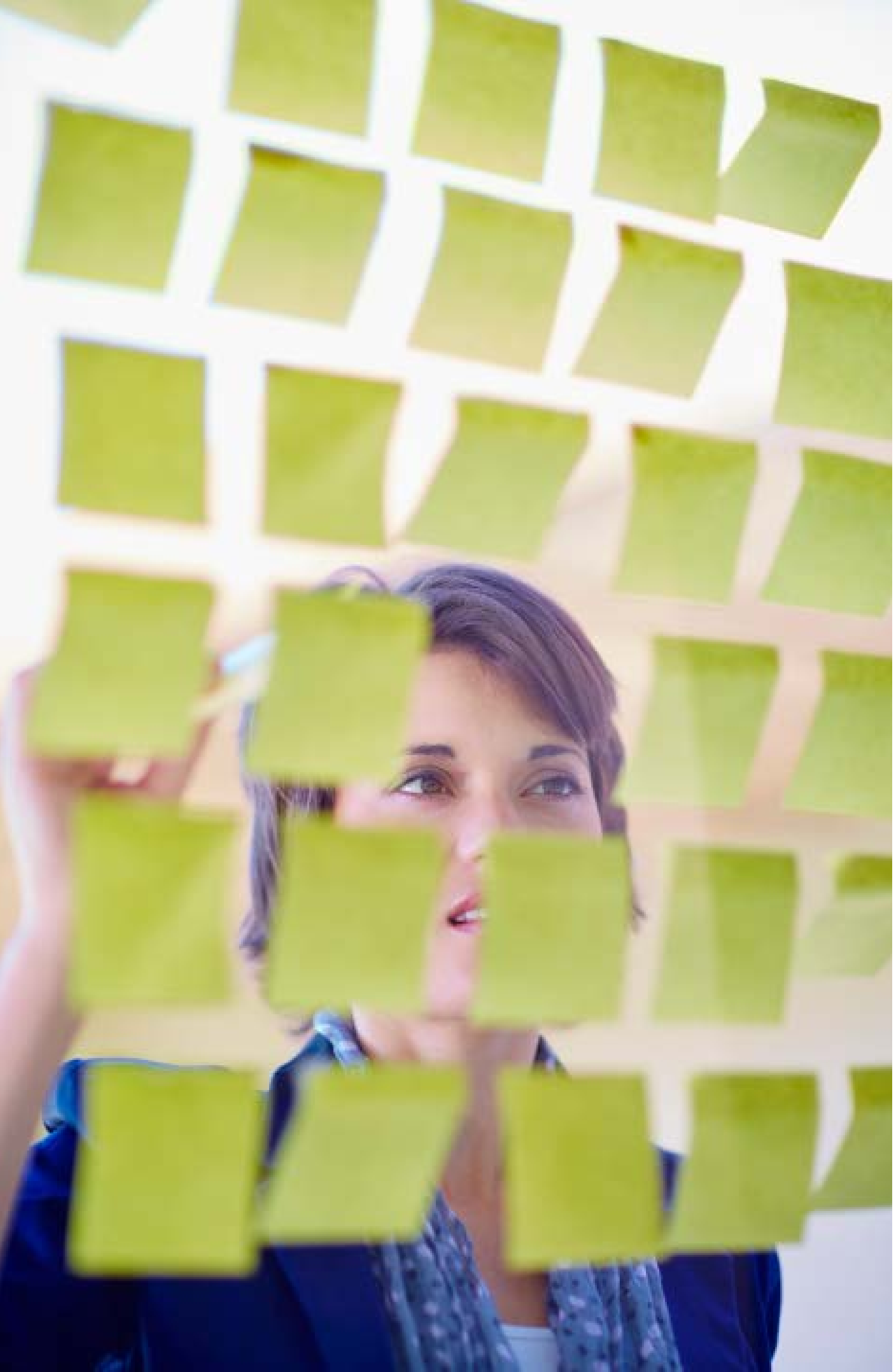
What You Need to Know About CECL:

