**Lease implementation considerations**

**Q: If we have one lease with a rate implicit, can we still use the risk-free rate for the remainder of our leases?**

A: Yes, if the implicit rate in a lease agreement is known by the lessee, the lessee MUST use the implicit rate, even if the lessee has elected to use the risk-free rate as the discount rate.

**Q: Is the rate revisited annually?**

A: No, The rate used should match the term of the lease at the inception of the lease (or the remaining term of the lease at the date of lease standard’s adoption). The rate is only revised when the lease is required to be remeasured, such as when the lease is modified or when a triggering event changes the certainty of exercising a renewal option.

**Q: What is the phase in period that lease accounting will affect the capital ratios?**

A: The impact of the adoption of the new lease standard is recognized immediately for regulatory capital purposes. There is no phase-in period like there is for the adoption of CECL.

**Q: Do you have to record the short term and long-term lease liability separate?**

A: Since most financial institutions do not present a classified balance sheet, this is not necessary. However, if a classified balance sheet is presented, the short-term portion of the lease liability should be classified as part of current liabilities, and the rest of the lease obligation will be classified as long-term.

**CECL adoption considerations**

**Q: Are there any examples or guidance to look at to know what qualitative adjustments should be used?**

A: We recommend financial institutions begin with the qualitative factors highlighted in the 2006 interagency policy statement on the allowance for loan lease losses when determining what qualitative adjustments should be used in their CECL model. Some of the factors discussed in the interagency statement may already be considered in the inputs of the CECL model used, and therefore additional qualitative adjustments may not be needed. Additionally, financial institutions may find other qualitative factors not included in the interagency policy statement are also relevant for the credit risk associated with their loan portfolio.

**Q: How should an institution find guidance for prepayment speeds?**

A: We recommend an institution first look at its asset-liability management (ALM) models for prepayment speeds applicable for different pools. Industry prepayment speeds for certain loan pools may be obtained from public sources or third parties, but institutions should always look at their historical activity to see if these prepayment speeds are relevant for their specific loan pools. In addition, smaller credit unions may consider utilizing the prepayment information provided in the NCUA’s CECL model, which is based on a peer group of credit unions using a peer set of credit unions combined with market-based prepayment data.

**Q: Is it possible to include nonaccrual loans in the same risk category. Since really that is figured into the lifetime history? Then just have to make a qualitative assessment if that ratio of nonaccrual or delinquent loans is higher than historic. Seems like separating and adding a higher rate would be double counting?**

A: Since nonaccrual loans often do not share the same risk characteristics as performing loans, it often is not appropriate to include nonaccrual loans in the same pool as performing loans. Although it might seem like this might be double counting the CECL loss, it probably does not. Under CECL, an institution should estimate lifetime losses, and some performing loans will eventually become nonaccrual loans and then have a charge off. Estimating CECL lifetime loss rates for these performing loan pools should take this into account these changes in credit quality and the eventual chargeoffs. Because it is more likely the nonaccrual loans will have amounts charged off, higher CECL loss rates are typically estimated for nonaccrual loans.

**Q: Would a single bank holding company that has only a couple of insider loans be subject to CECL requirements?**

A: Yes, CECL applies to loans between officers and directors and the holding company (or bank).

**Q: In the past, many banks would use various qualitative factors such fluctuations in past dues/nonaccruals, economic factor adjustments, loan concentration increases, etc.  We would also typically apply bp adjustments based on the fluctuation, such as 10bp for 10%-25% change or 25bp for over 25% change.  These bp adjustments were assigned typically because it seemed everyone used them.  Will this arbitrary bp adjustments be acceptable, and if not, how would you go about trying to determine what the bp adjustment should be?**

A: Technically under US GAAP (existing and under CECL), arbitrary adjustments to significant estimates like the allowance are not appropriate. It is likely that management of the institution, regulators, and auditors felt these adjustments were supported by historical losses and other information. We recommend instead of using “arbitrary” adjustments, institutions estimate qualitative adjustments using historical data from previous periods, peer information, information from third-parties, or other applicable information to support the qualitative adjustments in their CECL methodologies. Having supportable qualitative factors is generally even more important under CECL, as the impact of inappropriately supported qualitative adjustments may be magnified resulting in inappropriate CECL allowances for credit losses (that is, allowances that are too large or too small).

**Q: Do we include previously acquired non-PCD loans in our CECL analysis?**

A: Yes, previously acquired non-PCD loans should be included in the CECL model.

**Q: At the AICPA conference in September the FASB rep stated that they assumed a majority of acquired loans in a transaction would be considered to be PCD, while in practice the opposite was happening. It sounded like they were going to be issuing guidance around this that would allow for PCD accounting for nearly all acquired loans. Can you shed light on this?**

A: FASB has indicated that they expected most loans acquired would be treated as purchased credit deteriorated loans, but that the industry has not applied the standard the way that FASB was expecting. Consequently, the FASB is working on a project that would require institutions to apply the PCD accounting model to most acquired loans that meet the “seasoning” criteria being developed by the FASB. Nothing formal has been issued related to this FASB project.

**Q: Are you required to record the adjustment to the new CECL method as of 1/1/23?**

A: Yes, although the adjustment does not have to be made on 1/1/2023, the adjustment will be effective as of 1/1/2023 for calendar year institutions. (Fiscal year institutions will adopt CECL as of the beginning of its first fiscal year beginning after December 15, 2022.)

