CECL Implementation: Practical Ideas to Move Forward

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CECL Implementation: Moving Forward

- CECL Reminders
- Review CECL Methodologies
- Latest Thoughts
- Developing an Action Plan

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CECL Reminders

Institution Type	Effective Date – Annual Periods Beginning After:	Effective Date for Calendar Year-Ends
“Large” public business entities (SEC filers)	12/15/2019 (and interim periods <u>within</u> the first year)	1st quarter of 2020
“Small” public business entities (non-SEC)	12/15/2020 (and interim periods <u>within</u> the first year)	1st quarter of 2021
All other entities	12/15/2021 (and interim periods <u>after</u> the first year)	1st quarter of 2022

- Transition – Cumulative effect adjustment to retained earnings <u>as of the beginning of the year</u>

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CECL Reminders

- Two Financial Instrument Impairment Models

Model	Applies To	Example
CECL	Financial assets measured at amortized cost	Loans Debt securities HTM
"Modified OTTI"	Financial assets measured at fair value with changes in fair value recognized in OCI	Debt securities AFS

  - A model is not required for financial assets measured at fair value with changes in fair value recognized in net income (e.g., equity securities) since impairment will already be recognized in net income

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Review CECL Methodologies

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Review CECL Methodologies

- Any reasonable approach may be used

Simpler

- Loss Rate
- Remaining Life
- Vintage
- Migration (Roll Rate)
- Probability of Default
- Discounted Cash Flow

More Precise

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Review CECL Methodologies

- Which methodology(ies) should we use?
  - No one right answer
  - Institutions may use different methodologies for different loans
  - Could even change over time
  - Each methodology has pros and cons
  - Still need to consider qualitative adjustments for each methodology

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Excel-Based Sample Methodologies

- Snapshot/Loss Rate Calculation
- Migration
- Vintage

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Remaining Life Method

- This will look similar to current methodologies, but there are some important differences
- Calculate an average annual loss rate
- Estimate future outstanding balances based on contractual maturities and estimated prepayments
- Multiply the average annual loss rate by the estimated outstanding balance at each future reporting period
- Add up the estimated losses for each period

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Remaining Life Method

Future Year End	Estimated Paydown (000s)	Projected Balance (000s)	Average Annual Loss Rate	CECL Loss Estimate (000s)
2017		234,000	0.20%	468
2018	75,027	158,973	0.20%	318
2019	63,835	95,138	0.20%	190
2020	43,910	51,228	0.20%	102
2021	51,228	0	0.20%	0
				1,078

- Historical lifetime loss rate = 1,078 / 234,000 = 0.46%

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Remaining Life Method

- Apply average annual loan loss rate to projected loan balances

Pros	Relatively simple and familiar methodology, can leverage current process, can be done internally
Cons	Need to calculate and support projected balances (or amortization adjusted remaining life) and subjective Q factors, could result in large ALL, especially during times of larger losses
Add'l Data	Projected loan balances <u>or</u> calculated amortization adjusted remaining life

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Probability of Default

- Relatively simple formula:
  - Probability of Default (PD)
  - x Loss Given Default Rate (LGD)
  - x Outstanding Principal / Exposure (E)
  - = CECL Loss Estimate
- Can be difficult to calculate/support these inputs without some statistical analysis
- Will generally require special software

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Probability of Default

- Calculate estimated losses based on: probability of default (PD), estimated loss when a loan defaults (LGD), and estimated balance at default (E)

Pros	Very precise, can incorporate Q factors directly into the analysis
Cons	Difficult to calculate the inputs to the analysis without statistical techniques, likely requires special software
Add'l Data	Loan specific data to support the three inputs into the analysis

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Discounted Cash Flow

- Projected cash flows discounted at the loan pool's effective yield
- Need to be able to create an amortization schedule for each loan in the pool that incorporates various inputs (payment amount and schedule, prepayment factor, loss rate, discount rate, etc.)
- A relatively easy model for individual loan analysis
- Can be difficult to complete this for an entire pool
- Will generally require special software

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Discounted Cash Flow

- Estimate future cash flows for each loan and discount cash flows at the effective loan yield

Pros	Very precise, works well for individual loan analysis, can discount future losses (lower ACL)
Cons	Difficult to use for loan pools since it requires detailed cash flow information for each loan, likely requires special software
Add'l Data	Loan specific data to support estimated future cash flows for each loan

