4 ADVANTAGES OF **ALLL SCENARIO BUILDING**

sageworks®

ED BAYER, VICE PRESIDENT
JOHNATHAN WILLIAMS, ACCOUNT EXECUTIVE

TABLE OF CONTENTS

Executive Summary - - - 3

Introduction - - - 4

Provision Expense Planning by Quarter (or Month) - - - 5

Altering Look-Back Period - - - 7

Changing Loss Methodologies - - - 9

Capital Planning for CECL - - - 10

Conclusion - - - 11

Endnotes and Additional Resources - - - 12

About Sageworks & the Author - - - 13

This whitepaper was written or last modified on Jan. 28th, 2015

EXECUTIVE **SUMMARY**

Successful banks and credit unions have learned that, in addition to compliance with current regulatory expectations, they must be mindful of future regulatory demands and plan accordingly. Proactive institutions have taken aggressive approaches to prepare for impending regulatory changes: to both understand the requirements and put in place the procedures that will allow them to comply. These proactive steps will help improve examiner relationships, reduce regulatory and accounting risk and aid in strategic planning at the board level.

This planning extends to managing the allowance for loan and lease losses (ALLL).

Though it may be an often overlooked device for managing the ALLL, scenario planning enables bankers and auditors to assess the outcome of the ALLL calculation under various assumptions or "scenarios." This process is similar to stress testing, where institutions build various scenarios of stress and apply them to the portfolio to determine its stability or risk of loss.

INTRODUCTION

WEBINAR ON STRATEGIC PLANNING:

Building a Better ALLL: What You Need in Your Strategic Plan

Scenario planning is a way to estimate the impact that ALLL-calculation variables may have on the final reserve without performing a completely new calculation.

This process can be challenging, especially for institutions that use spreadsheets or disparate systems to perform the ALLL calculation. It can be difficult to capture and manage the data necessary to build historic trends, but data management is an imperative step towards creating projections and running multiple scenarios.

In this paper, we examine four common components, scaling from tactical to more strategic, of the ALLL calculation for which banks can implement the strategy of scenario building (although admittedly there are many more) and realize some strategic advantage:

1. Tactical planning for the quarterly (or monthly) provision

2. Altering look-back period

3. Changing loss methodologies

4. Capital planning for the FASB's CECL model

PROVISION EXPENSE PLANNING **BY QUARTER (OR MONTH)**

For many institutions, the process for calculating the provision each quarter bore some resemblance to the below example:

Month closes; accounting/finance develop final balances, charge offs, recoveries; credit department and special assets work ASC 310-10-35 (FAS 114) impairments by gathering total recorded investments, recent appraisals, adjusted selling costs and tax liens; meanwhile, controller and/or CFO wait for these completions, then calculate ASC 450-20 (FAS 5) loss rates and make adjustments to qualitative risk factors; and finally a lucky individual is tasked with creating all the necessary documentation to support this adjustment.

ADDITIONAL RESOURCE:

See the difference between manual and automated ALLL calculations:

ALLL Timelines

The above process is a 2-3 week, meticulous experience that many community banks still endure each quarter. And given the criticality of the ALLL and the provision expense to board presentations, the process is often rushed in order to finish in time for board reporting. This leaves little room for planning or analysis in advance of releasing final numbers.

Banks and credit unions that have optimized the process can perform what-if scenarios in advance in order to forecast an expected provision expense for the quarter (or month) and plan accordingly. Oftentimes institutions that automate the ALLL calculation with a software solution are able to conduct what-if scenarios, thanks to accessible data archives and increased efficiencies across the calculation.

PROVISION EXPENSE PLANNING **BY QUARTER** (CONT.)

