Remaining Life

A Viable CECL Methodology for Some Financial Institutions

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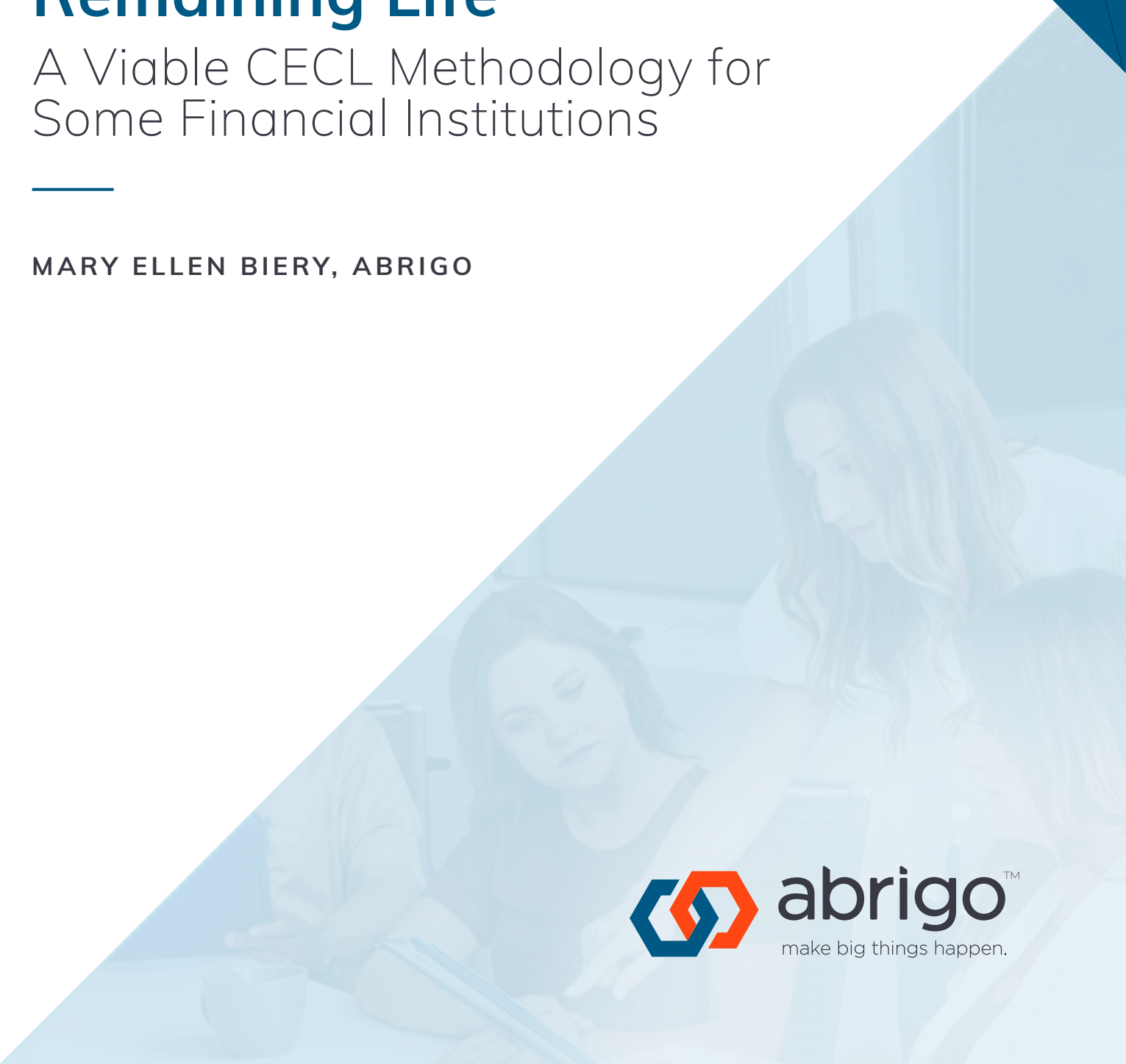

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INTRODUCTION

The current expected credit loss standard, or CECL, has been called one of the biggest changes ever to accounting for financial institutions, and every bank and credit union in the U.S. must assess CECL's impact on its processes and on the allowance. However, with the Q1 2020 compliance date for SEC-registered institutions quickly approaching, a majority of financial institutions haven't yet begun testing CECL-compliant methodologies, according to the 2019 Abrigo Lender Survey.

One of the challenges is that many community financial institutions are looking for simpler, more practical methodologies for implementing CECL than those being used by larger, more complex banks and credit unions. This whitepaper explores one methodology that represents a streamlined option for some financial institutions to implement the new standard for accounting for credit losses.

A HISTORY OF THE "REMAINING LIFE" METHODOLOGY AND CECL

As the deadline to CECL implementation moves closer, many financial institutions are grappling with how to apply the new standard to their allowance for loan and lease losses (ALLL) process in a practical way. Some are seeking to make a calculation that allows them to comply fairly quickly, despite obstacles such as insufficient loan-level data, insufficient loss history, or a shortage of staff to help with implementation.

