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Current Expected Credit Loss (CECL): Weighted Average Remaining Maturity (WARM) Method

April 11, 2019

Speakers from:

- ► Board of Governors of the Federal Reserve System (FRB)
- ► Federal Deposit Insurance Corporation (FDIC)
- ► Office of the Comptroller of the Currency (OCC)
- ► U.S. Securities and Exchange Commission (SEC)
- ► Conference of State Bank Supervisors (CSBS)
- ► Financial Accounting Standards Board (FASB)
- ► National Credit Union Administration (NCUA)

Welcome, Everyone

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Today's Presenters

- **FRB**
  - Lara Lylozian, Assistant Chief Accountant
- **FDIC**
  - Robert Storch, Chief Accountant
  - John Rieger, Deputy Chief Accountant
- **OCC**
  - Nicole Cooke, CECL Program Manager
- **SEC**
  - Kevin Vaughn, Office of the Chief Accountant
- **CSBS**
  - Jami Flynn, Director, Supervisory Processes
- **FASB**
  - Shayne Kuhaneck, Assistant Director
- **NCUA**
  - Alison Clark, Chief Accountant

Goals of Today's Session

- Address acceptability and use of the Weighted Average Remaining Maturity (WARM) method
- Review qualitative adjustments
- Discuss supervisory expectations across the agencies
- Answer your questions

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CECL Overview

- CECL is a new accounting standard that changes the accounting for credit losses (allowance).
- Today's accounting practice uses an incurred-loss approach based on historical loss experience, adjusted for current conditions.
- In contrast, CECL is a forward-looking standard that:
  - Uses reasonable and supportable forecasts of economic conditions
  - Recognizes lifetime expected credit losses
  - Applies to financial instruments carried at amortized cost, including all loans held for investment and securities held to maturity
- SEC filers must implement CECL in 2020, and non-SEC filers must implement in 2021 or 2022. Institutions may elect early adoption beginning in 2019.

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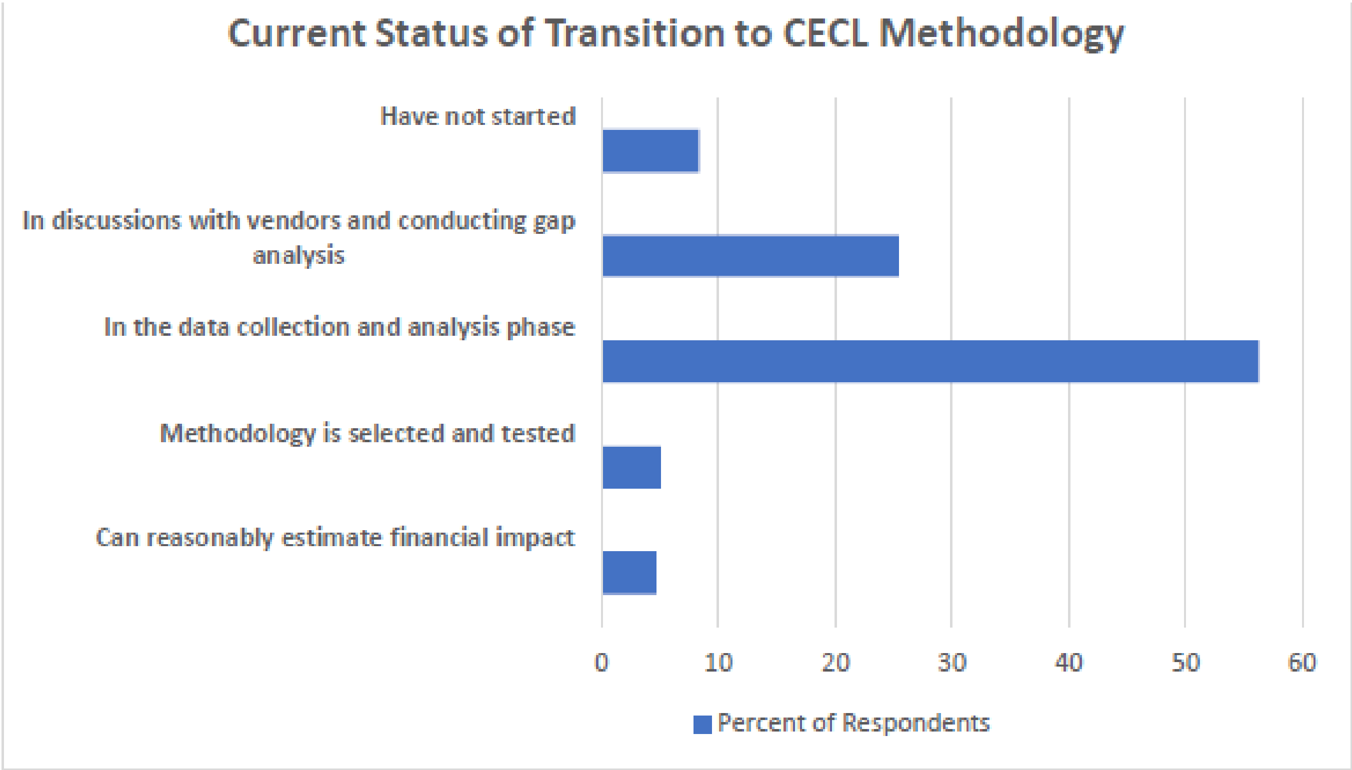
Community Banks are Preparing for CECL in Advance



