intervention is not forthcoming.
- Have you identified the "ownership" and developed a timetable?
- Do you have a "data" game plan?
- Have you identified a 3rd party partner(s)?
- Does your timetable include running parallel beginning Q1 2022?
- Opportunity to improve processes, breakdown silos, and align financial reporting with CRM.

CECL Solutions - Roadmap

1. STAKEHOLDER IDENTIFICATION AND TRAINING
2. RISK IDENTIFICATIONS AND SEGMENTATION
3. DATA INVENTORY AND GAP ANALYSIS
4. TECHNOLOGY AND RESOURCE ASSESSMENT
5. GOVERNANCE AND OVERSIGHT

Stakeholder Identification and Training

- Identify relevant stakeholders from management, senior management and the Board of Directors.
- Determine structure (working groups, CECL Committee, etc.) for CECL implementation efforts.
- Evaluate training needs and assess internal/external sources.

Risk Identifications and Segmentation

- Identify portfolio characteristics and drivers of portfolio performance.
- Assess current pooling methodologies and consideration of significant risk drivers for each.
- Evaluate effects on pool life and credit risk and modify as needed.
- Perform historical trend analysis and assess alignment with risk drivers.

Data Inventory and Gap Analysis

- Identify the data elements and related sources that are needed.
- Determine the accessibility of accurate and complete data sets.
- Identify data gaps and assess alternatives.

Technology and Resource Assessment

- Assess the capabilities and limitations of in-house systems and resource.
- Evaluate the cost-benefit and suitability of third-party providers/solutions.
- Select model(s) and perform a parallel run.

Governance and Oversight

- Define ongoing roles of senior management and the Board of Directors.
- Develop formal policies, procedures, and processes around the maintenance and execution of the CECL model.
- Establish initial and ongoing processes for internal and external financial reporting and disclosure (Internal Controls over Financial Reporting or ICFR).

CECL Solutions – CRI CECL Dashboard

- Automatically aggregates 11+ years of Call Report data, thus eliminating the common challenge of obtaining historical data
- Utilizes GAAP compliant methodologies to calculate your ALLL
- Calculates peer group loss rates to help support Q-factor adjustments
- Allows for user-defined inputs to further customize past Call Report data
- Provides a customized regression analysis based on leading economic indicators to forecast future charge-offs at your institution

Questions?

CRI: Join Our Conversation

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PRESENTER

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