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Bank Insights

A CECL Special Report

Three Ways CEOs Should Adjust their Strategic Thinking in the CECL-Era

By Adam Mustafa, Invictus Senior Partner

Bank CFOs across the industry are sitting on pins and needles waiting for the Financial Accounting Standards Board (FASB) to **announce** its overhaul to the accounting treatment for loan loss provisioning. In a nutshell, this revision—the current expected credit loss model (CECL)—will mean less earnings for banks in the future. I will not join the cottage industry of consultants and SAAS companies by opining on why you should spend lots of money on technology to solve this problem. Instead, this article focuses on the impact of CECL on the CEO's world.

1. **The risk-reward trade-off of organic growth would take yet another hit.** The heart of strategic planning is maximizing this tradeoff. The low interest rate environment, competitive conditions, and rising asset inflation has already made the risk/reward tradeoff of making new loans far less attractive relative to historic standards. The cost of provisioning for bad loans will only exacerbate this – especially for longer-term real estate loans, which get penalized harder under CECL since the bank will have to provision for the "life of the loan."

   Net net – new loans will require even more capital to support them (or depending on what camp you're in, the high cost of capital that already exists will become more transparent). As a result, other alternatives including M&A and returning capital back to shareholders will become more attractive by default. CEOs at the smartest banks are already looking for ways to quantify this so they can navigate the bank strategically in the way that creates the most shareholder value.

2. **The smartest banks will benefit because CECL will reward those banks who grow at the RIGHT time**. One of the biggest fallacies in banking is that growth is always good. In most industries, growth is usually always good. Not in banking. Growth is good in certain environments, and not in others. In general, growth is always best at the beginning of a business cycle, not the end of one. Consider the banks that grew rapidly in 2005-07. Banks that grew more in 2003-04, but slowed down around 2005, fared much better because they made few loans at the peak of the real estate bubble that eventually burst. In today's environment, banks that grew more during 2009-11, when the economy was at the 'bottom' and in the early part of the recovery, actually made some very safe and resilient loans. Those loans also have very attractive interest rates.

   Banks with the right CECL tools will be rewarded since these loans need much less capital to support them. Banks that have been aggressively growing more recently will discover that loans closed over the last year or two will require much more capital to support them because they were originated when economic conditions were at their post-crisis peak, meaning they have more downside risk. We're back to the old adage of "the best loans are made in the worst of times" and vice versa. A good CECL model will capture this.

   From the CEO's perspective, CECL can provide even more clarity to help determine whether it makes sense to prioritize growth moving forward. For those banks that grew at the right times and pulled back from growing at the wrong times, CECL will emerge as a powerful vehicle that quantifies the bank's "story" to a CEO's board, shareholders, creditors, and regulators.

3. **You will need to adjust your strategy for structuring and pricing new loans.** The intended and unintended consequences of CECL will result in greater loan loss expensing for certain loans. Since CECL would require banks to reserve for expected losses for the life of a loan, the term and structuring of a loan would take on greater import.

   Take two identical CRE loans. Imagine everything about them is the same, including that they both include 20-year amortization schedules. However, one of the loans has a

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Possible Credit Loss Models under CECL

- Vintage
- Loss-rate methods
- Roll-rate methods
- Probability of default methods
- Provision matrix methods using loss factors
- Discounted cash flow methods measurements.

Source: **Federal Reserve 2014 presentation**

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maturity date at the end of the fifth year, while the other one is fully amortizing and matures at the end of the 20th year. In that scenario, the second loan will require a greater reserve since the principal is outlaid for a longer period of time. (The ironic part is one could argue that the first loan has more refinancing risk, perhaps making it a riskier loan). If the second loan requires a greater reserve, then it is a less capital efficient loan. This will incentivize you to either (i) shorten the length of the loan or (ii) look to get something in return from the borrower such as a higher interest rate on longer-term loans. This is just one example.

The bottom line is that banks will have to become even more cognizant about how they structure loans moving forward because they will have a direct impact on loan loss expenses. This has strategic implications because competitive conditions may limit your ability to control the terms with borrowers. ■

Editor's Note: Adam Mustafa, a co-founder of Invictus, has been providing stress testing, capital adequacy advisory and M&A services to banks, regulators, bank investors, and bank D&O insurers since the beginning of the financial crisis.

CECL Will Focus on Forward-Looking Forecasts

By Richard Murphy, Invictus Executive Advisor

One of the most vexing issues to come out of the financial crisis for banks, regulators and accounting boards was the way banks recognize impairments to loans and debt securities. It was painfully apparent that methodologies to estimate losses proved to be highly inadequate, inaccurate and untimely.