Source: Community Banking in the 21st Century Research and Policy Conference-2018 National Survey; Co-sponsored by the Federal Reserve System, the CSBS, and the FDIC

Starting Point: Charge-off History

"How can my organization get started on implementing CECL?" *- Common question from smaller institutions*

Consider starting with an analysis of charge-off history . . .

Historical charge-off report

Detailed charge-off reports should be available in periodic reporting to senior management or board of directors

Analyze charged-off loans

Identify attributes of charged-off loans, e.g.:

- Loan type
- Year of origination
- Loan term

If there are other attributes that may be relevant, begin capturing them now

Trends and themes

Which "risk characteristics" do charged-off loans have in common?

What other trends or themes are relevant to estimating expected credit losses?

What is the "lifetime loss rate" for a historical pool of loans?

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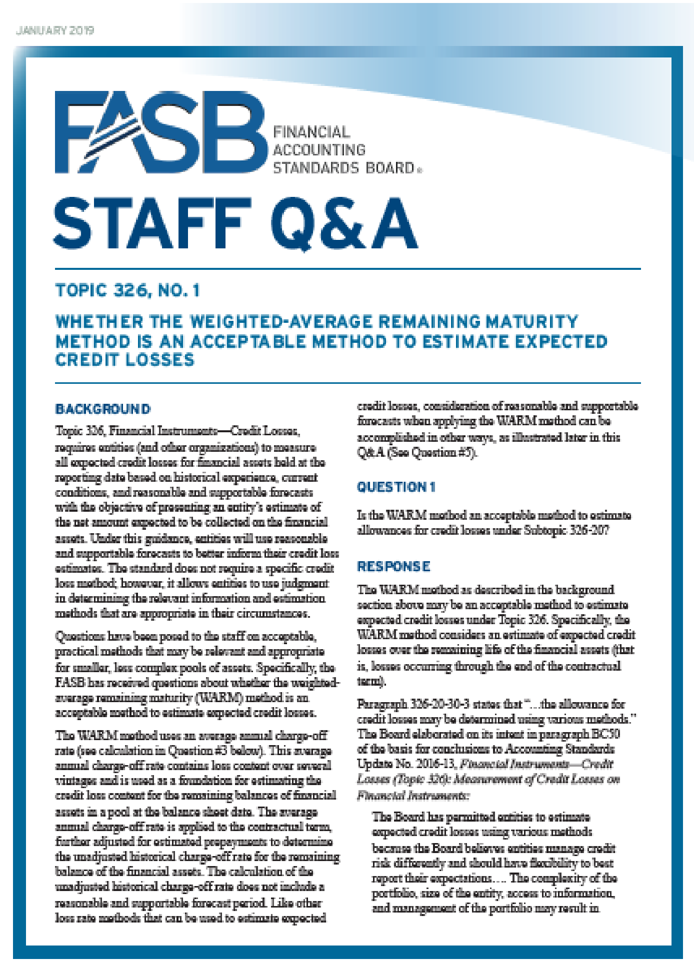
Estimating the Allowance – the WARM Method

WARM Method

Weighted
Average
Remaining
Maturity


JANUARY 2019

FASB FINANCIAL ACCOUNTING STANDARDS BOARD

STAFF Q&A

TOPIC 326, NO. 1

WHETHER THE WEIGHTED-AVERAGE REMAINING MATURITY METHOD IS AN ACCEPTABLE METHOD TO ESTIMATE EXPECTED CREDIT LOSSES

BACKGROUND

Topic 326, Financial Instruments—Credit Losses, requires entities (and other organizations) to measure all expected credit losses for financial assets held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts with the objective of presenting an entity's estimate of the net amount expected to be collected on the financial assets. Under this guidance, entities will use reasonable and supportable forecasts to better inform their credit loss estimates. The standard does not require a specific credit loss method; however, it allows entities to use judgment in determining the relevant information and estimation methods that are appropriate in their circumstances.

