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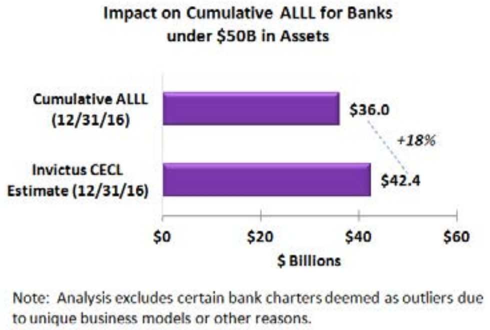
INVICTUS
Bank Insights

CECL Myths and Realities: Why Small Banks May Benefit from the New Accounting Standard

By Adam Mustafa, Invictus Co-founder

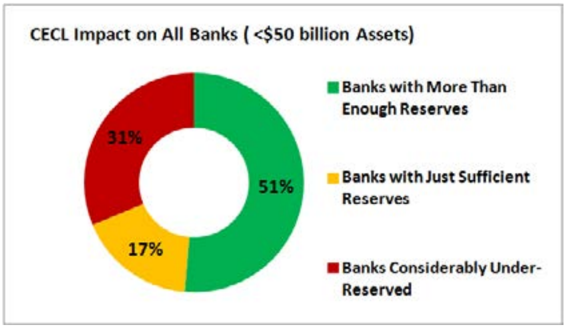
Small community banks may actually benefit from the new Financial Accounting Standards Board's current expected credit loss (CECL) model, even though they will face the toughest challenges in implementing the forward-looking process, according to a new Invictus Consulting Group analysis of banks with assets below $50 billion. The analysis also found that:

- ✓ CECL will increase the allowance for loan and lease losses (ALLL) by nearly 18 percent, but the bigger banks would feel the brunt of the pain.



Note: Analysis excludes certain bank charters deemed as outliers due to unique business models or other reasons.

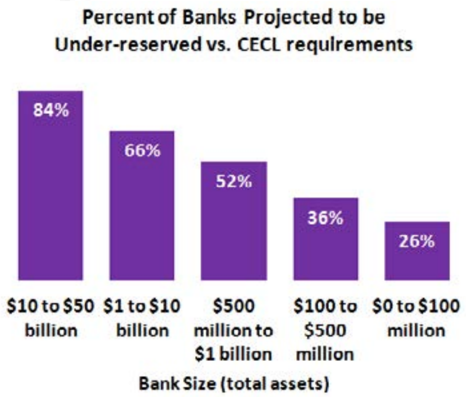
- ✓ Ironically, slightly more than two-thirds of banks under $50 billion in assets will NOT feel a significant impact from CECL. Only about 31 percent of these banks are under-reserved and vulnerable.



Inside this issue:

- How to Prepare for CECL Now *(p. 2)*
- Latest CECL Regulatory Guidance *(p. 3)*
- CFPB Wins Key Court Ruling *(p. 4)*

- ✓ Bank size matters. The larger the bank, the more CECL should hurt.



These findings fly in the face of nearly everything reported about CECL in the last 12 months. When the proposal was first debated, even regulators suggested that it would increase loan loss reserves by 30 to 50 percent, especially for community banks. Those estimates were computed when the economy and the banking industry were still in the early stages of recovery from the Great Recession. Times have changed.

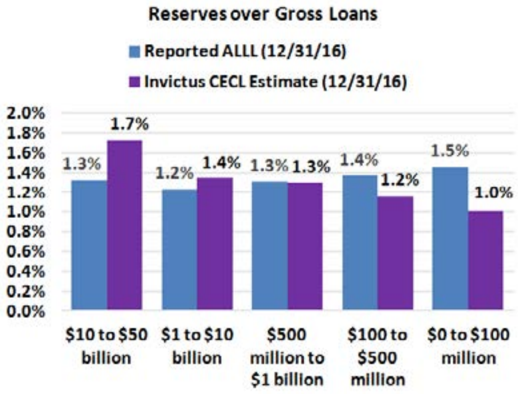
Invictus calculated its CECL study by using its proprietary capital stress testing system, but turning off the stress and adjusting the time horizon to reflect the "life of a loan" concept underpinning CECL. The Invictus stress testing system is uniquely qualified to perform this analysis because the methodology is consistent with the main CECL principles: loan portfolio segmentation, vintage analytics, expected loss modeling and risk rating migration patterns.

