Early Observations on the Results of Preliminary CECL Calculation Testing

Ardmore is working with its software partner Argus Information and Advisory Services to assist our 2020 CECL banks with their transition. We have started running calculations using CECL life of loss calculations, including current Q factors but without adding projections, to see how the amount of reserves may be impacted. What follows are some notes about the results of our preliminary testing.

Based on the CECL calcs completed so far on our 2020 community banks ($1 - $3 Billion in assets) we are seeing anywhere from a 10% - 70% jump in total ACL. The severity of the variance in reserves – as expected, has to do with the amount of actual losses in history, the amount of historical data available and types of assets in the portfolio (tenor, risk rating) as well as the size of the asset pools.

A couple of early general observations from our CECL analysis so far FYI:

- The actual quarterly calculation process is not likely to be much different than today. The set-up of the CECL calculations (LOL, data assessed/used, sub pools, logic of the methodologies used) will be the most difficult part to create and understand. Of course, the Bank will need to understand and explain all of it, so the pain of CECL for most banks is mostly "up front".

- As we have been predicting, the management of Q factors will be probably the most important consideration for community banks. For example, one Bank we tested (about $1Billion, mostly Ag loans) currently has Q factors that are almost 10X their actual ALLL reserve calc - due to the lack of loss history. So, the impact of CECL on their reserve amount is actually relatively small - about a 10% difference on the total reserve calc amount. It's the amount of Q factors that will be the difference.

- If this bank can reduce some of their current Q factors under CECL (in a reasonably supportable and justifiable way) and then add some smaller new Q factors for projections, they may be able to actually reduce their total ACL to be about the same as their current ALLL amount. This process is where the artistry in Q-factor construction and justification (justified with portfolio reporting and analysis) comes in.

  This is "the next frontier" for CECL that is currently evolving in the industry. Argus and Ardmore will offer support to its clients that are creating Q factors through delivering a series of reports from the CPM software suite that show portfolio analytics – including portfolio concentrations, trends and potential correlations with economic factors. It is totally up to the institution themselves to establish the rationale and support for their potential ACL adjustments. The CPM reports are intended to offer data to support the justification the bank creates for their Q factor adjustments.

Relating to the question of which methodologies should be used for calculating the life of loan loss, the fact is that best practices for community banks in this specific area are still being established. For our first cut we are running all of an institution's asset pools through both vintage and cohort life of loan loss rate methodologies to see the results. (These two are the methods most like the current methodologies and are readily able to be used with current data). As discussed, other more sophisticated data heavy methods

like DCF and PD are more likely future options should it become clear that these are indeed achievable at reasonable cost and considered a "best practice" by auditors and examiners.

Currently, our approach to asset pooling ("portfolio segmentation") has been to start the process with existing pooling structures as a starting point as they are class code/asset based and match loss history data currently available. Once we complete the run through these models using the current pool structure, we can "experiment" with further pool disaggregation's or aggregations including leveraging risk-based data characteristics.

Until we can prove that such modifications actually "move the needle" for the CECL calculations for community banks, we are hesitant to recommend a bank use its resources to test out the vast variety of pooling possibilities. We will typically be creating sub pools within the vintage calculation for tenor bands and sub pools by risk ratings within the cohort method during our first tests, however.

New CECL FAQ from the Agencies

On April 3rd, the FDIC published an update to their "Frequently Asked Questions" document on CECL first published in 2016. A number of the updates dealt with technical issues including explaining the new "three-year smoothing" option for the one-time capital hit caused by the CECL transition, clarifying the transition date for non-Public Business Entities ("PBE"), and the impact of CECL on the Call Report. What follows are some other notable highlights of other new items included in this update.

Note: These are Ardmore's observations, to access the entire FIL please go to the following web address: https://www.fdic.gov/news/news/financial/2019/fil19020a.pdf

FAQ 39 Addresses the potential adoption of the nine-quarter projection period for CECL based on the fact that the Fed uses that period for it's DFAST (Dodd Frank Stress Testing) and CCAR (Capital test) projections. The FDIC says that an institution should not automatically adopt the nine-quarter period for it's loss projections and instead that period should be established based on bank management's expectations. "*Each institution's reasonable and supportable forecast periods for financial and regulatory reporting purposes should be properly supported and documented independent of the stress testing process*".

FAQ 40 Continues to clarify that the economic scenarios used by the Fed for future economic views should not be used by banks as a projection of economic conditions for their CECL loss projections. "*In contrast, the forecasts used for estimating expected credit losses under CECL should incorporate economic variables and other factors relevant to the collectability of an institution's portfolios based on management's expectations*."

FAQ 42 Reinforces the Agencies stance on not recommending a specific methodology or type of methodology for the CECL calculation. "*The agencies will not provide an approved formula or mandate a single approach...the agencies are closely monitoring interpretations of the new accounting standard and implementation practices…within the range of U.S. GAAP*".

FAQ 44 Speaks to the issues of applying new internal controls around data used to perform CECL calculations. While explaining that the application of controls should be appropriate for the

complexity of the institution, the FDIC points out that the CECL calculation uses new data items that were not previously under scrutiny for regulatory reporting. "*The design and implementation of an internal control environment … is essential for data that were not previously collected or maintained or were not previously used for financial and regulatory reporting*".

FAQ 45 Tries to clarify how CECL is to be addressed by "smaller, less complex institutions". The Agencies will not define what a "smaller less complex institution" is, but do suggest that if an institution is performing it's ALLL calculation today in a less complex manner, it should be similarly acceptable to perform it's CECL calculation in a less complex way. While offering no specifics, the FAQ states: "*This aspect of the supervisory guidance will remain applicable under CECL, just as it is under today's incurred loss methodology*".

FAQ 46 is the last new item addressed and goes into detail about the institution's responsibilities to create, document and maintain their CECL calculation and ACL methodology – similarly to how the ALLL is managed today. Some highlights include:

"…*management is expected to adopt and adhere to written policies and procedures and to maintain written supporting documentation…for the following:*

(1) The systems and controls that support the maintenance of the ACL at an appropriate level
(2) The ACL methodology;
(3) Loan grading system(s) or process(es);
(4) Summary or consolidation of the ACL balance;
(5) Validation of the ACL methodology; and
(6) Periodic adjustments to the ACL process, as necessary."

Ardmore Banking Advisors periodically publishes updates regarding the CECL rule, it's impact on community banks and how best to apply it. These updates are the opinion of Ardmore Banking Advisors analysts and are not intended represent information approved by regulatory agencies or treated as such.