These efficiencies could include the following:

- Extracting up-to-date balances on ASC 450-20 (FAS 5) homogenous pools
- ASC 310-10-35 (FAS 114) impairment analyses
- Expected/anticipated charge-offs
- Moving the loss rates forward
- Adjusting and documenting external qualitative risk factors
- Other steps requiring manual processes

Institutions that can practice scenario building will have an expected provision range already determined before the end of the quarter or month. This not only gives the institution a chance to plan; it also can serve as a signal to auditors and examiners that the institution is proactive with risk management efforts.

The expected range may also allow the institution to leverage capital efficiently, without being held up by the ALLL calculation's delays. Instead, capital commitment planning can exist virtually independently from the ALLL.

ALTERING **LOOK-BACK PERIOD**

Scenario planning also allows an institution to examine the impact of using different look-back periods.

The example below showcases how an institution's historical loss rate may be markedly different after changing this one variable. In the first table, the bank uses a four-quarter look-back period, with an average loss rate of 3.2612 percent. However, when the bank incorporates an additional four quarters into the look-back period, a larger amount of loss is factored in, and the overall average increases to 5.8529 percent.

Section 1: Historical Loss Rate Method

Period Ending Dates	6/30/2014	3/31/2014	12/31/2013	9/30/2013	Average
Loss Rates	-0.0922 %	7.6005 %	5.4777 %	0.0586 %	3.2612 %

6/30/2014	3/31/2014	12/31/2013	9/30/2013	6/30/2013	3/31/2013	12/31/2012	9/30/2012	Average
-0.0922 %	7.6005 %	5.4777 %	0.0586 %	0.0694 %	29.2180 %	4.2803 %	0.2105 %	5.8529 %

This variability in look-back period (four to eight quarters) yielded a considerable difference in loss experience.

ALTERING **LOOK-BACK PERIOD** (CONT.)

Aside from changing the length of the period, banks can also build scenarios by using different time periods (annual, quarterly or even monthly loss rates) or by weighting certain periods.

Banks with drastically decreasing or increasing portfolios may find a material difference and benefit from a more granular view when switching from a two-year to a 24-month look-back period.

In addition, twelve quarters may be most appropriate for the bank or credit union, but recent quarters may be more indicative of the current economy. An appropriate scenario to test, then, would weight the most recent four quarters at 40 percent while the remaining eight are weighted across 60 percent.

RECORDED WEBINAR:

How to Justify Q Factors in Periods of Low Loss

Adjusting or at least testing look-back windows can be a very timely exercise for institutions, now when many banks and credit unions are trying to maintain their ALLL levels. In this instance, institutions may wish to examine alternate scenarios, including different look-back windows, to ensure their ALLL levels are reflective of probable and estimable credit losses.

CHANGING **LOSS METHODOLOGIES**

Another instance in which financial institutions can use scenario building is to calculate the impact of changing loss methodologies, such as transitioning from a historical loss methodology to migration analysis.

Because the transition may result in a material difference (increase or decrease) in loss experience, it is recommended to estimate the impact before the change is made. The results may lead to one of the following conclusions:

1. The difference is relatively negligible, and the loss methodology change will occur immediately.

2. The difference is relatively sizable, and the institution will wait until year-end to make the change to allow for the provision increase/decrease to be better digested.

3. The difference is large, and buy-in from examiners is preferred before making the adjustment.

If an institution is operating "very efficiently" without much of a capital cushion, a provision to the ALLL is even more significant, making scenario planning all the more advantageous. It provides the bank or credit union with foresight into the provision amount caused by methodology changes, so the institution does not compromise capital thresholds.

RELATED ARTICLE:

Implementing Migration Analysis for the ALLL?

CAPITAL PLANNING FOR **CECL**

DID YOU KNOW?

Sageworks will host a CECL webinar with top accounting firms upon release of guidance?

Register for the Webinar

A final benefit that comes with scenario planning is increased preparedness for the Financial Accounting Standards Board's proposed Current Expected Credit Loss (CECL) model. This proposed model will require institutions to consider expected rather than incurred losses as required by today's guidance.

