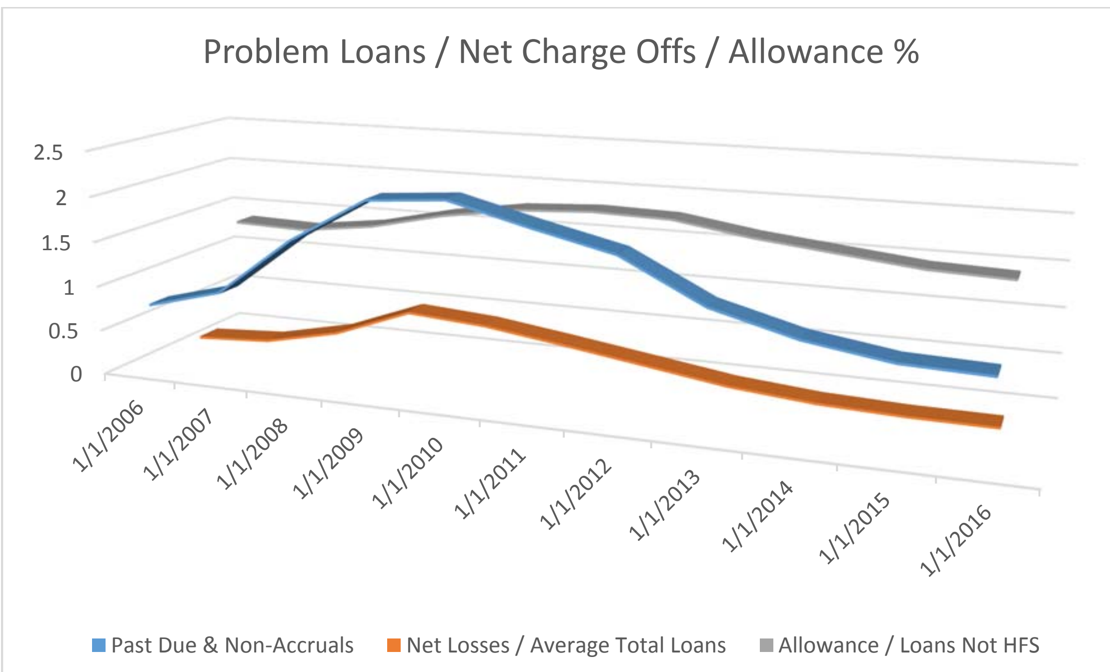
CECL Impact – Historical Net Loss Analysis

- Problem Loans / Net Charge offs / Allowance Levels
- By Mike Borland, MBA

In preparation for completing the development of new analytical reports and strategies to assist banks adapt to CECL (FASB Accounting Standards Update No. 2016-13) we have analyzed 10+ years' worth of community bank experience with problem loans and related net loss experience beginning with the year 2006 to current 2016 results. Our objective was to gain insights into the level of the allowance for loan losses that community banks maintained during a prolonged credit downturn, which the years 2008 thru 2012 surely were for the typical community bank. This background will help us gauge and plan for the impact of moving from an incurred and probable loss analysis model to an expected loss over life of loan (full recognition at loan origination) estimation of losses. Remember too that the new accounting rules require banks to reasonably forecast, based upon key economic indicators, future losses.

Historical Problem Loan Levels

The following chart tracks community banks problem loan levels represented by past due and non-accrual loans as a percent of total loans, net loss experience, and the allowance for loan losses maintained as a percent of total loans (excluding those held for sale).



Problem loan levels began to rise significantly in 2008 and peaked in 2010 and they actually rose above the levels of the allowance for loan losses most banks maintained for several years running. Net losses peaked in 2009 and then began to decline, reaching normal levels roughly during 2013. On the whole it would appear that community banks weathered the financial crisis of 2008/2009 in pretty good shape, although we all know there were exceptions. So on

