# Get clarity on what's ahead

## Crowe 2020 Financial Services Conference

## ALLOWANCE FOR LOAN LOSSES AND CECL

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# YOUR PRESENTERS

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# AGENDA

- Allowance Considerations Heading into Dec. 31
- Observations from the Adoption of CECL
- Segmentation, Q-Factors, Forecasts, and Sensitivity

# ALLOWANCE CONSIDERATIONS HEADING INTO DECEMBER 31ST

If you have never experienced something before, you can’t say you know how it’s going to turn out.

*-Howard Marks,*
*Oaktree Capital*

# ALLOWANCE CONSIDERATIONS HEADING INTO DEC 31

Loan Modifications

Delayed CECL Adoption under the CARES Act

Paycheck Protection Program Loans

## What best describes your outlook for provision expense in the fourth quarter of 2020

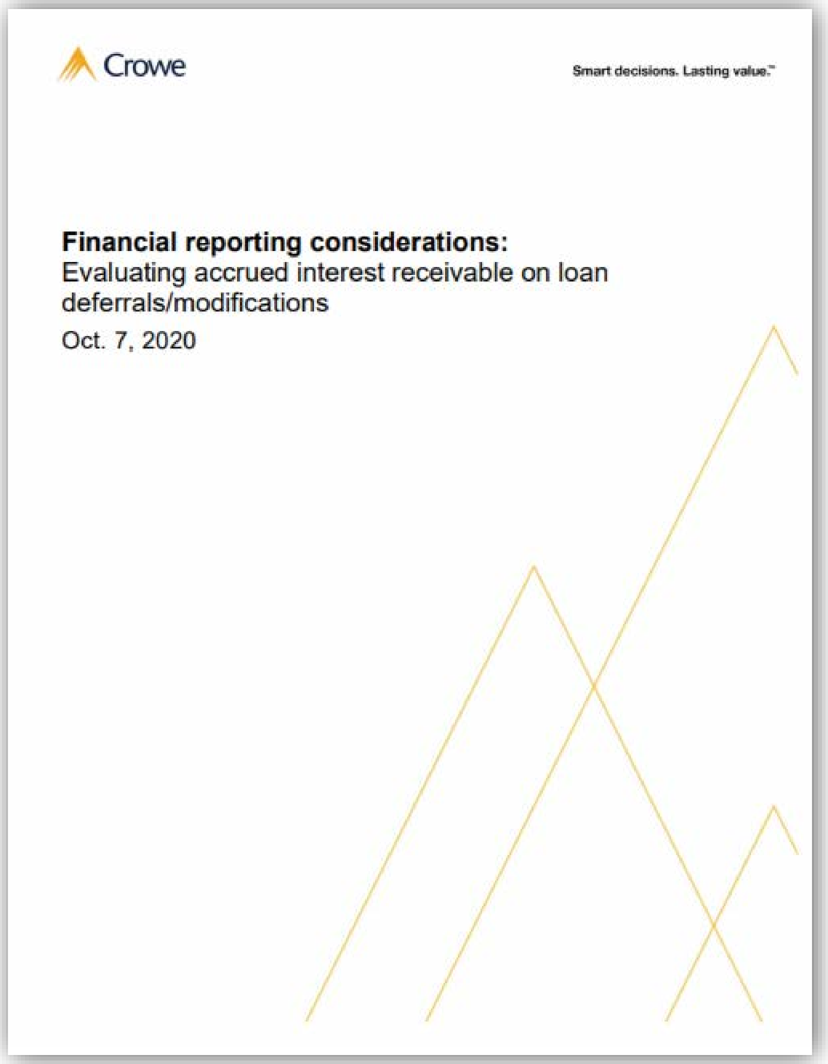
A. I think it will be minimal – my bank has largely provided what we think we will need as of 9/30
B. I think it will be significant because we are expecting a lot of charge-off activity and believe we will need to replenish the allowance as a result
C. I think it will be significant because we still have a lot of losses that we do not think are yet reflected in our estimate/we think the forecast for 2021 will deteriorate from the forecast at 9/30
D. I think we will be able to reverse provision expense because of an improving forecast/improving economic conditions
E. No clue

# LOAN MODIFICATIONS: ALLL/ACL CONSIDERATIONS

Elevated accrued interest balances

Separate segmentation

Qualitative factors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Smart decisions. Lasting value.™

**Financial reporting considerations:**
Evaluating accrued interest receivable on loan deferrals/modifications

Oct. 7, 2020

# LOAN MODIFICATIONS: ALLL/ACL CONSIDERATIONS FOR AIR

| Collectability of Accrued Interest Receivable |
| --- |
| For modification programs that allowed for the deferral of principal and interest payments for which interest still accrued during the deferral period, the balance of AIR at the end of the reporting period might be substantial.<br><br>For modified loans still on accrual status, there might be no individual indicators that full collection of principal and interest are in doubt; however, when assessed on a collective basis, the answer might be different.<br><br>We believe institutions should assess the collectibility of their AIR balances and establish an allowance against the portion of the balance that is not expected to be collected (for current expected credit loss (CECL) adopters) or that is probable of not being collected (for non-CECL adopters). |

# LOAN MODIFICATIONS: ALLL/ACL CONSIDERATIONS FOR AIR

| Concept | ACL/CECL | ALLL/Incurred |
|---|---|---|
| Recognition | Estimate expected credit losses on the amortized cost basis of the loan, which includes applicable accrued interest, unless an accounting policy election is made to exclude the AIR because it is written off timely. | A loss must be recognized when it is both probable and estimable. Regulatory guidance requires an institution to evaluate the collectibility of any “recorded accrued and unpaid interest (i.e., not already reversed or charged off).” |
| Establishing the allowance | A valuation allowance that is classified in the same line item as the AIR balance should be established with an offset to credit loss expense | |
| Charging-off/reversing accrued interest | ASC 326 allows an entity to make an accounting policy election to write off AIR by reversing interest income or recognizing credit loss expense or a combination of both. | In accordance with call report instructions, the reversal of AIR on a loan placed in nonaccrual status should be handled in accordance with generally accepted accounting principles. One acceptable method is to reverse the AIR that has been accrued year-to-date through the interest income account in which the accrued interest was initially recorded. |

# LOAN MODIFICATIONS: ALLL/ACL CONSIDERATIONS

**Cash flow modeling and system inputs**

DCF, WARM,
AL systems contract modeling

3 – 6 month interest-only modifications predominance

Amortization methods

**Will performance of modifications help or hurt segment performance?**

**Do modification programs indicate risk characteristics have materially changed?**

Q-Factor overlay to pool?

Create new segmentation?

## LOAN MODIFICATIONS: DISCLOSURES

- Few rules or requirements outside of SEC Guide 3 requirements
  - "*Describe the nature and extent of any loans which are not now [nonaccrual, past due or TDRs], but where known information about possible credit problems of borrowers… causes management to have serious doubts as to the ability of such borrowers to comply with the present loan repayment terms and which may result in disclosure of such loans [as nonaccrual, past due or TDRs].*"

- Suggested disclosures:
  - Approach(es) to COVID related modifications (e.g., types and durations of modifications)
  - Concentrations (e.g., industry, loan product)
  - Quantitative data about modification and re-modification volume
  - Implications for other disclosures such as loan grading and nonaccrual status

# DELAYED CECL ADOPTION UNDER THE CARES ACT

**Key Considerations**

- Forecast used for 1/1 adoption date must be based on what was known/knowable at that point – **cannot wrap-in pandemic effects**
- Mid-year acquisitions add complexity: PCI vs. PCD, different acquired loan accounting models
- Disclosures – consider if a dry run is warranted to get key stakeholder input in advance. Crowe's illustrative CECL disclosures are a helpful place to start! https://www.crowe.com/insights/asset/i/illustrative-cecl-disclosures-financial-institutions
- Benefit of parallel runs – multiple control operations, better understanding of the model, ability to back-test
- To recast (or not recast) Q1, Q2 and Q3 2020. SEC will not require registrants to recast quarterly results for the adoption of CECL. Institutions should consider the pros and cons to not recasting the results when making that decision.