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Summary

- Generally all CECL methodologies will be a variant of one of these methodologies or a hybrid of multiple methodologies used together
- No “one size fits all”
- All of these methodologies will also require a qualitative analysis for current conditions and forecasted conditions
- The less precise a methodology is, generally the more qualitative analysis must be completed

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Latest Thoughts

- Federal Reserve and FDIC, along with the CSBS, FASB, and SEC, presented a webinar on February 27, 2018
  - https://www.webcaster4.com/Webcast/Page/583/24368
- Federal Reserve, FDIC, and OCC, along with the CSBS, FASB, and SEC, presented a webinar on July 30, 2018
  - https://www.webcaster4.com/Webcast/Page/583/26144

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Latest Thoughts

- Highlights:
  - Less complex institutions can develop their own methodology(ies)
  - One size doesn't fit all (even within an institution)
  - Expect a good faith effort by the effective date
  - Many concepts used today will be applicable under CECL, though they may be applied differently
  - Will need to forecast losses

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Latest Thoughts

- Challenges highlighted by the regulators:
  - Minimal losses
  - Losses do not have a predictive pattern
  - Small loan pools
  - Not a significant amount of historical data
  - Change in pool/portfolio composition
  - Change in economic environment

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Latest Thoughts

- Other thoughts from regulators:
  - Data availability is a factor when considering the CECL methodology
  - Necessary changes to systems/operations
  - May need to look at peer data if you don't have enough of your own data
  - May need to warehouse data outside of spreadsheets
  - Start now!

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Implementation Challenges

- Accuracy of data
- Overwriting data
- Lines of credit/demand notes
- Loan renewals (origination date)
- Loan duration
- Qualitative factors
- Not enough data (statistically irrelevant)
- Forecasting

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Implementation Challenges

- Issues financial institutions are facing
  - Inappropriate mindset – “This won’t be a significant change” or “This isn’t that important”
  - Not enough or not the right resources
  - Data is not as clean as we thought
  - Project planning, getting started

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Using a Third-Party Model

- Should we purchase a CECL model?

Pros	Cons
Can be relatively easy to run	Significant investment (up front and ongoing)
Can take advantage of more precise methodologies	Greater model risk management
Can run “what if” scenarios	Vendor can’t do all the work
Can be run by multiple people	
Can provide support for Q factors and disclosures	

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Selecting a Third-Party Model

- Factors to consider when selecting (or developing) a model:
  - Investment (cost) – Need to consider all of the cost
  - Is it CECL compliant?
    - Will auditor/regulators accept it?
    - Do we understand it well enough?
  - How will the vendor support it/we maintain it?
  - Ease of use/ease of connection to existing systems
  - Additional features that could be utilized

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BankTrends Model

- Wipfli has partnered with BankTrends to provide access to its web-based CECL solution
- Utilizes call report data and the Remaining Life Methodology – automates certain user input
- Includes peer group data and a statistical forecasting tool
- Current annual price = $7,500 – significantly cheaper than many other models
- Contact your relationship executive to set up a demo

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Developing an Action Plan

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Developing an Action Plan

- Dedicate resources to the process
- Assess the current state
- Identify appropriate loan pools
- Evaluate CECL methodologies
- Accumulate necessary data
- Update roadmap (timeline and milestones)

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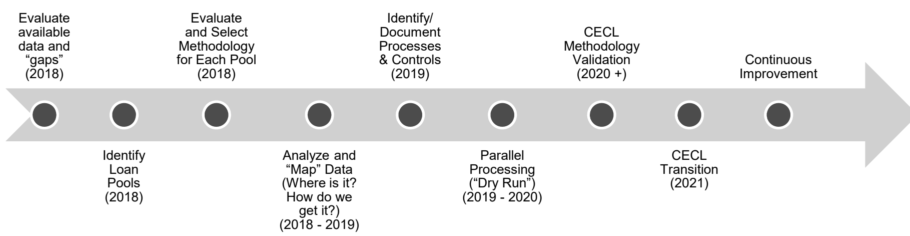
Sample Milestones (non-PBE)



- Data gathering through the whole process
- Not always a "linear" process
- Communication with core vendor, regulator, auditor
- Continue to learn/be prepared to adapt

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How Wipfli Can Help

- Data Evaluation
  - We can review your loan downloads and other loan reports to help identify data gaps and recommend feasible methodologies
- Sample Calculations
  - We can help develop sample calculations (using your data) using certain methodologies, similar to the examples shown previously
- Project Management Assistance
- BankTrends Consulting

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Questions?

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