There are several logical reasons why smaller banks should be less exposed to CECL, as revealed by the analysis:

- More community banks tend to be over-reserved today since many are privately-held and do not have the pressure of meeting quarterly earnings estimates;
- Smaller banks also tend to prioritize the preservation of conservative underwriting over winning new business at any cost. As a result, their existing loans tend to have lower loan-to-value ratios, higher debt service coverage ratios, and more importantly, they tend to grow less aggressively in 'good times' (knowing all too well that the worst loans are made in the best of times).
- More than 90 percent of a bank's loan loss reserve today is derived from qualitative factors. Since charge-offs in the industry have significantly declined over the last three years, banks simply do not

have a meaningful history of losses on which to build an adequate loan loss reserve. As a result, CFOs are forced to depend more on these qualitative factors – which are supposed to be a proxy for the forward-looking component of the existing ALLL. The problem is that the qualitative factors have virtually no data or science behind them, leaving CFOs to resort to guesswork and art. What CECL will do is replace the guesswork with analytics, leading to lower loan loss reserves for many banks.

- Smaller banks tend to be more focused on real estate loans, which are less risky than the C&I and consumer loans that tend to represent a greater portion of a bigger bank's balance sheet. This difference is exacerbated by the reduced exposure of small banks to construction loans since the financial crisis.



Despite the inconvenience and cost of implementing CECL, the silver lining for community banks is that the data shows that many of them should benefit from it. Please read on for how to prepare for CECL in the short-term. ■

What Community Banks Need to do to Prepare for CECL

By Adam Mustafa, Invictus Co-founder

While smaller banks are in a better position to benefit from CECL from a technical perspective, they will struggle the most with the implementation due to a general lack of sophistication and the relative cost of using third-party tools.

Smaller banks may also find themselves caught in the middle of two conflicting forces. In one corner, the service providers that stand to benefit the most from CECL are using scare tactics to convince banks to spend oodles of money today on a so-called solution. "Best start yesterday or else you are doomed," they say. In the opposite corner, overly passive and reactive auditors are advising banks to wait until more guidance is available. The right answer for community banks is somewhere in the middle.

For now, community banks should be proactive, but they shouldn't spend too much money. My advice:

- Determine what additional data you need down the line, and devise a plan to adjust your business processes to collect it dynamically.
- Rethink your loan classification systems and their portfolio segmentations.
- Figure out what is best for your bank. As federal regulators noted in a Financial Institution Letter in December, "CECL allows institutions to apply judgment in developing estimation methods that are appropriate and practical for their circumstances."
- Understand the role of vintage in CECL. Don't confuse it with seasoning. The risk profile of a loan is primarily a function of the economic conditions that existed on the day the loan was originated. What's most important is the ability to measure the economic conditions that exist in the expected environment underpinning your CECL model against the economic conditions that existed for each vintage. In 2011, economic conditions were worse than in 2007. Therefore, the 2007 loans should require more of a reserve than loans originated in 2011, but not as much than a loan written in 2016.
- Thought leadership on how you adapt CECL to your institution will be rewarded. Be aggressive on data gathering, but don't buy a black-box solution. Your CECL system can be simple; don't believe the hype about how it has to be complex.

The best way to prepare for CECL is to start small, and build out.