# PPP LOANS AND THE ALLOWANCE

## Allowances: CECL and Incurred

- SBA guarantee exists at inception of the loan and throughout its life
- If loan is transferred, *guarantee transfers with it
  - The arrangement does not contemplate loan existing without guarantee
- Guarantee is considered “embedded” and considered when estimating credit losses

## CECL

- Credit enhancements that mitigate credit losses are considered in estimating credit losses

## Incurred

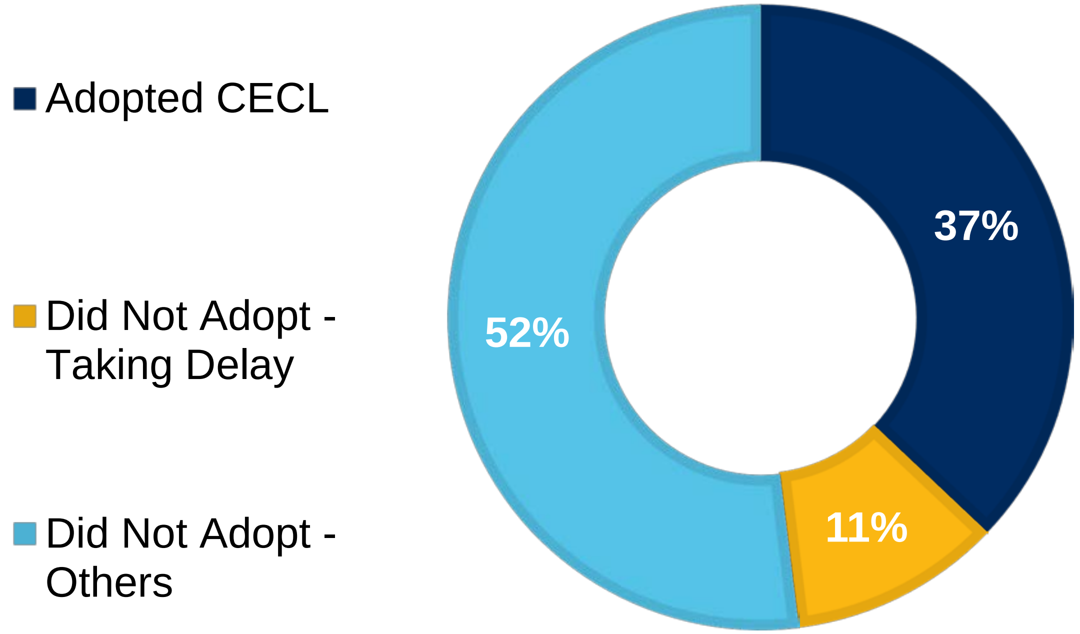
- Considered in determining allowance under ASC 450, “Contingencies,” or ASC 310, “Receivables”

AICPA Technical Q&A (TQA) 2130.43 Consideration of the SBA Guarantee Under the PPP

# OBSERVATIONS FROM THE ADOPTION OF CECL

# CECL DAY 1 ADOPTION: THE STATS

**PERCENTAGE OF ISSUERS WHO…**



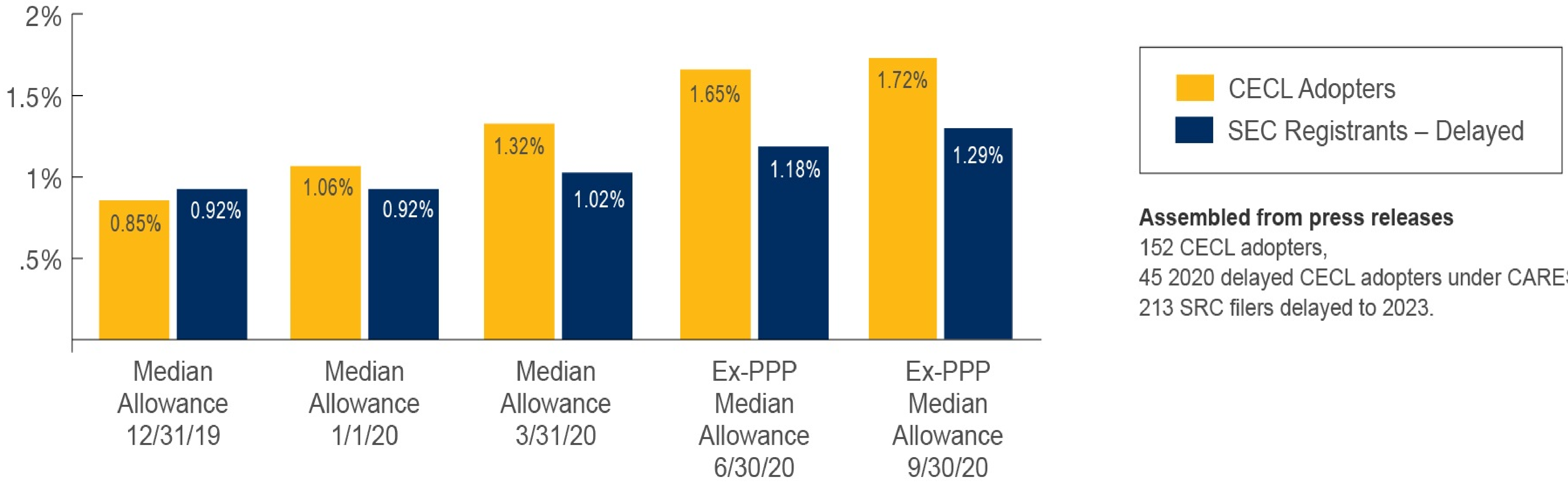

*Delay taken under Section 4014 of CARES Act*

Number of Banks Adopting Jan. 1, 2020: 152

Average increase in ACL on Day 1: 31%

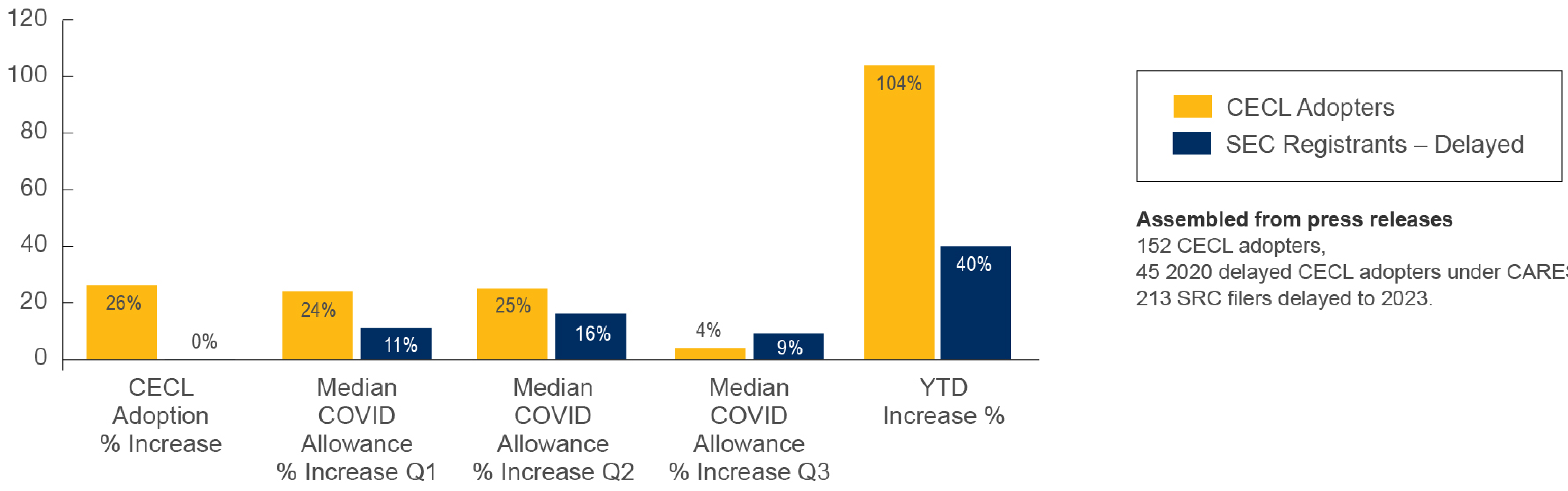
Range of Day 1 ACL Impact: -39% to +222%