Questions have been posed to the staff on acceptable, practical methods that may be relevant and appropriate for smaller, less complex pools of assets. Specifically, the FASB has received questions about whether the weighted-average remaining maturity (WARM) method is an acceptable method to estimate expected credit losses.

The WARM method uses an average annual charge-off rate (see calculation in Question #3 below). This average annual charge-off rate contains loss content over several vintages and is used as a foundation for estimating the credit loss content for the remaining balances of financial assets in a pool at the balance sheet date. The average annual charge-off rate is applied to the contractual term, further adjusted for estimated prepayments to determine the unadjusted historical charge-off rate for the remaining balance of the financial assets. The calculation of the unadjusted historical charge-off rate does not include a reasonable and supportable forecast period. Like other loss rate methods that can be used to estimate expected credit losses, consideration of reasonable and supportable forecasts when applying the WARM method can be accomplished in other ways, as illustrated later in this Q&A (See Question #5).

QUESTION 1

Is the WARM method an acceptable method to estimate allowances for credit losses under Subtopic 326-20?

RESPONSE

The WARM method as described in the background section above may be an acceptable method to estimate expected credit losses under Topic 326. Specifically, the WARM method considers an estimate of expected credit losses over the remaining life of the financial assets (that is, losses occurring through the end of the contractual term).

Paragraph 326-20-30-3 states that "…the allowance for credit losses may be determined using various methods." The Board elaborated on its intent in paragraph BC50 of the basis for conclusions to Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments:*

> The Board has permitted entities to estimate expected credit losses using various methods because the Board believes entities manage credit risk differently and should have flexibility to best report their expectations…. The complexity of the portfolio, size of the entity, access to information, and management of the portfolio may result in

On January 10, 2019 FASB issued [Staff Q&A on WARM.]

WARM Method (continued)

What is the WARM method?

- The remaining life method utilizes average annual charge-off rates and remaining life to estimate the allowance for credit losses (ACL).
- For amortizing assets, the remaining contractual life is adjusted by the expected scheduled payments and prepayments (i.e., paydowns).
- The average annual charge-off rate is applied to the amortization adjusted remaining life to determine the unadjusted lifetime historical charge-off rate.

Average annual charge-off rate X **Amortization adjusted remaining life** = **Lifetime historical charge-off rate**

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WARM Method: Common Questions

What factors should an entity consider when determining whether to use the WARM method?

- How complex is the pool of assets?
- What is the contractual term of the pool?
- Extent of the loss history available
- Are the losses sporadic with no predictive patterns?
- Number of loans in the pool
- Does the composition of the pool vary significantly from historical pools of financial assets?

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Loss Rate Methods: Today and Future

Current U.S. GAAP

Annal / Current Conditions

[Unadjusted historical charge-off experience (Annual) ± Qualitative adjustments (Current Conditions)] X Loss emergence period X Loan category balance = ASC 450 (FAS 5) ALLL

CECL

[Unadjusted historical charge-off experience (Lifetime) ± Qualitative adjustments (Current and Forecast)] X ~~oss em nce peri~~ X Loan category balance = CECL ACL (ASC 326)

WARM Method
Fact Pattern

- **Estimate the allowance for credit losses as of 12/31/2020**
- **Pool of financial assets of similar risk characteristics**
  - Amortized cost basis of ~$13.98 million
  - 5-year financial assets (contractual term adjusted by prepayments)
- **Management expects the following in 2021 and 2022:**
  - Rise in unemployment rates
- **Management cannot reasonably forecast beyond 2022**
- **Assume 0.25% qualitative adjustment to represent both current conditions and reasonable and supportable forecasts.**

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WARM Method (continued)

Step 1: Calculate annual charge-off rate

Table 1: Calculate Average Annual Charge-off Rate				
		A	B	C = B/A
Year	Amortized Cost	Average Balance	Actual Annual Net Charge-offs	Annual Charge-off Rate
2015	$ 5,126			
2016	8,969	7,048	21	0.30%
2017	11,220	10,094	51	0.51%
2018	12,312	11,766	42	0.36%
2019	12,936	12,624	32	0.25%
2020	13,980	13,458	49	0.37%
Balances are in thousands except charge-off rate data				
			Average annual charge-off rate	**0.36%**

Totals may not sum precisely due to rounding.