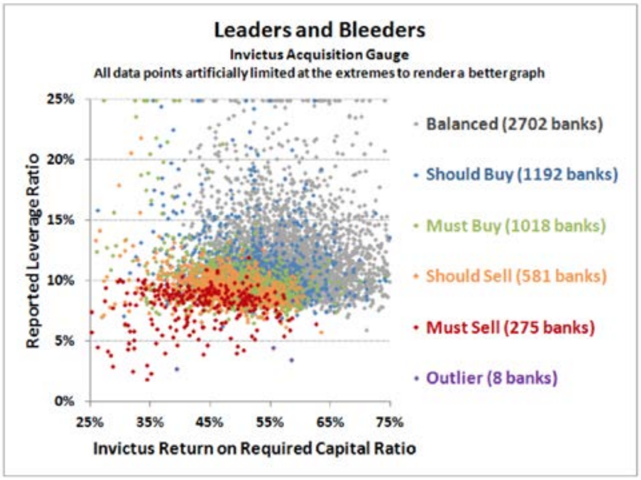
Believe it or not, most banks have the ability to run a very simple CECL analysis right now. The secret to CECL will be loan portfolio segmentation. If you get your segmentation right, you will find that it's 80 percent of the battle. Mock calculations can then be performed on each segment. The assumptions driving the model might not be 100 percent accurate, but at least this would give your bank a starting point to determine what additional data you need to improve such assumptions. Then, as you get more data, you run more mock calculations until you get it right. That would enable your bank to evolve its calculations by the time CECL is implemented. The worst thing you can do is try to build a perfect system on Day One. That is what will lead to wasted money and time. ■

The Latest Regulatory Guidance on CECL

The FDIC, the OCC and the Federal Reserve issued frequently asked CECL questions (and answers) for banks in December. Among the highlights:

- ✓ CECL will cause an earlier recognition of credit losses. That's because CECL removes the "probable" and "incurred" notion thresholds, meaning that there will be new triggers used for recognizing credit losses. While the total amount of net charge-offs on financial assets does not change, the timing of credit losses will happen sooner.
- ✓ CECL is forward-looking. This is key. The new standard broadens the range of data that must be considered to estimate credit losses, requiring not just historical and current conditions but also forecasts "that affect expected collectability."
- ✓ CECL does not require vintage disclosure for non-public community banks. (In our opinion, vintage analysis is the best way for banks to implement CECL). "Acceptable methods include loss rate, roll-rate, vintage analysis, discounted cash flow, and probability of default/loss given default methods. Neither a vintage nor a discounted cash flow method is required for estimating expected credit losses. Additionally, an institution may apply different estimation methods to different groups of financial assets. To properly apply an acceptable estimation method, an institution's credit loss estimates must be well supported."
- ✓ CECL will affect how banks account for troubled debt restructuring (TDRs). The new standard means that "credit losses on TDRs should be calculated under the same expected credit loss methodology that is applied to other financial assets carried at amortized cost – in other words, under CECL."
- ✓ Banks do not need third-party vendors to help measure their expected credit losses under CECL.
- ✓ CECL will require more data collection. "Depending on the estimation method or methods selected, institutions may need to capture additional data and retain data longer than they have in the past on loans that have been paid off or charged off to implement CECL."
- ✓ Although CECL won't go into effect for several more years, regulators recommend that banks begin evaluating and planning now for "the potential impact of the new accounting standard on regulatory capital."

Invictus Data Insights



Invictus performs a quarterly analysis on all FDIC-insured banks in the country to assess their best approach to M&A. The analysis is based on the post-stress capital ratios of banks, plus the Invictus Ratio, which generates a gauge of five categories: Balanced, Should Buy, Must Buy, Should Sell, Must Sell and Outlier. (This is not a prediction of what banks will do, but rather an indication of what they should do to maximize shareholder value.) The latest "Leaders and Bleeders" analysis, based on 2016 Fourth Quarter data, shows a slight increase in the number of Seller banks and a slight decline in Balanced banks, most probably because of the low interest rate environment. Loan income declines each quarter as older, higher interest rates roll off and are replaced with lower rate loans.

Broadly, the Seller banks have poor post-stress capital ratios, lose capital fast under a stress test, and do not achieve good returns on their required capital (where required capital is based on a stress test).