# CECL VS INCURRED ALLOWANCE TRENDS FOR SEC FILERS




**Assembled from press releases**
152 CECL adopters,
45 2020 delayed CECL adopters under CARES Act,
213 SRC filers delayed to 2023.

# CECL VS INCURRED RESERVE INCREASES




**Assembled from press releases**
152 CECL adopters,
45 2020 delayed CECL adopters under CARES Act,
213 SRC filers delayed to 2023.

# US TREASURY CECL STUDY

- *The Current Expected Credit Loss Accounting Standard and Financial Institution Regulatory Capital*, issued Sept. 15, 2020
- “A definitive assessment of the impact of CECL on regulatory capital is not currently feasible…Drawing conclusions right now regarding CECL’s impact since its initial implementation in early 2020 is challenging because CECL has not been fully implemented by all entities, and numerous market factors relating to the COVID-19 global pandemic (including government responses) have affected the economy, financial institutions, and borrowing and lending dynamics,”
- Treasury “recognizes the seriousness of the concerns that have been raised concerning CECL’s potential effects on and implications for regulatory capital, lenders, borrowers, and the US economy.”
- Treasury “supports the goals of CECL—including providing users of financial statements with more forward-looking information and carrying assets on financial statements in a manner that reflects amounts expected to be collected”

https://home.treasury.gov/system/files/216/The-CECL-Accounting-Standard-and-Financial-Institution-Regulatory-Capital-Study-9-15-20.pdf

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# US TREASURY CECL STUDY RECOMMENDATIONS

| | |
|---|---|
| 1. | The prudential regulators should continue to monitor the effects of CECL on regulatory capital and financial institution lending practices, and calibrate capital requirements, as necessary. |
| 2. | The prudential regulators should monitor the use and impact of transitional relief granted, and extend or amend the relief, as necessary. |
| 3. | FASB should further study CECL's anticipated benefits. |
| 4. | FASB should expand its efforts to consult and coordinate with the prudential regulators to understand—and take into account when considering any potential amendments to CECL—the regulatory effects of CECL on financial institutions. |
| 5. | FASB should, in consultation with relevant stakeholders, explore the costs and benefits of further aligning the timing of the accounting recognition of fee revenues associated with financial assets under GAAP with the earlier accounting recognition of potential credit losses under CECL. |
| 6. | FASB, together with the prudential regulators, should examine the application of CECL to smaller lenders. |

## CECL ADOPTION CHALLENGES IN THE CURRENT ENVIRONMENT

- **Effectiveness of models.** Extreme economic circumstances challenged the effectiveness of many models built for CECL that were primarily driven by declines in home price index or changes in unemployment.
- **Developing a reasonable and supportable forecast.** In benign times, developing a forecast and understanding its interaction with the model may the most difficult part of applying the standard. The pandemic increased this challenge, especially in estimating the impacts of announced and potential fiscal stimulus and loan modification efforts.
- **Rapidly changing economic conditions. Economic forecasts changed significantly during the first quarter and into April 2020.** Significant pressure was placed on banks to communicate which economic conditions were captured in their estimate and to provide expectations of how the changing economic environment may affect future results. This will likely continue.

# ADVICE FROM BANKS WHO HAVE ADOPTED CECL

Agility to support robust, on-demand analysis and sensitivity testing is invaluable.

Use stressed scenarios to determine calculation limits and develop contingency plans in advance.

More parallel runs are best.

Q-factors are still important. Identify what is missing/different from the base calc and avoid double counting.

Data quality (and warehousing) takes time and must be taken seriously.

# ADVICE FROM BANKS WHO HAVE ADOPTED CECL

Remember off-balance-sheet credit exposures and held-to-maturity securities are also in scope

Document key decisions as you implement – do not save the effort until the end

Don’t ignore unique pockets of the portfolio that might warrant additional segmentation or qualitative factors.

It is unlikely CECL is going away.
FIs adopting in 2023 should not count on substantive changes to the standard.

## If I had to pick a silver lining of adopting/preparing to adopt CECL, it would be

A. It pushed us toward a data warehouse/data governance process which has improved the reliability and accessibility of our loan data

B. We know so much more about our loan portfolio now and are making better decisions on credit, pricing and policies

C. It allowed us to build our reserve more quickly in response to the pandemic

D. Automating the process with a vendor has produced benefits over our old process (i.e., saves time, automated disclosures/reporting, etc.).

E. I am just not that optimistic – I cannot see a silver lining.

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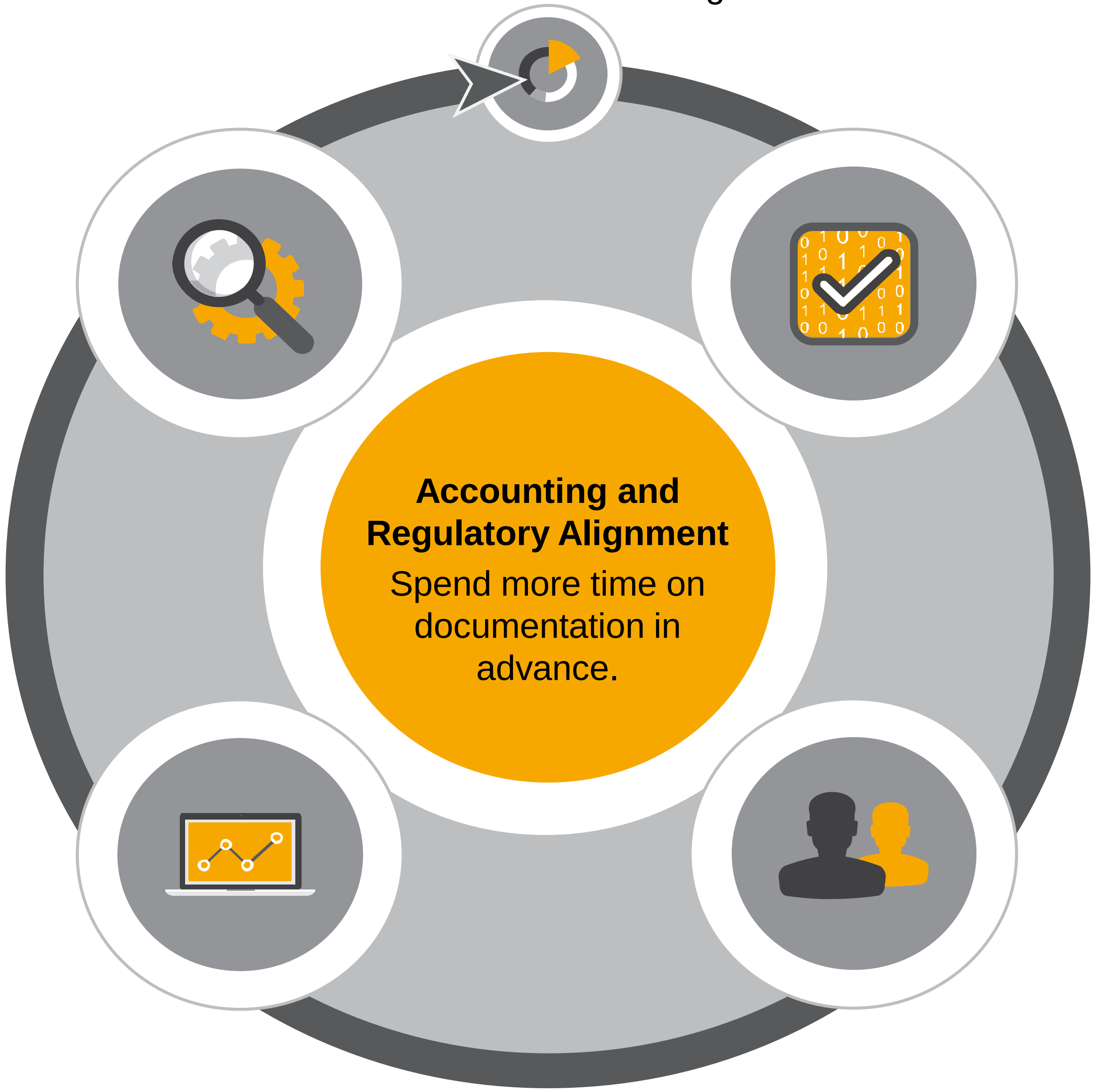
# CECL TRANSITION KEY TAKEAWAYS