The good news for these institutions is that financial institutions have a variety of options to choose from, and accounting rule makers and regulators have emphasized that institutions should utilize those methodologies that best fit their circumstances:

> *"[T]he agencies are not going to dictate or require institutions to adopt a particular method or particular methods for different pools for estimating expected credit losses. That's something the institution would need to do based on their analysis of what methods are the best fit under their circumstances for their institution, the types of portfolios they have, thinking about the methods they're applying today and whether they can be leveraged with appropriate changes in the inputs and assumptions to achieve the objectives of CECL. … [E]ach institution needs to look at the available methods, talk to their peers, talk to their examiners, talk to their auditors if they have them, and, again, look at what they're already doing and whether that can be leveraged for use in the future."*
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> Bob Storch, Chief Accountant at the FDIC during the July 30, 2018, "Ask the Regulators: CECL Questions and Answers for Community Institutions" webcast.

SEEKING SIMPLE, PRACTICAL METHODS

One methodology option that appeared in the regulatory literature after the accounting standard update was first issued in 2016 is a "remaining life" loss rate methodology. This is also referred to in the industry as the Weighted Average Remaining Maturity method, or WARM, and the Weighted Average Remaining Life method, or WARL. Banking regulators presented the method during an interagency webinar in February 2018 as one of the options for smaller, less complex community institutions to calculate the allowance for credit losses (ACL) using simple, practical methods. The FASB also released a Q&A document on this approach in January 2019 and regulators held a webinar specifically on WARM on April 11.

During the February 2018 webinar, then-Federal Reserve Chief Accountant Joanne Wakim emphasized that for smaller, less complex community institutions, "simple practical methods should work" for calculating the allowance under CECL. However, she noted that regulators were not "signing off" on the remaining life methodology and other simpler loss rate methods being presented as necessarily being appropriate in any and all situations. Regulators have repeated this caveat, although they seem to have spent more time and effort explaining this method than any other single method at this point.

At the very least, this could indicate the number of institutions that may fall into the classification of being "smaller and less complex" and for which this method may form a good starting and potentially ending point. Indeed, Wakim and others have encouraged institutions to involve management and auditors in methodology selection, and to consider the simpler methods as a starting point for CECL estimations.

This is a crucial point for financial institutions considering utilizing the remaining life method for CECL. CECL is a scalable standard, and so the remaining life loss rate methodology might represent a viable starting point for many institutions and a potential ending point for some. Along with the help of a software solution that can automate the process, some financial institutions utilizing the remaining life methodology will be able to produce meaningful results that can be fine-tuned and scaled as the institution grows.

WHAT IS THE REMAINING LIFE METHOD

The remaining life method may look most similar to the traditional loss rate method that many community institutions utilize under current GAAP. This is one reason many financial institutions may find it attractive as an option to comply with CECL. However, the remaining life method has some additional "twists and turns," as Federal Reserve Senior Accounting Policy Analyst Sarah Chae said during the February 2018 webinar.

Simply put, the remaining life method utilizes an institution's average annual charge-off rate and a pool's remaining life to estimate the allowance for credit losses. For amortizing assets, the remaining life is calculated by taking the contractual life and adjusting it by any expected scheduled payments as well as prepayments (i.e., paydowns).

The average annual charge-off rate is calculated using the same process as today's incurred loss method. That rate is applied to the amortization-adjusted remaining life to come up with the unadjusted lifetime historical charge-off rate.

As the FASB notes in its Staff Q&A, "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."

One important fact about this method, as FASB has noted, is that the calculation of the unadjusted historical charge-off rate does not include a reasonable and supportable forecast period. Instead, like other loss rate methods that may be used for CECL, consideration of reasonable and supportable forecasts can be accomplished in other ways. For example, a qualitative approach to adjust historical loss information for current conditions and reasonable and supportable forecasts is one option, according to the FASB.

Below are some examples regulators have shown for calculating an allowance using the remaining life method:

Step 1: Compute annual charge-off rate (same as incurred loss info)

Year End	Amortized Cost	A Average Balance	B Annual Net Charge-offs	C = B/A Annual Charge-off Rate
2015	$9,350			
2016	$9,398	$9,374	$32	0.34%
2017	$10,779	$10,088	$33	0.33%
2018	$11,050	$10,914	$50	0.46%
2019	$10,738	$10,894	$42	0.39%
2020	$10,000	$10,369	$31	0.30%

Average annual charge-off rate = 0.36%

($ in thousands)

Step 2: Calculation Option 1

Year End	Est. Paydown	A Projected Amort. Cost	B Avg. Annual Charge-off Rate	A*B Allowance for Credit Losses
	2020 Actual Amortized Cost	$10,000		
2021	$3,849	$6,151	0.36%	36
2022	$2,528	$3,623	0.36%	22
2023	$1,828	$1,796	0.36%	13
2024	$1,208	$588	0.36%	7
2025	$588	-	0.36%	2