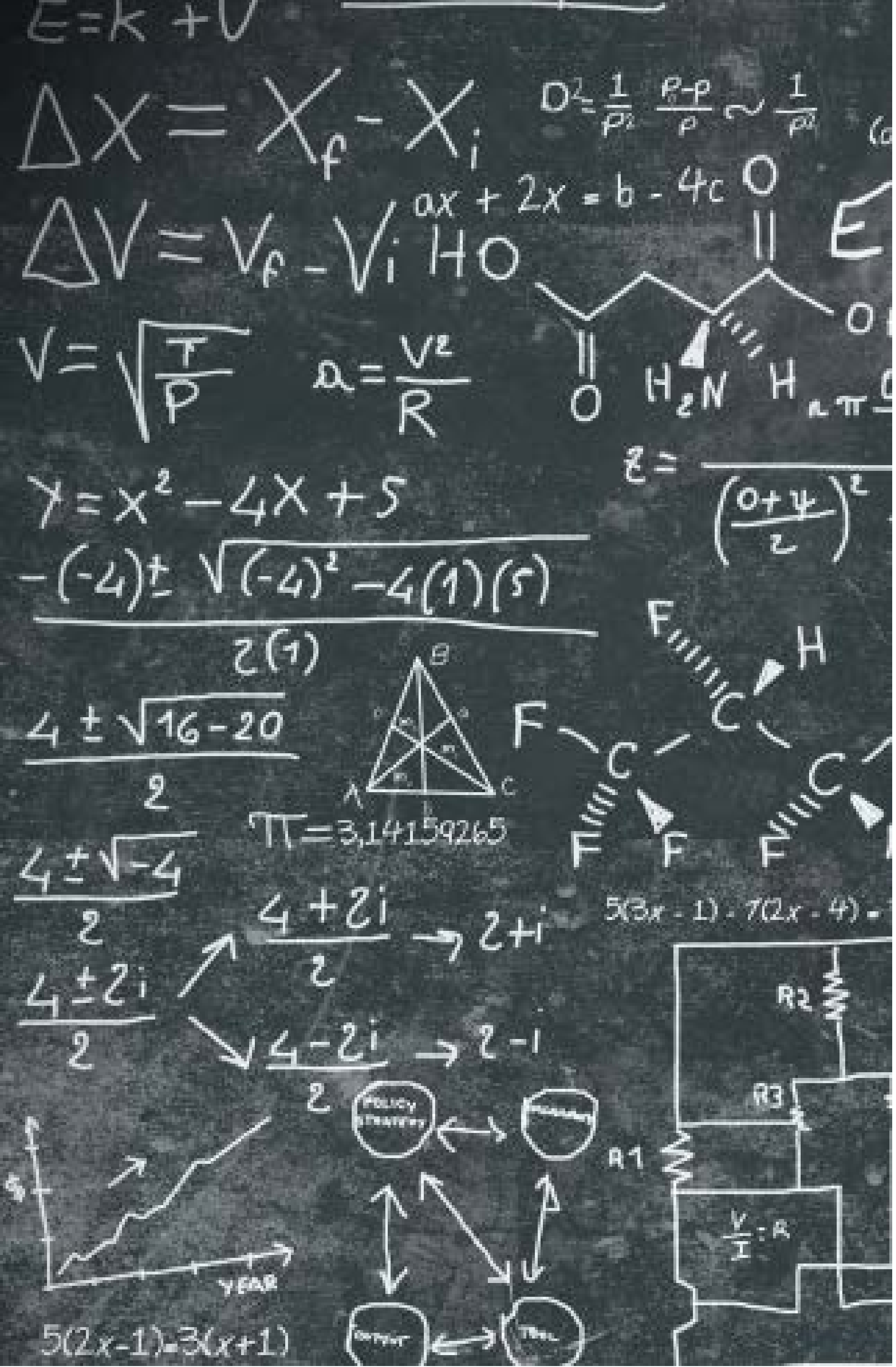
REAL ANSWERS, REAL GUIDANCE

Tracy Harding, CPA
Rob Smalley, CPA



Agenda

- CECL Overview
- Example – (yes a real example with numbers!)
- Acquisitions
- Process