**Risk Identification**

Renewed importance with portfolio triage due to the economic environment and industries most heavily impacted. Don’t ignore unique pockets of portfolios that might warrant separate segmentation or other considerations

**Governance and Oversight**

Understanding the sensitivity of the models to certain inputs and assumptions is crucial, especially with new models and in a volatile environment. More parallel runs, sensitivity analysis, and stressed scenario runs are all important




**Data Inventory**

Pain point for many adopters, and time consuming to identify and correct data issues

**Enabling Technology**

Implementing and fine-tuning the technology for data aggregation and running models takes a lot of time.

**Resource Capabilities**

It’s important to bring several groups together to accomplish this goal

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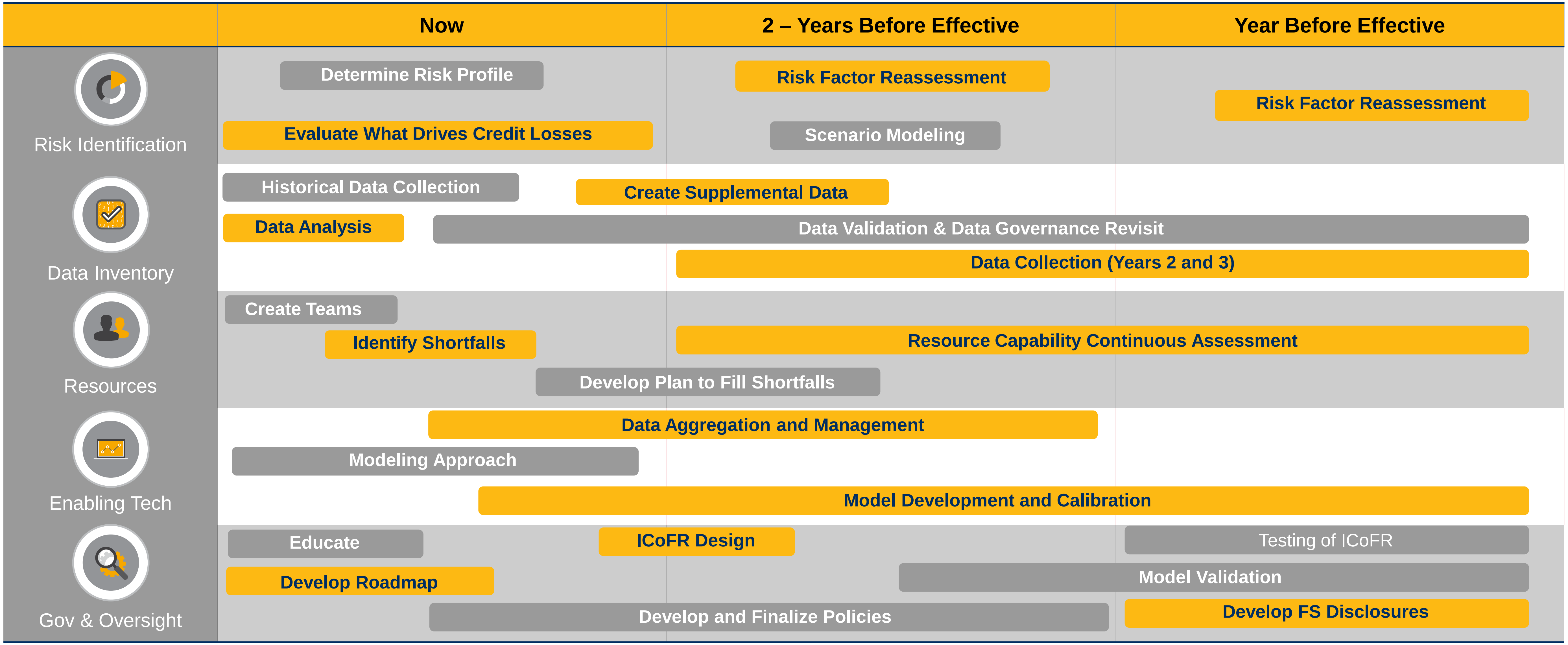
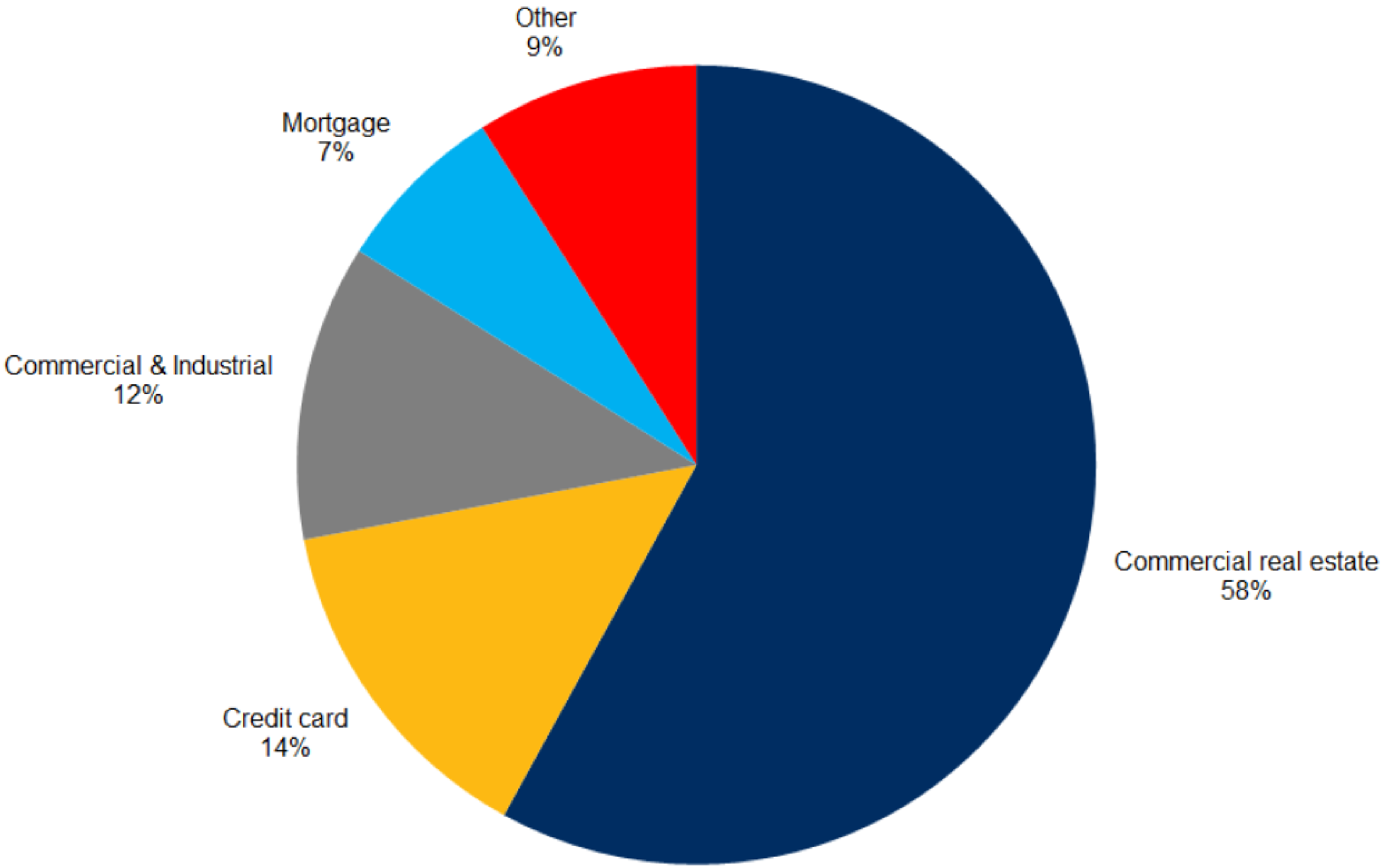
# WHAT DOES A ROADMAP LOOK LIKE?