Estimated unadjusted lifetime charge-off amount: $80

Unadjusted lifetime historical charge-off rate: 0.80%

Qualitative adjustments: 0.25%

Total allowance for credit losses rate as of 2020: 1.05%

Total allowance of credit losses as of 2020 ($10,000 x 1.05%): $105

($ in thousands)

WHEN TO USE THE REMAINING LIFE METHOD

Regulators have noted that the remaining life method may be appropriate for smaller, less complex institutions and for certain types of loan portfolios, such as segments without losses. This method doesn't require loan-level information; instead, an institution could use pool level information for making a remaining life calculation. It could pull in its own call report data or even pull in call report data for peers. The remaining life method is generally not considered appropriate for larger or SEC-registered institutions, although FASB has noted that an entity may be large and complex but may have a specific pool that is insignificant to the entity and that lends itself to a less complex risk management strategy. These types of issues are yet another reason institutions should discuss the applicability of the remaining life and other methodologies with their auditors or examiners.

Among the factors an institution should consider when deciding whether to use the remaining life method, according to the FASB:

- The complexity of the pool of assets
- The contractual term of the pool
- The extent of the loss history available
- Whether the losses are sporadic with no predictive patterns
- The number of loans in the pool

"Certain common challenges can exist regardless of the loss rate method selected by an entity," FASB said in its Q&A. "These include, but are not limited to, situations involving minimal loss history, losses that are sporadic with no predictive patterns, low numbers of loans in each pool, data that is only available for a short historical period, a composition that varies significantly from historical pools of financial assets, or changes in the economic environment. In some instances, these challenges will be minor and can be effectively resolved using qualitative adjustments thereby making the WARM method acceptable. In other instances, these challenges will be more significant, and an entity may find that the WARM method is inappropriate for its situation."

BENEFITS OF AN AUTOMATED SOLUTION AND THE REMAINING LIFE METHOD

Because the remaining life loss rate methodology begins with an institution's average annual charge-off rate and is not limited by a lack of loan-level historical data, the method could well represent a more feasible option for some financial institutions. This could especially be the case with the help of a CECL software solution that automates both the calculation of paydown adjustments to the contractual life of a pool as well as the adjustments related to "reasonable and supportable forecasts."

As regulators have noted, one of the critical aspects of the remaining life methodology is adjusting the contractual life of a pool by any prepayments or expected scheduled payments, and these assumptions are likely to receive scrutiny. In addition, regulators have acknowledged that community financial institutions are seeking additional guidance on developing reasonable and supportable forecasts; FASB is developing an upcoming Q&A on the topic this spring. In some cases, an automated solution is able to greatly simplify the process of pulling in external data, such as from the St. Louis Fed's FRED database, and adjusting it to support and document the institution's own expectations for the "reasonable and supportable forecast" aspect of the calculation.

An automated CECL solution that allows financial institutions to use the remaining life methodology to produce meaningful estimations without requiring an inordinate commitment of resources means the institution will be able to implement a CECL-compliant, streamlined process. In addition, a solution that incorporates additional methodologies means that the institution will be able to fine-tune the CECL process in quarters to come as the institution grows and as best practices evolve.

In the meantime, however, institutions choosing to utilize the remaining life method will be able to tell a coherent and credible story about their portfolio – one supported by data and documentation. Regulators have been clear that financial institutions need to support and document significant judgments in their ACL estimations under CECL. Utilizing a solution that allows testing of various options of segmentation and methodology selection and that facilitates documenting why one path was chosen over another based on test results can streamline efforts to support and document management's decisions.

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CONCLUSION

The 2019 Abrigo Lender Survey found that while many institutions are taking the necessary steps to be prepared for CECL, others are falling behind their peers. In the case of community financial institutions that are looking for a practical transition to CECL, the remaining life methodology is an option to consider. In addition, the use of an automated CECL solution that supports the remaining life method as well as more sophisticated methodologies can provide these institutions with a streamlined approach that allows them to generate meaningful estimations under CECL in a timely manner while providing suitable options as the institution grows.

ABOUT THE EXPERT

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Mary Ellen Biery is a Senior Writer and Content Specialist at Abrigo, where she works closely with executives and subject matter experts to produce content for the company's blogs and websites, as well as for other outlets. She is a veteran financial reporter whose work has appeared in The Wall Street Journal and on Dow Jones Newswires, CNBC.com, MarketWatch.com, Nasdaq.com, and other sites.

ABOUT ABRIGO

Abrigo is a leading technology provider of compliance, credit risk, and lending solutions that community financial institutions use to manage risk and drive growth. Our software automates key processes — from anti-money laundering to fraud detection to lending solutions — empowering our customers by addressing their Enterprise Risk Management needs.

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ADDITIONAL RESOURCES

ALLL.com - a website for information about the allowance for loan and lease losses and the transition to CECL.

Whitepaper: CECL: Where are We Now? Results from the 2019 Abrigo Lender Survey

On-demand webinar: Navigating Loan Pool Segmentation under CECL

FASB Staff Q&A: Topic 326, No. 1: Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Credit Losses

April 11, 2019, FDIC Community Bank Webinar: Current Expected Credit Losses (CECL) Weighted-Average Remaining Maturity (WARM) Method

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