**Q: Is there a need for an adjustment to retained earnings at year end December 2022 for the difference between CECL and ALLL.**

A: No. An institution should determine the difference in the allowance for loan (credit) losses under the existing accounting methodology and under the CECL methodology(ies) as of December 31, 2022 (for a calendar year institution). This difference is not recognized in 2022. Instead, this adjustment is recognized as of 1/1/2023 (for a calendar year institution).

**Q: Any thoughts or comments on SCALE?**

A: Although the SCALE methodology is an acceptable methodology in certain circumstances, the institution using the SCALE methodology almost always does not know what inputs, assumptions, and qualitative factors were used by the peer group in their data and how those inputs, assumptions, and qualitative factors differ from the institution’s historical and expected experience. Because of this significant drawback to the methodology, we recommend institutions obtain feedback from regulators (and auditors, if applicable) before using this methodology.

**Q: We have a portfolio of loans from acquisitions that we fair valued at the purchase date and have a separate reserve. Currently we remove these from our calculations, how should this be handled under new CECL guidelines?**

A: Under CECL, if the acquired loans and originated loans share similar risk characteristics, they should be evaluated together. If the acquired loans and originated loans do not share similar risk characteristics (for example, because of different underwriting standards), they should be evaluated separately. In either case, all loans held of investment (both acquired and originated) should be evaluated for expected lifetime loan losses using a CECL methodology.

**Q: How do you handle current PCI loans with discounts in the CECL standard?**

A: At the CECL adoption date, the credit loss component of PCI loans is reclassified to an allowance for credit losses, resulting in the carrying basis of the loans being “grossed up.” Subsequent to CECL adoption, these loans should be evaluated under the CECL model, although they may not be included in other CECL loan pools because the risk characteristics may not be similar to other performing loans.

**Q: Related to change in disclosure of impaired loans, would you have disclosure of impaired loans for prior year when you have comparative financial statements?**

A: Yes, an institution should follow existing disclosure guidelines for the prior year in a comparative financial statement.

**Q: Will there be any regulatory push back for taking funds out of the ALLL due to CECL accounting standards?**

A: We cannot know for sure how much regulators in the field will push back against individual institutions reducing allowance balances. Communication from the chief accountants of the regulatory bodies has been that if institutions have properly supported a CECL allowance for credit losses that is less than the existing allowance for loan losses balance, recoveries of previous loan loss provision (i.e., “negative provisions”) would be acceptable. It should be noted that there were SEC certain SEC companies that recorded a reduction to their allowance upon adoption of CECL, and more than a few SEC companies, that have adopted CECL, did record negative CECL loan loss provisions during 2021.

**Q: After we arrive at our adjustment for our HTM securities. Would this adjustment also be subject to QF as well?**

A: Yes. All CECL methodologies should incorporate an evaluation of qualitative factors that account for changes between historical loss experience and current and future expected loss experience.

**Q: If all HTM Securities are investment CDs within the NCUA/FDIC limit of $250k would it be sufficient to say based on that coverage no CECL analysis necessary?**

A: Yes, it is very likely an institution can come to a conclusion that no allowance is necessary for CD investments that are entirely covered by NCUA/FDIC insurance.

**Q: Can we assume a $0 allowance for credit losses for certain HTM securities?**

A: Yes, but careful consideration should go into such a evaluation. Institutions should consider the risk of loss even if it is remote, but it is possible to conclude some securities will have no credit losses. For example, securities that are fully guaranteed by the US government, such as US Treasury securities and GNMA securities, should have no credit losses. In addition, institutions *may* be able to conclude *senior* securities issued by US government agencies (e.g., FNMA and FHLMC) will have no credit losses based on no historical losses and the willingness of the US government to support these senior securities in the past.

**Q: Is it appropriate, after considering materiality and a range of reasonableness for the calculation, to not make an adjustment?**

A: If an institution determines the existing allowance for credit losses balance is within a reasonable range of estimated losses after calculating a CECL allowance for credit losses, it would be appropriate to not adjust the existing allowance balance.

**Q: For our loan pools AG operating and AG Real estate we were reading from the ASC code 326-20-30-9 which we interpreted to recommend using a reasonably supported forecast but only for the time period we could reasonably forecast which we felt was two years. Is this how Wipfli interpret this or are we missing something? The commodity futures only go out about 12-18 months, therefore that makes it really difficult to predict the life of the loan pool of 5 years.**

A: CECL requires institutions to consider adjustments for a reasonable and supportable forecast period. In practice, some institutions can support a forecast period of up to three years (in some cases more) while other institutions do not believe they can support forecast adjustments beyond a year. Institutions should future changes impacting expected losses, but only over a reasonable and supportable forecast period.

**Transfers of AFS securities to HTM**

Q: What is the FHLB borrowing requirement - related to capital and impact of AOCI?

A: Certain FHLB borrowing lines may have limitations based on tangible capital. Reductions of AOCI may impact borrowing capacity. In addition, the FHLB cannot make a new advance to a member institution whose tangible capital is not positive.

**Q: Can you give an example of when an institution will be required to sell the security**

A: An institution may determine it is more likely than not it will have to sell a security if, in its liquidity projections, it expects it will have to sell a security available for sale prior to its maturity to provide future liquidity.