# SEGMENTATION, Q-FACTORS, FORECASTS, AND SENSITIVITY

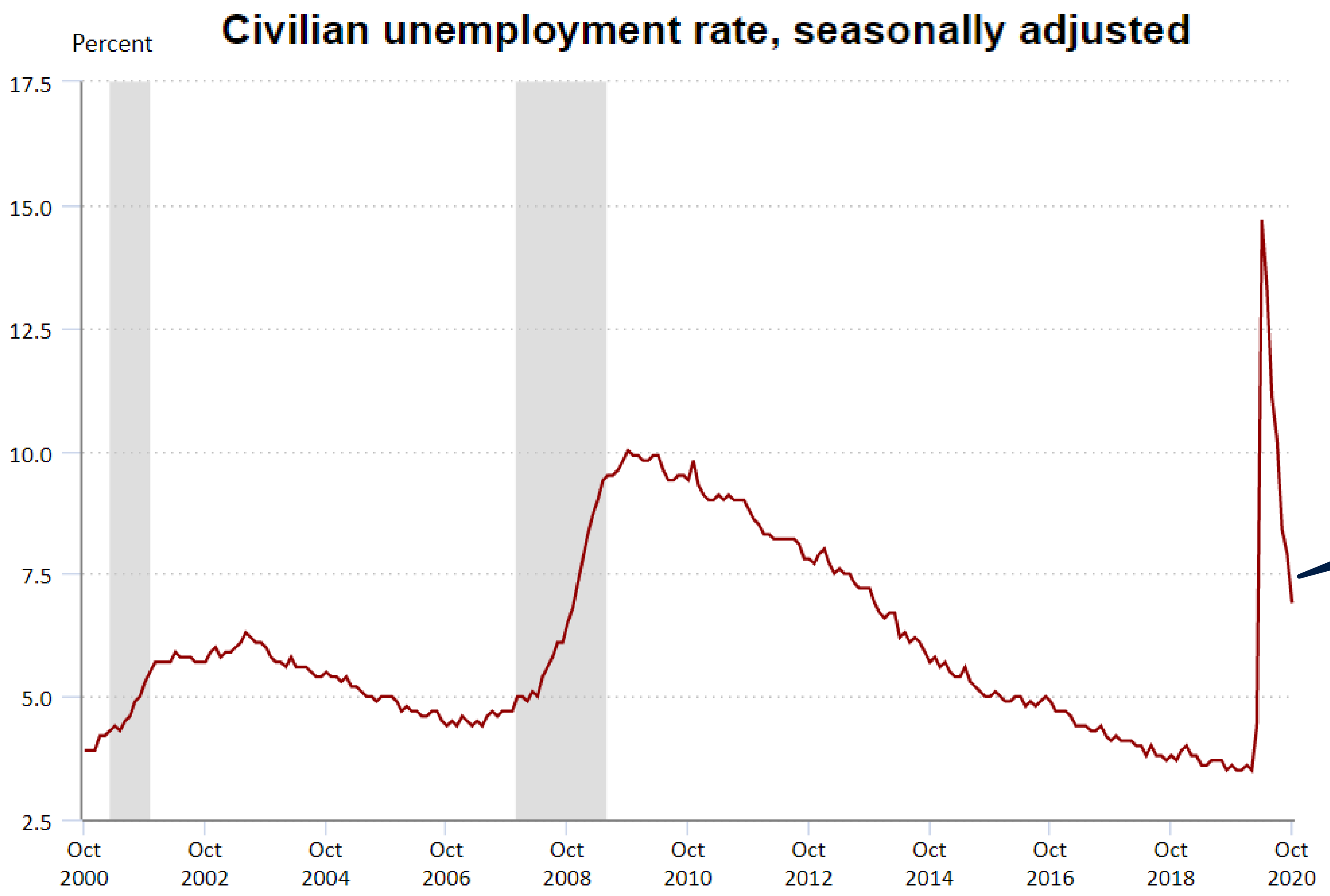
Don’t ignore unique pockets of risk in portfolios

## Which loan class will be the most affected by COVID-19?




Source: Audience poll results during AICPA Banking Conference

# UNEMPLOYEMENT REACHES ALL-TIME HIGHS




Source: U.S. Bureau of Labor Statistics.