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WARM Method (continued)

METHOD 1

Step 2: Method 1-Estimate the ACL

Table 2: Estimated Amortized Cost Basis				
		A	B	A*B
Year End	Est. Paydown	Projected Amort Cost	Avg Annual Charge-off Rate	Allowance for Credit Losses
2020 Actual Amortized Cost		$ 13,980	**0.36%**	$ 50
2021	$ 3,700	10,280	**0.36%**	37
2022	3,900	6,380	**0.36%**	23
2023	3,000	3,380	**0.36%**	12
2024	2,160	1,220	**0.36%**	4
2025	1,220	-	**0.36%**	-
Est. unadjusted charge-off amount for remaining balance				126
Paydown & amortized cost balances in thousands				
Unadjusted historical charge-off rate for remaining balance				0.90%
Qualitative Adjustment				0.25%
Total allowance for credit losses rate as of 2020				**1.15%**
Total allowance of credit losses as of 2020 ($13,980 x 1.15%)				**161**

Totals may not sum precisely due to rounding.

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WARM Method (continued)

METHOD 2

Step 2: Method 2-Estimate the ACL

Table 3: Estimated Amortized Cost Basis

Year End	Est. Paydown	Projected Amort Cost	Remg Life	
2020 Actual Amortized Cost		13,980	1.00	
2021	$ 3,700	$ 10,280	2.00	
2022	3,900	6,380	3.00	
2023	3,000	3,380	4.00	
2024	2,160	1,220	5.00	
2025	1,220	-		
Weighted avg amortization adjusted remaining life			2.52	A
Paydown & amortized cost balances in thousands				
Average annual charge-off rate			**0.36%**	B
Unadjusted historical charge-off rate for remaining balance			0.90%	A * B
Qualitative Adjustment			0.25%	
Total allowance for credit losses rate as of 2020			**1.15%**	
Total allowance of credit losses as of 2020 ($13,980 x 1.15%)			**161**	

Totals may not sum precisely due to rounding.

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WARM Method (continued)

METHOD 2

Step 2: Method 2-Formula for 2.52 years

Table 4: Weighted Average Determination

		B	C	D = BxC	D/A
	Year End	**Est. Paydown**	**Remg Life**	**Alternative:**	
2020 Amort Cost		13,980	**A**		
	2021	$ 3,700	1.00	$ 3,700	0.26
	2022	3,900	2.00	7,800	0.56
	2023	3,000	3.00	9,000	0.64
	2024	2,160	4.00	8,640	0.62
	2025	1,220	5.00	6,100	0.44
Paydown balances in thousands					
			2.52	**Sum**	2.52

Excel Formula:

2.52 = Sumproduct (column B: Column C) / A

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WARM Method: Common Questions (continued)

What are the key assumptions for the WARM method?

- Average annual net charge-off rate:
  - Lookback period
- Amortization adjusted remaining life:
  - Paydowns (does not include charge-offs)
    - Contractual principal payments
    - Prepayments
- Qualitative adjustments:
  - Current conditions
  - Reasonable and supportable forecasts

Generally: Amount and number of Qualitative Adjustments are driven by precision of assumptions and model.

WARM Method: Today and Future

2006 Interagency Policy Statement and 326-20-55-4

Incurred (today's methodology)

Qualitative Adjustments = Current Conditions

CECL

New to CECL

Qualitative Adjustments = Current Conditions + Reasonable and Supportable Forecast

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WARM Method: Common Questions (continued)

Are qualitative adjustments still relevant under WARM? If yes, how are they different from what we do today?

- Qualitative adjustments <u>are required</u> under WARM and capture expected future losses not reflected in historical charge-off rates:
  - May change in number and magnitude under CECL
- Identify available information relevant to assessing the collectability of cash flows:
  - Internal or external or a combination of both
  - Internal information may be sufficient
- Available information may relate to:
  - Past events
  - Current conditions
  - Reasonable and supportable forecasts

- Include forward looking information
- <u>Do not need</u> to forecast factors that are NOT relevant

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WARM Method: Common Questions (continued)

Can you give an example of a qualitative adjustment for current conditions?

