Accounting for Credit Losses,
Where will the road end up?

PACB
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CECL Model - the saga continues!!!
“Déjà vu All Over Again, and Again, and Again”

- Still no formal implementation date
- Formal comment period closed in September 2013
- Comments letters did evidence agreement within the investor community that a new model was needed, BUT there was concern that the proposed model was not objective enough
- Regulators (OCC, FASB, FDIC, FRB) support proposed FASB model for CECL
- Regulatory studies seem to evidence that the model would increase the ALLL by as much as 30% to 50%
- Complexities of the model include forecasting future losses (which are not linear), and data mining of loan losses to be linked to various events
- Disclosures would have to be enhanced and relevant
- FASB conducted workshops in June 2014 with select banks, regulators, and accounting firms
So why is CECL “necessary”?

Capital is King, and the sentiment of investors appears to be:

- Expected credit losses should be recognized at origination,
- Past, current and reasonable and supportable forecasts should be used to develop the ALLL,
- Investors would like to see more robust disclosures on credit losses (i.e. - expected and actual performance of assets by vintage over time and management’s ability to forecast expected losses) - DISCLOSURES HAVE NOT YET BEEN FINALIZED
So where are we as of “today”(*)

- FASB still is confident that new modeling will be issued, and is hoping for 4th Q 2014, but 1st Q 2015 is more likely
- Most recent Exposure Draft is being refined, and versions of prescriptive guidance is being evaluated, re-exposure is NOT expected
- Implementation Date is still not determined
- Various “staggered” methods are under consideration

(*) August 22, 2014
What are the primary changes in the new CECL Model, and what are the challenges?

The Current Expected Credit Loss ("CECL") Model creates three significant shifts from the current incurred loss model:

- **FORWARD LOOKING ANALYSIS** which requires the utilization of future information, and supportable forecasts to estimate the ALLL levels
- **REMOVES “PROBABLE” THRESHOLD** which requires you to forego worst-case and best-case scenario and evaluate the possibility that a loss exists or does not
- **LOSS HORIZON CHANGES** from the current 12 to 18 month horizon to the lifetime of the loan for all loans. This is broadly expected to expand the horizon used for estimating the ALLL for non-impaired loans and is generally expected to result in the need for an increase in the ALLL levels for non-impaired loans.

**WHAT CHALLENGES DO YOU THINK THIS SHIFTS WILL CREATE FOR YOU INSTITUTION?**
CHALLENGES

While the current model is a significant estimate inherently subject to change, the model is based on various date inputs that are objectively verifiable to a reasonable degree, i.e. - historical charge-offs, collateral values, discounted cash flows, estimated selling costs, etc. - with subjectivity layered on related to qualitative factors.

Proposed model inherently integrates assumptions that appear to be more open to interpretation, and therefore could create less consistency in the sector, and possibly a less “auditable” or “supportable” result:

- “utilization of future information”
- “supportable forecasts”
- “evaluate the possibility”

Supportability of data is the most common concern noted by “community banks”
Other “Community Banker” concerns:

AGAIN - “Capital is King!”

- CECL does not appear to meet result in a “match” of the timing of recognition of credit expense with compensation received for credit loss (interest income),
- Results in understated net asset value of the financial asset on “Day 1”,
- Immediately impacts regulatory capital ratios,
- Forecasting and “predicting” economic condition over life of loan is challenging
- Additional audit and regulatory scrutiny
- What are the internal control requirements for FDICIA and SOX entities?

MIDDLE OF THE ROAD OPTION? - Recognize some of the CECL or maintain a threshold that must be met before all expected losses are recognized
CECL - Information Set to Consider

- CECL requires estimates of expected credit losses based on internally and externally available information
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts
  - Qualitative and quantitative factors specific to borrowers and the economy

- CECL does not mandate specific approaches or policy elections to determine expected credit losses
  - Various methodologies permitted
    - vs. current practice where discounted cash flow mandated in certain situations
    - Required to consider time value of money, either:
      - Implicitly - historical loss ratios & probability of default
      - Explicitly - discounted cash flow
The time to prepare is now, so think about how you need to view your loan portfolio for CECL implementation - FOCUS ON:

- Methods for developing an estimate of expected credit losses
  - “Large” banks (over $10 billion) appear to desire less practical guidance, and would like the ability to create their own models, and feel they have the system, data and resources to support their conclusion
  - “Community” banks tend to favor a final pronouncement that provides a more structured roadmap, via illustrations

- Information considered/required in developing an estimate of expected credit losses
  - Specific approaches are not expected to be prescribed by the FASB,
  - Each entity should use techniques which are “practical and relevant” to them
  - Credit losses may vary based on information available to the entity
Methods for Developing a CECL estimate - BEGIN TO THINK ABOUT HOW YOU WILL AGGREGATE ASSETS

- A general assumption is that non-impaired assets will most likely be evaluated on a collective (pool) basis, so how will you establish your pools? They will most likely be more disaggregated than current loan “classes”
  - Credit Scores
  - Risk/Classification Ratings
  - Asset Type
  - Collateral Type
  - $$$ Size
  - Interest Rate
  - Geographic Location
  - Industry of Borrower
  - Term (HOT TOPIC!!)
Methods for Developing a CECL estimate - BEGIN TO THINK ABOUT POLICY ELECTIONS AND JUDGMENTS

- Definition of “default” for default-based statistics
- How you will measure “loss” for loss-rate statistics
- Which historical period to use for current expected credit loss statistics
- How to adjust historical losses to reflect current economic conditions and supportable forecasts
- Weighting of historical loss experience
- Method of adjusting loss statistics for recoveries
- How expected prepayments affect estimate of expected credit losses

The first question related to these assumptions for many community banks is, “Where do I start”? 

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Information to Consider in Developing a CECL estimate - Consider BOTH (a) information related to borrower, and (b) current and forecasted direction of the environment in which you operate

- Change in financial condition, credit rating, asset quality, or business prospects of the borrower,
- Failure to make scheduled payments,
- Changes in remaining terms,
- Changes in the nature and volume of YOUR financial assets,
- Changes in the volume and severity of past due assets, and classified assets,
- Changes in value of underlying collateral,
- Changes in lending policies and procedures and underwriting,
- Changes in other environmental factors: regulatory, legal, market, etc.
So what should I do after I leave today?

- Read the most current Exposure DRAFT
- Consider your financial assets and begin to think about your “pools”
- Examine your current model, and the data available to you,
- Evaluate your internal resources,
- Evaluate your ability to further data mine,
- Talk to your regulators and auditors!
Questions / Comments?

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