**6.9% in October**

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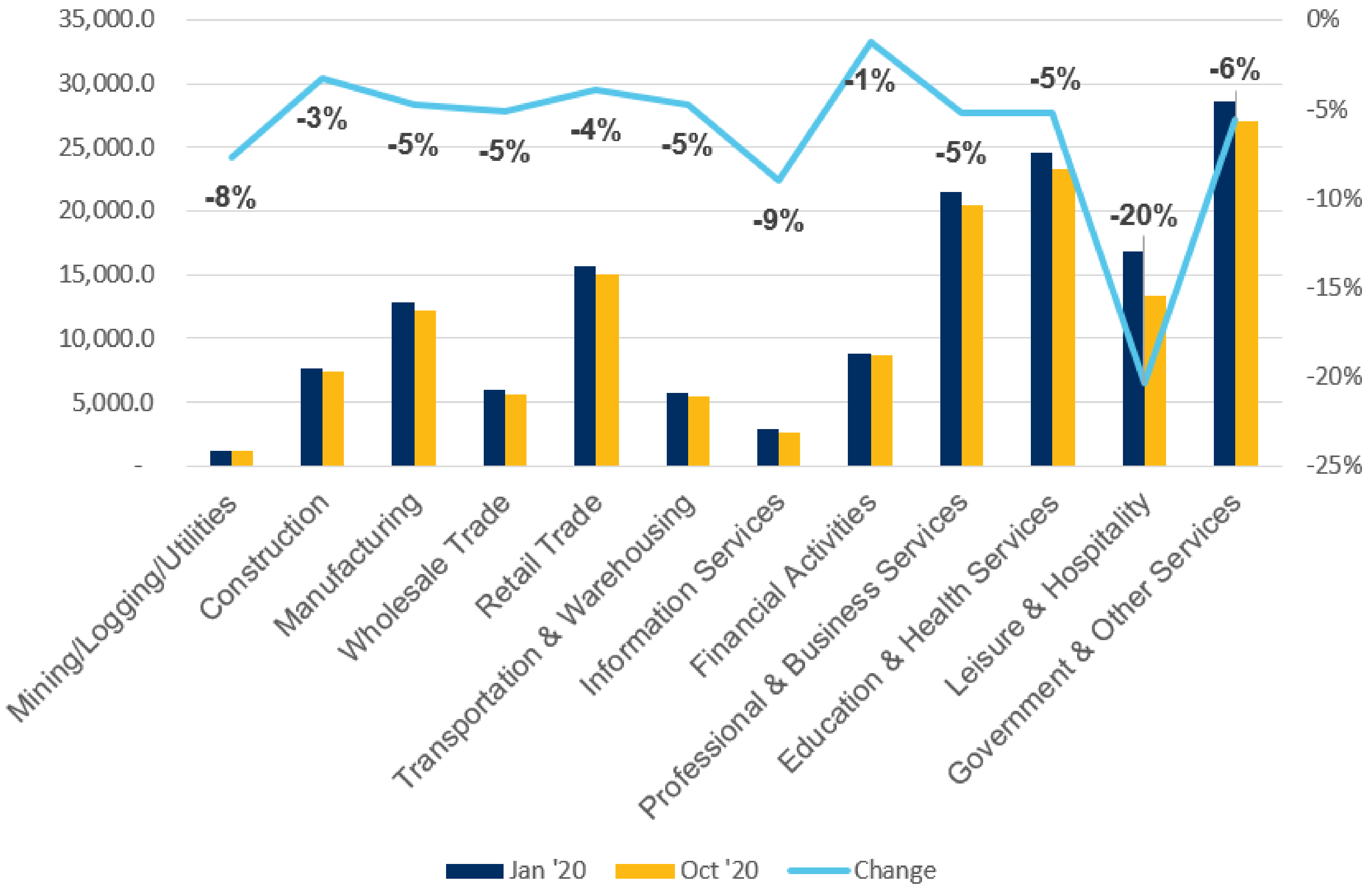
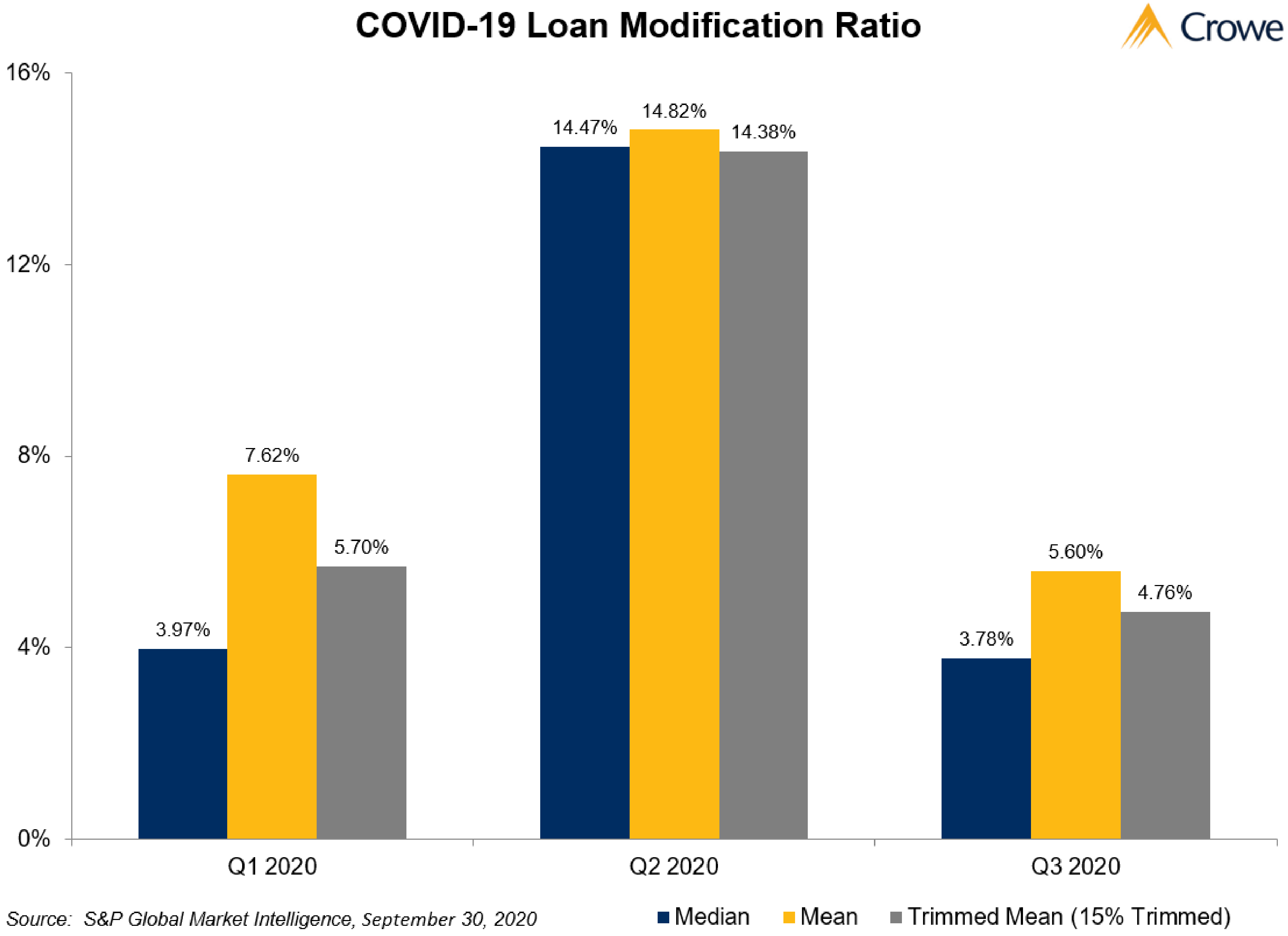
# Total Employment by Industry

