Combined Council of America's Credit Unions

THE "S" IN CAMELS RATINGS & CURRENT EXPECTED CREDIT LOSS MODEL (CECL)

Presented by:
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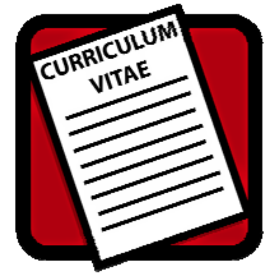

Dan is an independent consultant representing **Doeren Mayhew** in providing services to credit unions. He spent most of his career at Cindrich, Mahalak & Co., a CPA firm that specialized in working with credit unions and their subsidiaries. He joined that firm in 1980 upon graduating from Eastern Michigan University and became a partner in 1988. Dan also is the President of **Mahalak Consulting Co.**, a firm through which he provides a myriad of consulting services.

Throughout his career, Dan worked in all phases of the CPA practice. He has been involved in all audit activities, staff training and development, and a wide range of consulting projects. He is still personally involved in audit planning and meeting execution at Doeren Mayhew. His extensive experience allows him to provide clients with unique insights into any problems, issues, or challenges they are facing.

Throughout his tenure, Dan has been responsible for hundreds of credit union audits. He continues to work with credit unions in strategic planning, budgeting and forecasting, asset-liability management consulting, mergers and acquisitions, regulatory consulting, human resources consulting, and a variety of other consulting projects. He has worked in fraud/embezzlement investigations, including filing bond claims, working with authorities, and testifying in criminal proceedings. He is a frequent speaker on topics related to the credit union industry on both a local and national level, and has written articles for several credit union publications.

As one of the nation's largest CPA and Advisory firms with a highly specialized, focused financial institutions group, DM has a strong local and national reputation based on technical expertise, industry knowledge, along with exceptional service to credit unions.

Topics

- The NCUA has been discussing adding an “S” to the current CAMEL rating structure. The “S” stands for Sensitivity to Market Risk.
- The Financial Accounting Standards Board (FASB) adopted the Current Expected Credit Loss Standard in 2016. How will this affect your credit union?
- Questions

CAMEL Rating System

- Evaluates a credit union's overall condition by measuring five critical areas:
  - *Capital Adequacy*
  - *Asset Quality*
  - *Management*
  - *Earnings*
  - *Liquidity/Asset-Liability Management*
- Ratings are from 1 (sound in every respect) to 5 (extremely unsafe and unsound)

The Need for an “S”

- Currently interest rate risk assessed as part of liquidity rating
- Banking regulators already use an “S”
- Several states do as well
- Adding “S” would improve clarity, accuracy, and transparency in how IRR is assessed
- When proposed in 2016, was expected to be implemented in 2018, but not yet in place

What “S” Entails

- Sensitivity of the CU’s earnings to changes in interest rates
- Management’s ability to identify, measure, monitor, and control exposure to interest rate risk
- The CU’s nature and extent of interest rate risk exposure.
- Will separate this item from liquidity measurement

FINANCIAL ACCOUNTING SERIES

FASB ACCOUNTING STANDARDS UPDATE

No. 2016-13
June 2016

Financial Instruments—Credit Losses
(Topic 326)

Measurement of Credit Losses on Financial Instruments

An Amendment of the *FASB Accounting Standards Codification®*

Financial Accounting Standards Board

CECL

Current Expected Credit Losses

- Process began in 2008 in response to the financial crisis
- FASB approved Accounting Standards Update 2016-13 – Measurement of Credit Losses on Financial Instruments - in June 2016
- Effective for CUs beginning in 2021 – looks like this is being extended to 2022
- Affects not only loans and leases, but debt securities and off-balance sheet credit exposures

CECL

- Current GAAP requires “incurred loss” methodology
  - *Delays loss recognition until it is probable*
- CECL requires “expected loss” methodology
  - *Requires use of a broader range of reasonable and supportable information to make these estimates*

CECL Methods

- No specific estimation methods
- Various methods that reasonably estimate expected collectability of financial assets and are applied consistently over time
  - *Loss rate*
  - *Roll-rate*
  - *Vintage analysis*
  - *Discounted cash flow*
  - *Probability of default/loss given default methods*
- Different methods can be used for different groups of assets

CECL Inputs

- Losses now recognized for life of portfolio, so inputs must change to include this if using loss rates
  - *Annual loss rates used many times now*

CECL Segments

- Collective or pool basis required when similar risk characteristics exist:
  - *Credit scores or ratings*
  - *Risk ratings or classifications*
  - *Financial asset type*
  - *Collateral type*
  - *Asset size*
  - *Effective interest rate*
  - *Term*
  - *Geographic location*
  - *Industry of borrower*
  - *Vintage*
  - *Historical or expected credit loss patterns*
  - *Reasonable and supportable forecast periods*

How to Determine

- Based on relevant information about past events, including historical experience, current conditions, and reasonable and supportable forecasts that affect the collectability of the reported amounts
- Judgement is used to determine what information and methods to use
- Losses should be recognized for life of portfolio segments at issuance
- Cumulative effect of this change charged to beginning retained earnings

Balance Sheet

- Financial instruments carried at amortized cost should reflect the net amount expected to be collected
- Allowance for Credit Losses is a valuation account that is deducted from amortized cost to result in this
- This is a more forward-looking approach
- Net Worth may be reduced at initial adoption
- Allowance likely to be higher than in past

Income Statement

- Reflects measurement of credit losses for newly recognized financial assets
- As well as expected increases or decreases of expected credit losses that take place during reporting period
- Loan losses will be recognized earlier than under current GAAP

What Does Not Change

- When loans are charged off
- The net amount of loan losses
- When loans are placed on nonaccrual status

How to Prepare

- Become familiar with CECL
- Identify who should be involved
- Review existing practices to determine how they may be leveraged when applying new standard
- Determine method or methods to use
- Identify data necessary and be sure it is maintained
- Identify system changes necessary to implement
- Evaluate impact to regulatory capital

Data Needed (Minimally)

- Origination dates
- Maturity dates
- Origination amounts
- Initial and subsequent charge-off amounts and dates
- Recovery amounts and dates by loan
- Cumulative loss amounts for loans with similar risk characteristics

Other Issues

- HTM Debt Securities
  - *Need allowance for any credit losses*
- AFS Debt Securities
  - *Measured similar to current GAAP*
  - *Record through allowance, which would allow reversals of impairment*
  - *Allowance limited to difference between amortized cost and fair value*
- TDRs
  - *Qualification for TDRs remains the same*
  - *Allowance determined using CECL guidelines*

Questions?

My Contact Information.....

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