By 2012, the Financial Accounting Standard Board's model for accounting for ALLL, which focused on historical views on "incurred losses," was deemed unreliable. Losses mushroomed during the crisis years, and delayed recognition of the losses caused pain for banks and investors alike.

> Under CECL, a bank's expected credit losses represent all contractual cash flows that the bank does not expect to collect over the contractual life of the financial asset.

In response, FASB in December 2012 issued a number of draft proposals to address the need for more timely recognition of credit impairment and more accurate determination of "estimated" allowance for credit losses. FASB's draft proposal, **"ASU Financial Instruments-Credit Losses – Subtopic 825-15"** ushered in an ALLL model based on "current expected credit losses," better known as CECL. The board is expected to draft the **final standard** in the first quarter of 2016.

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A CECL Q&A

Q. What is likely to be the key impact on reporting?

The move to CECL is likely to increase the allowance balances due to "life of loan" credit loss estimates. Some say this will mean a more accurate balance sheet as asset balances, net of allowances, would reflect cash flows expected to be collected. Upon implementation, expect a one-time increase in allowance levels for existing assets on the books. After implementation, an on-going impact on earnings from new assets will probably occur.

Q: What is expected to happen when the proposal takes effect?

Initial estimates indicate an increase in ALLL of 25% to 50%. The cumulative effect of the change in ALLL would be run through retained earnings. The increase in the provision forcredit losses will reduce common equity Tier 1 regulatory capital, and regulators have no plans to provide "transition relief," according to meeting records of the Federal Reserve.

Q. How hard will CECL be to implement?

Community banks do not need complex models, however they may need to make changes to current systems for data collection and analysis. This may prove to be overwhelming to some smaller banks. The Federal Reserve meeting notes indicted that the proposal "likely will be difficult to implement, particularly for small banks," and that smaller banks with "a higher concentration of longer-tenor assets" may have a greater impact from the change. Dodd-Frank banks may already have risk management policies, processes and systems in place to estimate credit losses. Invictus is working with many of its clients to assist them with CECL preparation. For more information, contact Adam Mustafa at **amustafa@invictusgrp.com**.

Q. Is this a done deal?

FASB is set to draft a final standard in the first quarter of 2016. The Fed has recommended that if CECL is finalized as proposed, there should be a five-year transition for implementation. The Fed also noted that FASB has not yet justified the benefits of the proposal, which would cause banks to add between $25 billion to $50 billion in reserves. ■

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Under the proposed CECL model, a bank would recognize as an allowance its estimate of the contractual cash flows not expected to be collected. Unlike the incurred loss model, the CECL model does not specify a threshold for the the recognition of an impairment allowance. Rather, a bank would recognize an impairment allowance equal to the current estimate of expected credit losses for financial assets as of the end of the reporting period. Under CECL, a bank's expected credit losses represent all contractual cash flows that the bank does not expect to collect over the contractual life of the financial asset.

To make their ALLL estimates under CECL, banks will need to look at the economic conditions at the time of the loan, as well as forward-looking forecasts of what could happen during the life of the loan.

One tool for banks that may become essential is vintage analysis, according to an **April 2015 American Bankers Association Discussion paper**. It suggested that "vintage analysis, whereby loan portfolios are broken out into cohorts by each issuance year, could become a minimum requirement in order to support the ALLL estimate under CECL." ▪

Editor's Note: Richard Murphy, a former FDIC team leader, has spent 30 years in the banking industry.

CECL's Road to Implementation and its Potential Effect on the Economy

By Ryan Abdoo, Plante Moran

With FASB's Financial Instruments Project **expected to be finalized** in the first quarter of 2016, the new current expected credit loss model (CECL) is on the minds of all of us in the financial institutions industry. One area of focus remains the requirement to forecast expected losses and how an institution is going to support that forecast. As with anything new, the first few reporting periods are likely to be filled with uncertainty and debate among regulators, auditors, and management. But could there also be an overall concern with the potential impact on the general economy?

Back in the "old days" of calculating the allowance for loan loss, the industry's primary ratio of consideration was the allowance for loan losses as a percentage of loans. And with that ratio, wasn't it amazing how so many institutions had somewhere around 1.25 percent of total loans in the allowance? Well, that ratio probably wasn't a coincidence, as regulatory capital provisions include a formula that served as the baseline for that ratio. Under the former and current capital adequacy rules, banks are allowed to include the allowance for loan losses up to 1.25 percent of risk weighted assets in capital.

Many in the industry expect that allowance for loan losses will need to be substantially increased as a result of CECL. The question that remains is whether the regulatory agencies will provide a form of relief. If that doesn't happen, and allowances are required to significantly increase upon adoption of the CECL standard, some institutions and, potentially the industry as a whole, could be affected with the instant removal of all that capital from the market.