- Adjustments for current conditions continue to be critical under CECL.
- Adjustments to historical data or charge-offs rates bridge the gap between loans in the current portfolio as of the reporting date and loans in historical data sets.
- Example:
  - The bank's historical losses reflect loans originated under stricter underwriting standards.
  - Loans in the bank's current portfolio reflect loosened underwriting standards when compared with the historical periods used for the WARM lifetime historical loss rate.

WARM Method: Common Questions (continued)

Can you give an example of a qualitative adjustment for reasonable and supportable forecasts?

- Focus on the factors relevant to collectability
- Adjustments do not have to be macroeconomic in nature.
- Acceptable to forecast specific events (e.g., factory closure) even if other forward-looking information is only reasonable and supportable for a shorter period of time
- Example:
  - The bank hears that a company may close a large factory within its footprint. The factory employs a significant number of the bank's borrowers.
  - Later, the company announces it will close the factory in three months.
  - The bank estimates that almost all losses related to the closure will be realized within two years.

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WARM Method: Key Reminders

- The standard allows institutions to use various methods to estimate the amount they expect to collect (e.g., discounted cash flow, roll-rate, probability of default (PD/LGD), aging schedule).
- The WARM method is ***not*** a regulator preferred or a "safe harbor" method.
- There is no one method that is appropriate for every portfolio.

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Supervisory Expectations

Supervisory Expectations

- If you haven't started yet, get started!
  - Familiarize yourself with the standard, review the Joint Statement on the New Accounting Standard on Financial Instruments-Credit Losses from June 17, 2016 and the Interagency FAQs
  - Determine your effective date
  - Identify impacted areas
  - Determine steps and timing to implement
  - Begin data analysis
  - Evaluate and plan for capital impact
- Examiner communication
- Documentation and governance:
  - Continued applicability of guidance
    - 2001 and 2006 Interagency Policy Statements
    - Staff Accounting Bulletin No. 102

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Closing Remarks

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Resources

- FASB:
  - FASB CECL Standard (core guidance p.101-123)
  - Transition Resource Group (TRG)
  - TRG – Meeting Materials
- Interagency:
  - "Joint Statement on the New Accounting Standard on Financial Instruments – Credit Losses"
  - "Frequently Asked Questions on the Current Expected Credit Losses Methodology (CECL)"
  - Community Bank Webinar: Implementation Examples for the Current Expected Credit Losses Methodology (CECL), February 27, 2018
  - CECL Questions and Answers for Community Institutions, July 30, 2018
- Federal Reserve (webinars):
  - CECL Update: Frequently Asked Questions, October 3, 2017
  - Conversations with Industry Experts: Financial Accounting Standards Board (FASB) on Current Expected Credit Loss (CECL), July 28, 2016
  - Current Expected Credit Loss (CECL) Update: Current Supervisory Views, October 5, 2016

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Resources (continued)

- FDIC:
  - Accounting and Auditing Resource Center
- OCC:
  - CECL Homepage on BankNet
  - CECL Reference Guide for Bankers
  - CECL Call Report Effective Date Decision Tree
  - CECL Webinar Series
    - Part 1: Introducing CECL
    - Part 2: Implementation Considerations
    - Part 3: Debt Securities
    - Part 4: Data and Methods
    - Part 5: Third-Party Risk Management & CECL
    - Part 6: Purchased Credit Deteriorated Loans
    - Part 7: The Halfway Point
    - Part 8: The WARM Method
  - Dedicated Mailbox: CECL@occ.treas.gov
- CSBS:
  - Resource Center
- AICPA:
  - Accounting for Credit Losses

Acronyms

- ACL – allowance for credit losses
- AICPA – American Institute of Certified Public Accountants
- ALLL – Allowance for Loan and Lease Losses
- ASC – Accounting Standards Codification
- CECL – Current Expected Credit Losses
- CSBS – Conference of State Bank Supervisors
- FAS – FASB Accounting Standard
- FASB – Financial Accounting Standards Board
- FDIC – Federal Deposit Insurance Corporation
- FRB – Federal Reserve Bank
- GAAP – Generally Accepted Accounting Principles
- NCUA – National Credit Union Administration
- OCC – Office of the Comptroller of the Currency
- PD/LGD – probability of default/loss given default
- SAB – Staff Accounting Bulletin
- SEC – Securities and Exchange Commission
- WARM – weighted average remaining maturity

Thanks for joining us