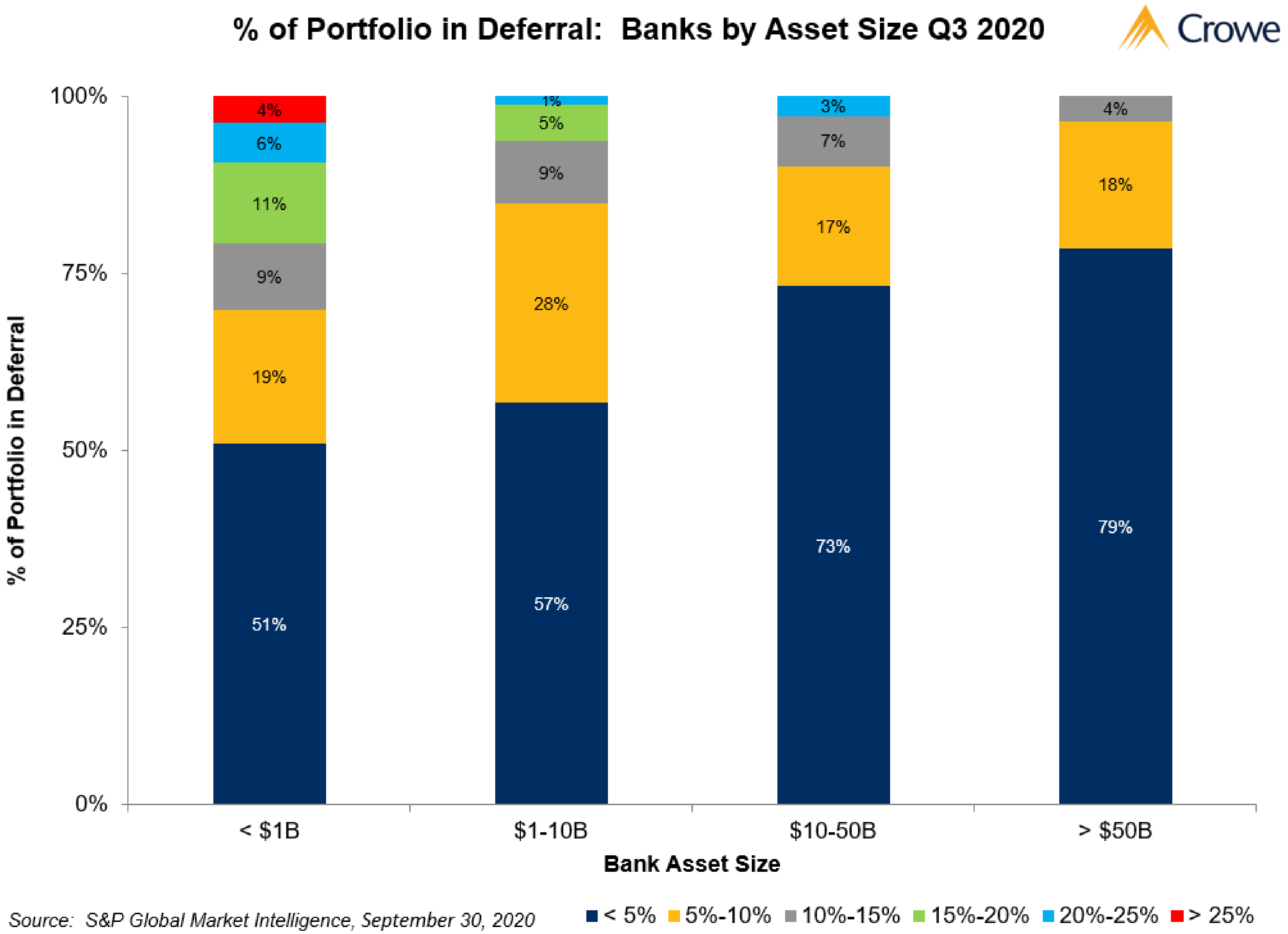



Source: U.S. Bureau of Labor Statistics.




Source: *S&P Global Market Intelligence, September 30, 2020*

# % of Portfolio in Deferral: Banks by Asset Size Q3 2020



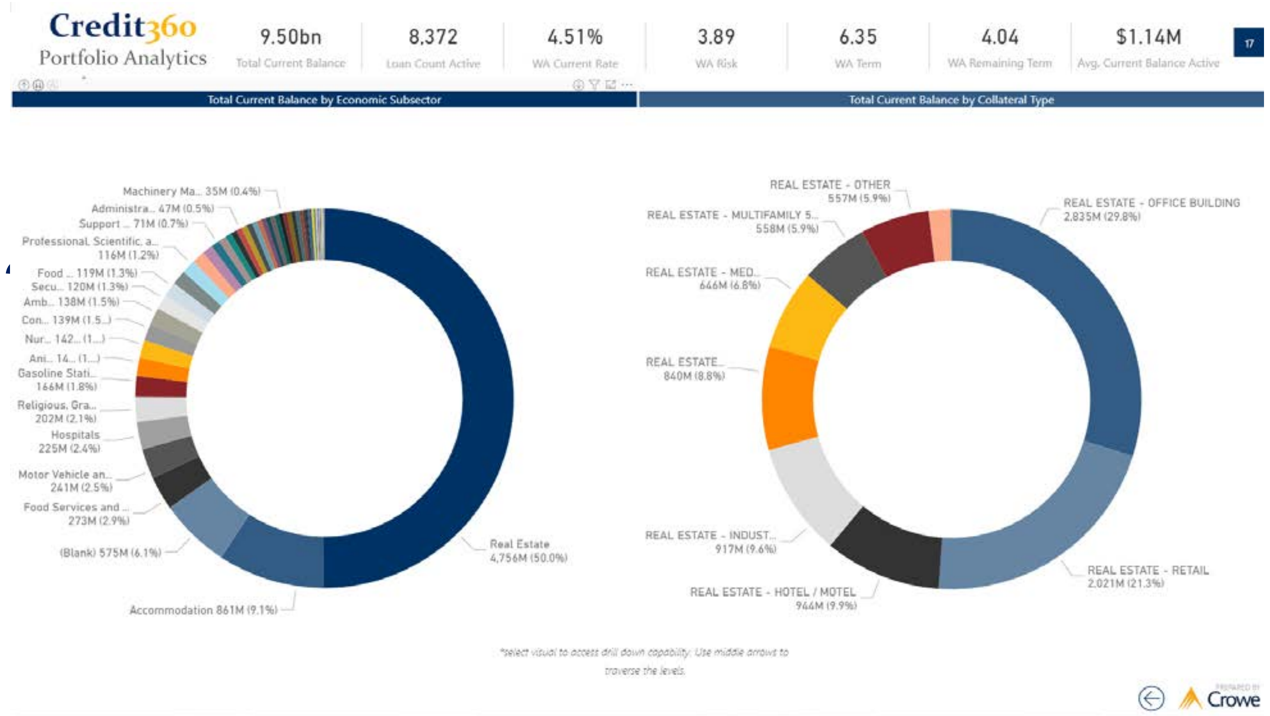

*Source: S&P Global Market Intelligence, September 30, 2020*

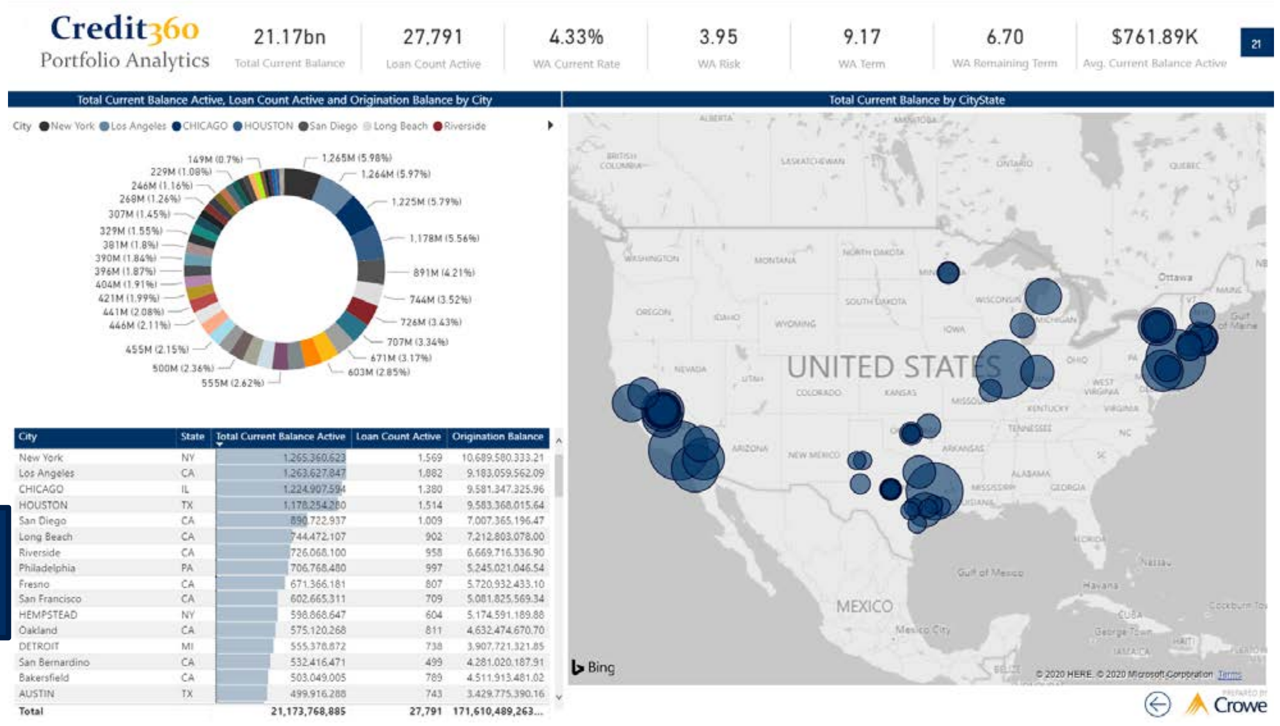
## Which best describes your organization's approach to forecasting as of 9/30/2020?