The industry and even the overall economy could face headwinds as institutions evaluate the effect of the new requirements and how they will ensure they maintain compliance with the capital standards set forth by BASEL III.

While banks await the final standard, they can still start thinking about implementation based on the draft proposal. Here are some questions to consider:

- How will the loan portfolio be segmented to create pools with at least two similar credit risk characteristics?
- How will the vintage of loans be factored into the loan pools?
- What data is available to estimate the average life of the loans within the identified pools?
- How will historical loss data be determined and tracked for each loan pool?
- How will credit losses be estimated for each pool? While not a requirement, is the institution positioned to develop and implement a probability of default model or migration analysis model?
- What economic data can be gathered to help support the economic cycles within the institution's lending area, commensurate with lending activities? ▪

Editor's Note: Ryan M. Abdoo, CPA, is a senior manager at Plante Moran in Chicago.

About the Expert

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Read Between the Lines

Each month *Bank Insights* reviews news from regulators and others to give perspective on regulatory challenges.

Community Banks Should Use Stress Tests to Assess Capital Needs

Stress tests can be valuable to community banks to assess "adequate capital needs for their exposures and market conditions, according to the **community bank performance panel** at the third annual Community Banking Research and Policy Conference, hosted by the Federal Reserve System and the Conference of State Bank Supervisors. CSBS has been a proponent of community bank stress testing **since 2010**, when it issued a white paper advocating stress testing for community banks as "a fundamental part of this new era of risk management."

Survey Finds Potential Compliance Cost of $4.5 Billion

Community banks have been complaining for years about their increasing regulatory burden, but no one has been able to calculate the cost – until now. A survey of community banks, conducted by the Fed and CSBS as part of its **Community Banking in the 21st Century conference**, found that the "hypothetical compliance cost" could be $4.5 billion a year. That's because banks in the survey reported that regulatory compliance made up 11 percent of personnel expenses, 16 percent of data processing costs, 20 percent of legal, 38 percent of auditing and accounting, and 48 percent of consulting expenses – or 22 percent of their income. The report does not indicate whether the costs outweigh the benefits, or whether they are even high or low, but it does note that "they are sufficient to frustrate bankers."

Loan Growth Misleading, Auto Loans a Red Flag: OCC's Curry

While loan growth at community banks may be strong, that doesn't mean there isn't trouble on the horizon, Comptroller of the Currency Thomas J. Curry **said in a speech** at the Exchequer Club on October 21. That's because credit quality "reflects the outcome of decisions made when loans are originated, perhaps months or years earlier, possibly under tougher standards than those in effect today. So the indicators that many are looking at most closely actually say little or nothing about the risk now embedding itself in bank portfolios," he warned.

Curry also warned about dangerous trends in auto lending, which made up more than 10 percent of retail credit at OCC-regulated banks at the end of the second quarter. Many banks are packaging auto loans into asset-backed securities, much like mortgage-backed securities were sold prior to the financial crisis. "Today, 30 percent of all new vehicle financing features maturities of more than six years, and it's entirely possible to obtain a car loan even with very low credit scores. With these longer terms, borrowers remain in a negative equity position much longer, exposing lenders and investors to higher potential losses," Curry warned. "How these auto loans, and especially the non-prime segment, will perform over their life is a matter of real concern to regulators. It should be a real concern to the industry."and institute a monitoring program with direct approval by bank's board.

CFPB Says Banks have Insufficient Data on Student Loans

Student loan debt, which is now more than $1.2 trillion, "continues to show elevated levels of distress," the Consumer Financial Protection Bureau writes in a **report** calling for reform of student loan servicing and increased standards. The CFPB estimates more than one out of four borrowers are delinquent or in default on student loans. One problem is the lack of data. Banks lump student loans with other types of non-mortgage credit products, which hampers oversight and limits policymakers, the CFPB said.

DIF Increase Means Community Bank Assessments to Decline

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Banks with assets of less than $10 billion should have lower assessments when the Deposit Insurance Fund reserve ratio reaches 1.15 percent, which is expected early next year, the FDIC said. The FDIC board has **proposed** increasing the fund to its statutorily-required minimum level of 1.35 percent. Banks with assets above $10 billion will pay for that increase with a surcharge of 4.5 cents per $100 of their assessment base.

About Invictus

Invictus Consulting Group's bank analytics, strategic consulting, M&A and capital adequacy planning services are used by banks, regulators, investors and D&O insurers. For past issues of Bank Insights, please go to the ***Invictus website****.*

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