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

- If you must dial in through the phone, please be aware that slides will be delayed. A copy is available under the Materials button in the webinar tool.

- This call is being recorded and will be available immediately following the session:
  - The archived recording can be accessed using the same link as today’s webinar.

- A survey will be delivered via email following the call. You must fill out this survey to receive CPE credits for this session.

- Email your question to: rapid@stls.frb.org

- Use the “Ask Question” button in the webinar tool
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
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.
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
“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?
Estimating the Allowance – the WARM Method
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.
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?
Loss Rate Methods: Today and Future

Current U.S. GAAP

- Annual
  - Unadjusted historical charge-off experience
  - Qualitative adjustments
- Current Conditions
  - Loss emergence period
- Loan category balance

ASC 450 (FAS 5) ALLL

CECL

- Lifetime
  - Unadjusted historical charge-off experience
  - Qualitative adjustments
- Current and Forecast
  - Loss emergence period
- 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.
WARM Method (continued)

Step 1: Calculate annual charge-off rate

<table>
<thead>
<tr>
<th>Year</th>
<th>Amortized Cost</th>
<th>Average Balance</th>
<th>Actual Annual Net Charge-offs</th>
<th>Annual Charge-off Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$ 5,126</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>8,969</td>
<td>7,048</td>
<td>21</td>
<td>0.30%</td>
</tr>
<tr>
<td>2017</td>
<td>11,220</td>
<td>10,094</td>
<td>51</td>
<td>0.51%</td>
</tr>
<tr>
<td>2018</td>
<td>12,312</td>
<td>11,766</td>
<td>42</td>
<td>0.36%</td>
</tr>
<tr>
<td>2019</td>
<td>12,936</td>
<td>12,624</td>
<td>32</td>
<td>0.25%</td>
</tr>
<tr>
<td>2020</td>
<td>13,980</td>
<td>13,458</td>
<td>49</td>
<td>0.37%</td>
</tr>
</tbody>
</table>

Balances are in thousands except charge-off rate data

**Average annual charge-off rate** 0.36%

Totals may not sum precisely due to rounding.
## Step 2: Method 1 - Estimate the ACL

<table>
<thead>
<tr>
<th>Year End</th>
<th>Est. Paydown</th>
<th>Projected Amort Cost</th>
<th>Avg Annual Charge-off Rate</th>
<th>Allowance for Credit Losses</th>
</tr>
</thead>
<tbody>
<tr>
<td>2020 Actual Amortized Cost</td>
<td>$13,980</td>
<td>0.36%</td>
<td>$50</td>
<td></td>
</tr>
<tr>
<td>2021</td>
<td>$3,700</td>
<td>10,280</td>
<td>0.36%</td>
<td>37</td>
</tr>
<tr>
<td>2022</td>
<td>$3,900</td>
<td>6,380</td>
<td>0.36%</td>
<td>23</td>
</tr>
<tr>
<td>2023</td>
<td>$3,000</td>
<td>3,380</td>
<td>0.36%</td>
<td>12</td>
</tr>
<tr>
<td>2024</td>
<td>$2,160</td>
<td>1,220</td>
<td>0.36%</td>
<td>4</td>
</tr>
<tr>
<td>2025</td>
<td>$1,220</td>
<td>-</td>
<td>0.36%</td>
<td>-</td>
</tr>
</tbody>
</table>

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.
Step 2: Method 2-Estimate the ACL

### Table 3: Estimated Amortized Cost Basis

<table>
<thead>
<tr>
<th>Year End</th>
<th>Est. Paydown</th>
<th>Projected Amort Cost</th>
<th>Remg Life</th>
</tr>
</thead>
<tbody>
<tr>
<td>2020 Actual Amortized Cost</td>
<td>13,980</td>
<td>13,980</td>
<td>1.00</td>
</tr>
<tr>
<td>2021</td>
<td>3,700</td>
<td>10,280</td>
<td>2.00</td>
</tr>
<tr>
<td>2022</td>
<td>3,900</td>
<td>6,380</td>
<td>3.00</td>
</tr>
<tr>
<td>2023</td>
<td>3,000</td>
<td>3,380</td>
<td>4.00</td>
</tr>
<tr>
<td>2024</td>
<td>2,160</td>
<td>1,220</td>
<td>5.00</td>
</tr>
<tr>
<td>2025</td>
<td>1,220</td>
<td>-</td>
<td>-</td>
</tr>
</tbody>
</table>

Weighted avg amortization adjusted remaining life: 2.52 A

**Paydown & amortized cost balances in thousands**

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Average annual charge-off rate</td>
<td>0.36% B</td>
</tr>
<tr>
<td>Unadjusted historical charge-off rate for remaining balance</td>
<td>0.90% A * B</td>
</tr>
<tr>
<td>Qualitative Adjustment</td>
<td>0.25%</td>
</tr>
<tr>
<td>Total allowance for credit losses rate as of 2020</td>
<td>1.15%</td>
</tr>
</tbody>
</table>

Total allowance of credit losses as of 2020 ($13,980 x 1.15%) = 161

Totals may not sum precisely due to rounding.
Step 2: Method 2-Formula for 2.52 years

<table>
<thead>
<tr>
<th>Year End</th>
<th>Est. Paydown</th>
<th>Remg Life</th>
<th>Alternative:</th>
</tr>
</thead>
<tbody>
<tr>
<td>2020 Amort Cost</td>
<td>13,980</td>
<td>A</td>
<td></td>
</tr>
<tr>
<td>2021</td>
<td>$3,700</td>
<td>1.00</td>
<td>$3,700 0.26</td>
</tr>
<tr>
<td>2022</td>
<td>3,900</td>
<td>2.00</td>
<td>7,800 0.56</td>
</tr>
<tr>
<td>2023</td>
<td>3,000</td>
<td>3.00</td>
<td>9,000 0.64</td>
</tr>
<tr>
<td>2024</td>
<td>2,160</td>
<td>4.00</td>
<td>8,640 0.62</td>
</tr>
<tr>
<td>2025</td>
<td>1,220</td>
<td>5.00</td>
<td>6,100 0.44</td>
</tr>
</tbody>
</table>

Paydown balances in thousands

Excel Formula:

\[ 2.52 = \text{Sumproduct (column B: Column C)} / A \]
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

Inurred (today’s methodology)

\[
\text{Qualitative Adjustments} = \text{Current Conditions}
\]

CECL

\[
\text{Qualitative Adjustments} = \text{Current Conditions} + \text{Reasonable and Supportable Forecast}
\]

2006 Interagency Policy Statement and 326-20-55-4
Are qualitative adjustments still relevant under WARM? If yes, how are they different from what we do today?

• Qualitative adjustments are required 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
- Do not need to forecast factors that are NOT relevant
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.
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.
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.
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
Closing Remarks
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
  - Current Expected Credit Loss (CECL) Update: Current Supervisory Views, October 5, 2016
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
• 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

THANK YOU