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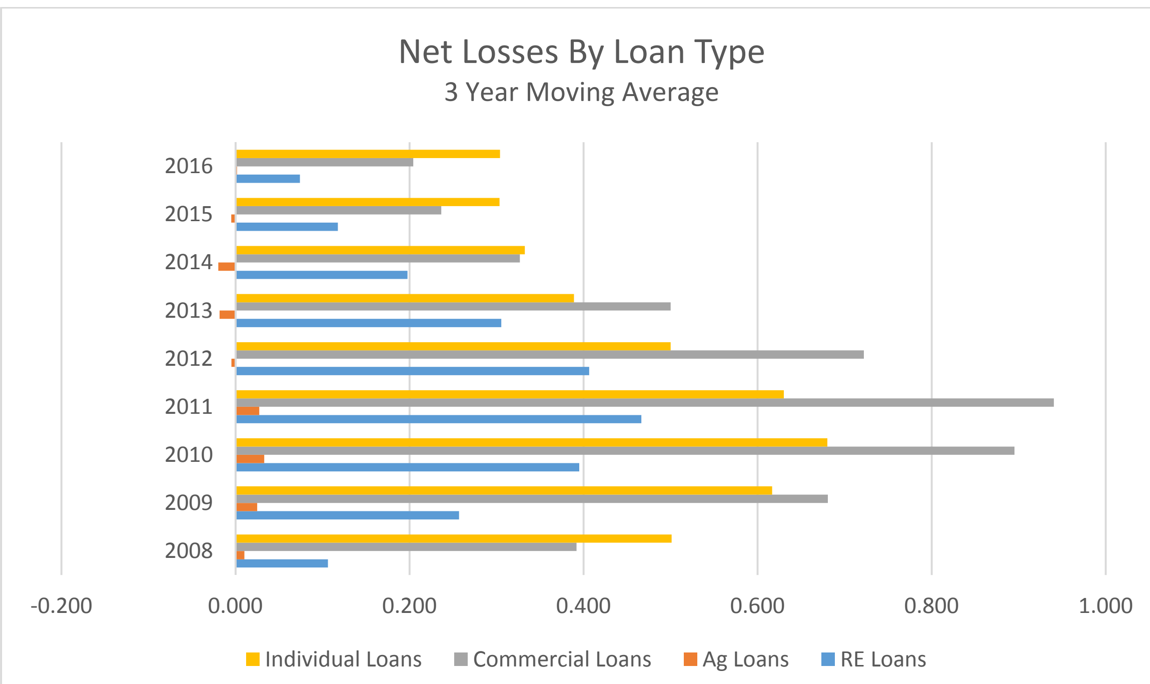
average community banks were able to maintain loan loss reserves under the current accounting rules sufficient to handle the net losses experienced. If our new accounting for loss rules were in place back in 2008 banks would have been required to update their projections for loan losses for future years based upon the deterioration of key economic indicators, that's the bad news. If the affected banks were able to have accurately forecasted and accrued loss reserves at loan origination then this deterioration would likely have minimal impact on earnings, that's the theory anyway.

The good news this chart appears to display is community banks on average have maintained healthy loan loss reserves relative to problem loans and net loss levels, note the widening gap between problem loans and the reserve. A key question banks will want to analyze is what will be the effect on current earnings if our bank must simultaneously recognize high levels of realized losses, thus depleting your allowance levels, and increase the reserves in their allowance for new projections showing an increase in projected losses in future years. Remember the new accounting for loss rules require your bank to reasonably estimate losses over the life of the loan and base this upon updated forecasts. No longer does the bank wait on the loss to become incurred and probable. This has the potential to magnify losses, even impacting capital levels, at community banks during the next economic downturn.

Net Losses Broken Out by Loan Type

Next we have broken out net losses by the four major loan types community banks typically make. Charted are 3 year moving averages for each of these four categories of loans; Loans to Individuals, Commercial Loans, Ag Loans, and Real Estate Loans. Our objective here is to gauge the variation of losses between the different types of loans within a typical community bank.



A typical community bank had the greatest loss experience in its loans to commercial enterprises, followed next by loans to individuals. Real estate loan loss were significantly less and Ag loans have seen only very minor loss levels.

Of course the recent past is not necessarily a good predictor of the near future, those of us that experienced the Ag lending crisis of the 1980s can attest that significant losses on Ag loans can occur.

Summary Conclusion

If you take an average of the net losses experienced by community banks over the last business cycle, defined as from 2008 to 2016, and compare that to what the typical community bank currently maintains in its loan loss reserves you get almost 4x, or 4 years' worth of coverage. <u>Depending upon the actual duration of their loan portfolios this appears to be a healthy number.</u> Duration is going to be a very important factor now because the new accounting rules require you to estimate and record an allowance for expected losses over the life of the loan. So all other factors being equal (which they aren't) loans with longer terms would be expected to experience greater losses. We do not have access to duration figures for our analysis here; banks would need and want to factor this into their own calculations to determine the impact of the accounting change.

Also, as alluded to in the previous section, most community banks would at a minimum want to break out and begin tracking loan charge offs and recoveries by at least the four different categories of loans mentioned and by year of origination. Actual rules for segmenting and grouping your loans require the portfolio exhibit similar risk characteristics, so further analysis and supporting documentation for your strategy would surely be required. As banks analyze and plan they need to keep in mind that making the accounting change is optional beginning in 2019, mandatory for most community banks for the year ending 12/31/2021.

General Recommendations

While the point of this whitepaper is to begin analyzing and gauging the impact of the new accounting rule on the adequacy of banks' loan loss reserves we have formulated a few general recommendations.

- If your bank has not already done so document your credit underwriting standards in as much detail as reasonably possible. How have these standards changed over time? Relate these standards to your core loan types. Your bank may need to explain why it thinks its portfolios exhibit more or less risk than peer averages, etc.
- Determine the appropriate loan segmentation strategy your bank should use. Loans should be grouped by loans with similar risk characteristics. Hopefully your bank's loan segmentation strategy ties in with key credit underwriting standards. Start tracking additional data on your charge offs and recoveries by these segment groups.
- Verify that your bank is tracking the necessary and appropriate credit factors by loans, e.g. do all personal loans contain the customer's credit score, do collateral based loans contain current collateral valuations and calculate loan to value ratios? Appropriateness would depend upon the individual bank's credit underwriting and loan segmentation strategy. Analyze your bank's portfolios currently held by key credit factors and loan durations.

Many community banks are probably going to find they have some work to do after analyzing and running some reports on their portfolios. In my experience banks aren't likely to get burned by not being perfect (having exceptions) but will do so by ignoring the issues and not having a coherent plan and some key documentation to back up that plan.

Not us!

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