TODAY
Incurred Loss Model

SPECIFIC RESERVES

- Identify impaired loans (ASC 310 or FAS 114)
- Determine required ALLL

GENERAL RESERVES

- Calculate historical loss rates for each pool (ASC 450 or FAS 5)
- Select loss emergence period
- Loss emergence period x historical loss rates
- Adjust historical loss rates to current environment
- Multiply product by loan balance in pool

There are issues with this approach

Retirement Model

STEP ONE
Set allowance for credit losses at
1 – 1.5% of loan portfolio

STEP TWO
Wait for the examiners or board to tell you your retirement date

STEP THREE
Buy a boat

CECL Pools

Institutions must pool loans with shared risk characteristics	Consider contractual life less expected prepayments - without renewals	Inclusion of forward looking information as reasonable and supportable forecasts	Revert to historical information beyond the period you can reasonably forecast

Specific Models

OPTIONS INCLUDE:

- Loss-rate methods
- Vintage model
- Migration or roll-rate
- Probability-of-default (PD) / Loss Given Default (GD)
- Discounted Cash Flows (DCF)

Best Model

13

CECL: The Nuts and Bolts

A VERY SIMPLE EXAMPLE

- Before CECL: No initial provision, partial doubling up when charge-offs occur
- Under CECL: Initial provision, no provision after Year 1 if expectations don't change

ABC Bank

COMPARISON OF INCURRED LOSS MODEL TO CECL

	20X1	20X2	20X3	20X4	Total	Average
Loans outstanding, beginning of year	-	1,000,000	990,000	980,000		
Loans originated 1/1/20X1	1,000,000	-	-	-		
Loan principal payments 12/31/20X4	-	-	-	(970,000)		
Chargeoffs	-	(10,000)	(10,000)	(10,000)		
Loans outstanding, end of year	1,000,000	990,000	980,000	-		
Chargeoff % to be applied to ending loan balance						
Before CECL	0.00%	1.00%	1.01%	1.02%	3.03%	0.758%
Under CECL	3.00%	2.02%	1.02%	0.00%	3.00%	N/A
ALL at end of year						
Before CECL	-	4,950	6,566	-		
Under CECL	30,000	20,000	10,000	-		
					Total	
Before CECL						
Allowance for loan losses, beginning of year	-	-	4,950	6,566	-	
Provision	-	14,950	11,616	3,434	30,000	
Chargeoffs	-	(10,000)	(10,000)	(10,000)	(30,000)	
Allowance for loan losses, end of year	-	4,950	6,566	-	-	
Under CECL						
Allowance for loan losses, beginning of year	-	30,000	20,000	10,000	-	
Provision	30,000	-	-	-	30,000	
Chargeoffs	-	(10,000)	(10,000)	(10,000)	(30,000)	
Allowance for loan losses, end of year	30,000	20,000	10,000	-	-	

CECL: One Potential Approach

DETERMINE SPECIFIC RESERVES
No change from current practice

FOR THE REST OF THE PORTFOLIO:

a. Group loans by common characteristics, as you’re doing now (maybe)

b. For each group, create subgroups by origination year

    i. Current year originations

    ii. Prior year originations

    iii. Originations for the year before last

    iv. Originations for the year before that

    v. Originations for the year before that

    vi. All other

CECL: One Potential Approach

FOR THE REST OF THE PORTFOLIO:

c. For each subgroup:

   i. determine economic and other relevant expectations for the weighted average remaining loan term; combination of:

      A. Federal Reserve forecast for the next three years

      B. Long-term historical conditions for the remainder

   ii. Select an historical loss period that best approximates the conditions in c(i)

   iii. Determine average lifetime losses for historical loss period in c(ii)

   iv. Adjust c(iii) for current or expected conditions you believe will be different

Questions?