That change will likely expand the loss horizons institutions must use for estimating allowances for non-impaired loans and will likely cause the allowance for non-impaired assets to rise from current levels[1]. In a February 2014 survey conducted by Sageworks, 50 percent of more than 500 banking professionals believed the proposal would increase reserves between 10 and 50 percent[2].

It is expected that when the new guidance is effective, an institution would need to record a one-time capital adjustment to account for the new methodology. While there are no immediate steps required, it is recommended for institutions to proactively review processes, methods and balances now to assess whether they are flexible enough to account for these and other future changes. Scenario planning could show the institution's worst-case scenario and help answer questions like:

- *If I needed to adjust my reserve by +50 percent, do I have sufficient capital?*
- *If the new model requires a 20 percent increase to the ALLL, how does that affect my Tier 1 ratio?*
- *How much of an increase to the ALLL can my bank handle without having capital adequacy issues?*

CONCLUSION

The advantages of scenario planning within the ALLL may extend beyond the four benefits outlined within this paper, including foresight for provision expense planning, loss-period determination, methodology changes and capital consequences of CECL[3].

Admittedly, the ability to run many of these scenarios relies on an institution's ability to not only capture a significant amount of data, but also its abilities to aggregate and query that data. Institutions that collect loan-level detail, store and archive month-end loan files and have access to this data for reporting will be able to run multiple scenarios. These institutions will better know and understand their ALLL and will be well-positioned to both examine the impact of future regulation and explore various possibilities for improving the ALLL calculation.

ENDNOTES

[1] Haynes, Lee. "Accounting & Auditing Update - Let's Talk About CECL." *Elliott Davis.* April 2014

www.elliottdavis.com/assets/2014-risk-management-seminar-accounting-update.pdf

[2] "How much will the CECL model impact allowance levels?" Sageworks 24 Feb. 2014. http://www.sageworks.com/blog/post/2014/02/24/how-much-will-CECL-model-impact-allowance-levels-polls.aspx

[3] "Global Banking 2020: Foresights & Insights" Knowledge@Wharton, The Wharton School, Ernst & Young, 2011.

http://www.kw.wharton.upenn.edu/ey-global-banking/global-banking-2020/

ADDITIONAL **RESOURCES**

ALLL.com by Sageworks, *the destination website for the ALLL*

http://www.ALLL.com

"e-Book: The Complete Guide to the ALLL," *Sageworks.*

http://web.sageworks.com/complete-guide-ALLL-reserves/

Bayer, Ed and Regan Camp, "Qualitative Risk Factors: How to Add Objectivity to an Otherwise Subjective Task," *Sageworks.*

http://web.sageworks.com/qualitative-risk-factors/

ALLL Forum for Bankers, *LinkedIn.*

http://www.linkedin.com/groups?gid=4844399

ABOUT **SAGEWORKS & THE AUTHORS**

Sageworks
Sageworks is a financial information company that works with financial institutions, accountants and private-company executives across North America to collect and interpret financial information. Sageworks provides a web-based suite of solutions to streamline credit analysis, risk rating, portfolio stress testing, loan administration and ALLL calculation.

Sageworks ALLL
Sageworks ALLL is an automated solution for calculating and documenting the allowance calculation. It helps bankers automate their ALLL process and add consistency to their methodology, making it defensible to auditors and examiners. To find out more, visit www.sageworksanalyst.com.

Johnathan Williams is an account executive at Sageworks, where he assists institutions with automating their allowance for loan and lease losses (ALLL), stress testing processes, and loan portfolio administration. He received his bachelor's degree from University of North Carolina at Charlotte.

Ed Bayer is a vice president at Sageworks. He previously served as senior risk management consultant, with a primary focus on allowance for loan and lease losses methodology and stress testing loan portfolios. He received his MBA from Vanderbilt University's Owen Graduate School of Management, and he received his bachelor's degree from the University of Tennessee.