Buyer banks are in better shape from a capital point of view, but should consider acquisitions of more efficient banks (those with a higher Invictus Ratio) to improve the bank's performance. Balanced banks have good post-stress capital and good efficiency. To see where your bank stands on the Invictus Gauge, please contact MandA@invictusgrp.com Statewide graphs of the Leaders and Bleeders analysis can be found on the Invictus website. ■

Read Between the Lines

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

While Under Fire, CFPB Wins Key Court Ruling

The U.S. Court of Appeals for the D.C. Circuit will hear oral arguments in May about whether the Consumer Financial Protection Bureau is constitutional in its current form. The decision to hear the case is a victory for the embattled bureau, recently **deemed** "the most powerful, least accountable agency in U.S. history" by Republican House Financial Services Chair Jeb Hensarling of Texas. A previous court order had ruled against the independent agency, which was established under the Dodd-Frank Act, giving the president the right to fire its director at will. The CFPB appealed. For now, CFBP Director Richard Cordray cannot be removed for any reason other than "for cause."

The ruling is significant because President Trump can shape the future of bank regulation by choosing who leads the various bank supervisory agencies. Cordray's term ends next year. Comptroller of the Currency Thomas J. Curry's term ends in April, and FDIC Chairman Martin J. Gruenberg's term ends in November. Also key is who Trump will choose to replace Federal Reserve governor Daniel K. Tarullo, whose **resignation** is effective in April.

Community Bank Takeaways from 2017 Dodd-Frank Stress Test Scenarios

While Dodd-Frank stress tests are not required for banks with less than $10 billion in assets, the scenarios often signal regulatory interests and direction that can be valuable for community banks. Of note: The 2017 stress test **scenarios** specifically mention multi-family loans. Regulators indicate that "declines in aggregate U.S. commercial and residential real estate prices should be assumed to be concentrated in regions and property types that have experienced rapid price gains over the past several years. In particular, given that prices of multifamily properties have risen rapidly in recent years, they should be assumed to decline by more than the CRE index."

Banks More Competitive Because of High Regulatory Standards: Curry

Despite the new anti-regulatory sentiments in Washington, Comptroller Thomas J. Curry gave a resounding defense of strong bank regulation in a **speech** at the Clearing House Annual Conference. He said the nation's largest banks are stronger than their European counterparts because U.S. regulators acted quickly to enforce tougher safety and soundness rules after the financial crisis. And he warned community banks not to get complacent. Small banks "should be careful not to undo the progress they've made since the crisis," he said. "To remain strong and healthy, community banks, and their examiners, need to focus on strategic risk, rising credit risk from stretching for yield while relaxing underwriting standards, expansion of new technologies, and compliance issues." Noting that he has spent more than 30 years in bank regulation, Curry stressed that "supervision is the regulators' best tool to affect behavior and promote strong risk management at the institutions we oversee; and while it is appropriate to reassess banking laws and regulations periodically, we must never settle for "light-touch" supervision. If we do, the OCC and the industry will suffer."

Regulators to Focus on Interest Rate Risk and Credit Risk

The FDIC has "heightened its focus on forward-looking supervision," according to the **FDIC 2016 Annual Report**. The report reveals that the Division of Risk Management Supervision initiated 170 formal enforcement actions and 121 informal ones in 2016. Additionally, 395 banks that had a CAMELS rating of 2 also were issued Matters Requiring Board Attention during exams. Chairman Gruenberg noted that while the banking industry is improving, "evidence of growing interest-rate risk and credit risk merit attention."

FDIC Issues De Novo Guide

Continuing its effort to attract investors in new banks, the FDIC has issued a new **handbook** to guide applicants through the deposit insurance process. The guide includes answers to questions that were asked during de novo outreach meetings conducted by the FDIC in the fall of 2016. It also includes advice from CEOs at successful de novos. To win approval for a new bank, it's important to develop a business plan, determine the right amount of capital that must be raised, and secure a good team of directors, officers and management. ▪

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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