Impact of CECL on Acquisition Accounting

GREAT NEWS
We can book an allowance upon acquisition!

BAD NEWS
Most of it will run through expense on the date of acquisition!

NEW TERMINOLOGY
PCD instead of PCI!

ABC Bank

ALL ACCOUNTING - ACQUIRED LOANS

Facts: XYZ Bank acquired 1/1/Y5

XYZ loan portfolio at date of acquisition:

	Principal loan balance	Fair value	ALL under CECL
PCD	1,000,000	910,000	100,000
Other loans	19,000,000	19,190,000	475,000
	20,000,000	20,100,000	575,000

Entry to record acquisition (disregarding other assets acquired and liabilities assumed):

	Dr	Cr
Loans	20,000,000	
Loan premium	100,000	
Cash		20,100,000
Loan premium	100,000	
ALL		100,000
Provision for loan losses	475,000	
ALL		475,000

Resulting fair value mark to be amortized:

	Principal loan balance	Recorded loan balance	Loan premium (aka fair value mark)
PCD	1,000,000	1,010,000	10,000
Other loans	19,000,000	19,190,000	190,000
	20,000,000	20,200,000	200,000

CECL Model: Criticisms

DAY ONE LOSSES

- You more or less do it now…
- Matching principle problem
- What other option is there really….IASB model….
- Timing is everything

Off-Balance-Sheet Credit Exposures

OBS credit exposures should be evaluated under the CECL model

Commitments that are unconditionally cancellable by the lender do not require an accrual

Held-to-Maturity Securities

Guidance treats HTM securities in more consistent way with loans

Banks will be allowed to use allowance for credit losses to reflect for potential losses in HTM portfolio

Use of allowance gives banks ability to recognize improvements in collectability of securities

Caution: CECL Model necessary

Available-for-Sale Securities

- Equities will be considered trading securities
- Recognize impairment related to credit losses through an allowance
- Credit loss = Amortized cost – PV of cash flows expected to be collected (discounted at effective rate)
- Estimated based on past events, current conditions and reasonable and supportable forecasts

The Future!

REASONABLE AND SUPPORTABLE?

Auditors and examiners now asked to opine on F/S with loan estimates that include future forecasts

What Are the Examiners Saying?

- They will start monitoring your efforts with respect to CECL starting with your next exam.
  - FIRST VISIT
    Plan in place
  - SECOND VISIT
    Demonstrative progress on that plan
- Can’t maintain an excessive allowance now in order to soften the blow of CECL
- Incurred losses are a subset of expected – they do not expect the allowance in any class to go down upon implementation

Public Business Entity (PBE)?

SEC FILERS

OTHERS…

- Banks with assets over $500M (subject to FDICIA Part 363)
- OTC / Pink sheets

Disclosures

- Many current disclosures still required
- Impaired loan disclosures no longer required; concept of impairment will no longer exist
- Vintage disclosures
  - SEC: 5 years
  - PBE: Start with 3, build to 5
  - OTHERS: Optional
- Discussion of factors that influenced management’s estimate

CECL Model

		Effective Dates – Calendar Years
SEC	42 months	Q1 2020
PBE	54 months	Q1 2021
Non-PBE's	63 months	4Q 2021 (change as if the beginning of the year)

EARLY ADOPTION IS PERMITTED STARTING WITH Q1 2019

What Should You Be Doing Now?

THE CLOCK HAS STARTED!

- Put together a team
- Discuss potential pools selections
- Figure out what data is available
- Produce a timeline – monitor progress
- Resources needed
- Start keeping a playbook
- Keep a look out for new guidance

Stay Informed

SIGN UP FOR OUR CECL UPDATES AT:

advisors.berrydunn.com/cecl-updates

Contact Us

TRACY HARDING, CPA
Principal
tharding@berrydunn.com

ROB SMALLEY, CPA
Senior Manager
rsmalley@berrydunn.com