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Notes from the Ambassador Bank Vault **December 11, 2018**

A Look at CECL: Highlights from the ABA Accounting Meeting

"Why, sometimes I've believed as many as six impossible things before breakfast." Lewis Carroll, Alice in Wonderland.

We participated in the American Bankers Association ("ABA") accounting, administrative, and investor committee meeting held in Washington, D.C. on December 6, 2018. The roundtable forum discussed the potential impact (operationally and from an investor perspective) that will likely result from the implementation of the Financial Accounting Standards Board ("FASB") rule change regarding accounting for loan loss reserves (Current Expected Credit Losses). We left with the sense that the new standard (commonly referred to as "CECL") may be good in theory, but it is hard to justify that the benefits will be worth the considerable resources (financial, time, and other) that banks and investors must devote to this complex accounting rule.

- The ABA roundtable forum included accounting/finance officers from national, regional, and community banks. Other participants included investors, sell-side analysts, auditors, FASB, SEC, and Public Company Accounting Oversight Board (PCAOB").

- CECL requires banks to immediately establish loss reserves for potential losses over the contractual life at the time a financial asset is originated or purchased based on reasonable and supportable assumptions.

- CECL is a more forward looking and subjective accounting approach to determine credit reserves compared with the current method (incurred loss), which records losses when it becomes probable that a loan becomes impaired.

- CECL does not specify a single method for measuring expected losses - individual banks decide how to best measure the appropriate loss estimation method. **This will initially make it more difficult for analysts and investors to compare banks and in turn, to determine appropriate valuations.**

- CECL is expected to have significant impact on impairment estimates, capital ratios, and lead to more earnings volatility.

- A preliminary estimate is that loan loss reserves could be 20-30% higher under CECL versus the current method. Although the accounting method will change, the economic impact (cash flows) will be the same.

- FASB believes that CECL will provide investors with more timely information to better assess credit quality and help banks better cope with the next credit downturn.

- We applaud the ABA's commitment to educate and familiarize the banking community with CECL, which is one of the more challenging accounting changes in decades for banks.

The implementation of CECL will become effective in 2020 for SEC filers. All other filers have an additional year. Early adoption is permitted for fiscal years beginning after December 15, 2018 – we do not expect many banks will "take advantage" of this. In addition to impacting banks' loan portfolios, CECL also includes investment portfolios classified as held-to-maturity. The standard also changes the impairment model for available-for-sale debt securities. This accounting method takes into account expected losses over the life of the loan of both non-impaired loans and investment securities and is a significant change over the incurred loss model.

Is your bank ready for CECL?

An in-depth analysis of how banks determine loan loss reserves under CECL was beyond the scope of the ABA roundtable and this article**. We do, however, recognize, that most institutions have started to prepare for the new standard.** CECL is more than just accounting: other areas of the bank that are involved include finance, information technology and risk management, lending, credit, and investor relations.

We believe that community banks are closely monitoring historical loss information and loan losses procedures, but outside consultants will be needed in many instances, particularly among smaller institutions. At the end of the day however, it will be the banks' responsibility. Because prescriptive guidance is not provided regarding how to develop estimates under CECL, management will need to evaluate the reasonableness of its assumptions and provide satisfactory documentation for the benefit of auditors and regulators. Estimates of CECL should include historical information, current economic conditions, and "reasonable and supportable forecasts". The standard does not prescribe a specific method to make the estimate and does not include a definition of "reasonable and supportable".

When will SEC disclosures be required?

It was recommended that material information be disclosed when data is reliable and known to the registrant. It was also suggested (outside this forum) that initial CECL disclosures will be part of the *Risk Factors* section of the Annual Report on Form 10-K for the year ending December 2018.)

Participants at the ABA forum indicated that with an implementation deadline of 2020, parallel models should be tested soon and that the models should improve over time. That said, we expect that there will be far more qualitative versus quantitative data disclosed until at least the second half of 2019.

Are higher loan loss reserves probable?

We believe that because FASB concluded that the incurred loss model inadequately accounted for credit losses prior to the Great Recession, it is logical to infer that the CECL model was intended to produce higher loss estimates and reserves. A preliminary estimate is that loan loss reserves levels could be 20-30% higher under CECL compared with the current, or incurred loss, method.

Given our belief that CECL will result in higher loss allowances compared with the incurred loss model; it follows that many companies will significantly boost reserves upon adoption. If such is the case, the initial adjustment is recorded by lowering retained earnings, but will <u>not</u> be recorded through the income statement. Call it a matter of timing or what you will, but there is an incentive to wait for more complete data and record the one-time adjustment to equity, rather than incur higher loan loss provisions earlier in anticipation of CECL.

There was a discussion on whether the FASB would favor a split loan loss provision between current originations and loans from prior periods. It's not definite, but it appears at this time that all originations will be treated the same way under CECL. It was noted that any splitting of the loan loss provision was initially viewed as costly and arbitrary.

Will loan loss provisioning under CECL be pro-cyclical?

We're afraid that the jury is still out on this question. In theory, CECL is counter-cyclical, but will depend on the economic and financial assumptions that individual entities use to determine potential loss models. In practice, however, it is difficult to model material losses when times are good and even more difficult to model insignificant losses when times are bad.

What happens to earnings comparisons? (Or, can you compare apples to oranges?)

Stocks typically trade on a forward-looking basis, but bank investors and analysts will have more difficulty than usual when forecasting earnings for 2020 due to CECL. We surmise that as the implementation date of CECL approaches, bank management teams will be pressed to provide information regarding the likely impact of the new accounting standard regarding loan losses.

Due to the more subjective nature of CECL, it will probably be harder to compare banks and develop more meaningful peer and year-over-year comparisons. As aforementioned, the cash flows may not change, but the sell-side analysts noted that most investors focus on income statements, rather than the statement of cash flows. It was also proposed that at least initially, CECL will act as a constraint on bank valuations and possibly mergers and acquisitions. It was also suggested that CECL will not be a reason to avoid owning bank stocks, but may be a reason to own less of them.

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