A. We have not yet adopted CECL and are still evaluating our options
B. We used a single scenario purchased from a national provider that best represented our view
C. We probability weighted two or more scenarios purchased from a national provider that best represent our view
D. We developed our forecast internally using a mix of information available from various sources
E. None of the above

# WHERE IS THE RISK IN YOUR PORTFOLIO?

- What are the troubled industries and what portion of your portfolio is most impacted in today's environment?
- "Uncertainty regarding the economic impact of COVID-19 has prompted banks to disclose exposure to at-risk industries," S&P Global – seen across 10-Q filings and earnings releases
  - Tell the story of your portfolio: where risk is and isn't
- How do you calibrate your allowance model (CECL or probable incurred losses) to the current environment and test sensitivity?
- CARES Act loan modifications:
  - How are you tracking these?
  - Future impact to allowance?




See [here]() for example videos of these analytics

# CALIBRATING ALLOWANCE MODEL – SEGMENTS, Q-FACTORS, FORECASTS

- Select the appropriate forecast:
  - is it consistent across the organization (CECL, goodwill, etc.)?
  - Is it at the appropriate level that correlates to the behavior of your portfolio (i.e. national, regional, state)?
  - Consider the sensitivity of different forecasts on the modeled results
- Identify the segments or subsegments impacted – re-segment (now or in the future) or consider q-factors to address segments with risk that differs from the rest of your portfolio or what is captured in the model
- What risks/elements of those segments or from the forecasts are captured in your quantitative model? How does your expectation of risk differ?
- Susceptibility to bias – intentional or unintentional – ensure that you have strong governance over the various judgmental decisions

# CALIBRATING ALLOWANCE MODEL – SEGMENTS, Q-FACTORS, FORECASTS

- Adjust historical credit loss for changes and expected changes in the general market condition of either the geographical area or the industry to which the entity has exposure (example from ASC 326)
- Anchoring the adjustment – one way to do this is alternative scenarios:
  - Synthetic downgrades for loans in at-risk industries or geographies
  - Modeled results from an alternate forecast
  - Impact of changing certain model assumptions

Scenario 1: Base Scenario

Scenario 2: Downgrade Affected Industries

| Scenario 1 | | | | Scenario 2 | | | |
|---|---|---|---|---|---|---|---|
| ScenarioName | Base Scenario | | | ScenarioName | Downgrade Affected Industries | | |
| PoolName | Current Balance 1 | Exp. Loss $ 1 | % 1 | PoolName | Current Balance 2 | Exp. Loss $ 2 | % 2 |
| C&I | $3,071,582,964 | $38,394,787 | 1.25% | C&I | $3,071,582,964 | $57,742,688 | 1.88% |
| Construction | $3,121,525,669 | $54,626,699 | 1.75% | Construction | $3,121,525,669 | $81,159,667 | 2.60% |
| Consumer | $183,042,465 | $3,660,849 | 2.00% | Consumer | $183,042,465 | $5,491,274 | 3.00% |
| CRE NOO | $4,536,377,748 | $49,900,155 | 1.10% | CRE NOO | $4,536,377,748 | $74,850,233 | 1.65% |
| CRE OO | $4,409,039,248 | $52,908,471 | 1.20% | CRE OO | $4,409,039,248 | $79,362,706 | 1.80% |
| Mortgages (1st Lien) | $4,459,641,738 | $44,596,417 | 1.00% | Mortgages (1st Lien) | $4,459,641,738 | $66,894,626 | 1.50% |
| Mortgages (2nd Lien) | $238,228,194 | $4,049,879 | 1.70% | Mortgages (2nd Lien) | $238,228,194 | $6,074,819 | 2.55% |
| Multifamily | $558,444,748 | $4,188,336 | 0.75% | Multifamily | $558,444,748 | $6,310,426 | 1.13% |
| Other | $595,886,111 | $5,958,861 | 1.00% | Other | $595,886,111 | $8,938,292 | 1.50% |
| **Total** | **$21,173,768,885** | **$258,284,455** | **1.22%** | **Total** | **$21,173,768,885** | **$386,824,731** | **1.83%** |

Alternative scenarios can help build a range for anchoring q-factors and/or understanding the sensitivity of the model.

## Which aspect of the allowance estimate for the fourth quarter do you expect to be most challenging?

A. Selecting the appropriate forecast(s)
B. Incorporating the impact of loan modifications/deferrals into our estimate
C. Quantifying qualitative factors
D. The auditors auditing the allowance
E. Something else

# JUDGMENTAL ASSUMPTIONS: AUDIT OUTLOOK

- Audits performed under PCAOB Auditing Standards (AS): AS 2501: *Auditing Accounting Estimates* will be effective for audits of financial statements for fiscal years ending on or after Dec. 15, 2020 (will be applicable for 2020 calendar year-end public companies)
- Among other requirements, AS 2501 requires the auditor to evaluate the reasonableness of the significant assumptions both individually and in combination.  Evaluation and documentation should include:

Does the company have a reasonable basis for the significant assumptions used?

Are the significant assumptions consistent with:

- Relevant industry, regulatory, and other external factors, including economic conditions;
- The company’s objective strategies, and related business risks;
- Existing market information;
- Historical or recent experience, taking into account changes in conditions and events affecting the company; and
- Other significant assumptions used by the company in other estimates tested?

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# JUDGMENTAL ASSUMPTIONS: AUDIT OUTLOOK

**KEY CHANGE**

For critical accounting estimates, the auditor should obtain an understanding of how management analyzed the sensitivity of its significant assumptions to change, based on other reasonably likely outcomes that would have a material effect

The auditor should take that understanding into account when evaluating the reasonableness of the significant assumptions and potential management bias

Relationship between critical accounting policies, auditing estimates, and CAMs…

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# JUDGMENTAL ASSUMPTIONS: AUDIT OUTLOOK

**PCAOB Spotlight: Staff Update and Preview of 2019 Inspection Observations**
**https://pcaobus.org/Inspections/Documents/Staff-Preview-2019-Inspection-Observations-Spotlight.pdf**

“Auditors did not evaluate the reasonableness of qualitative factors considered by management in calculating the general reserve related to the ALL. In certain instances, the audit procedures were limited to inquiry of the issuer’s personnel to understand the factors considered in computing the reserve and comparing the current reserve to the prior year to determine if the change in the reserve was in line with information auditors obtained orally through discussions held with the issuer’s personnel without corroborating the information with appropriate audit evidence.”

“Auditors did not test the accuracy and/or completeness of the issuer’s data used to develop the estimates.”

# QUESTIONS AND RESPONSES


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