PIPER | SANDLER

April 27, 2020

CECL Summary of Options:

Adopt Now, Delay Adoption, and/or Elect IFR

On April 7, Piper Sandler published a report on COVID-19 and the CARES Act that addressed the fiscal, monetary policy and regulatory and accounting steps taken by policy makers to address the coronavirus pandemic. (please see report at: http://www.pipersandler.com/2col.aspx?id=5874). On pages 11 and 12 in that report, we referenced the relief that would be available for the adoption of Current Expected Credit Losses (CECL) methodology pursuant to the CARES Act and the subsequent Interim Final Capital Rule (IFR) relating to CECL. These important forms of regulatory relief were perhaps lost among the $2.3 trillion in new and enhanced funding plans from the Federal Reserve announced on April 9th and $470 billion in Paycheck Protection Program and other relief signed by President Trump on April 22nd. As such, we wanted to circle back and provide a summary of the three options as 2020 adopters of CECL must make a choice as to how they will implement CECL.

CECL is a forward-looking accounting standard that replaces the existing incurred credit loss approach as of Q1 2020 for large SEC filers. (All others required to adopt as of Q1 2023). The CECL reserve consists of two components:

- Day 1 Reserves - The Allowance for Credit Losses (ACL) is based on the difference between incurred loss required reserves and CECL required reserves and calculated as follows: (12/31/19 FYE Loan and AFS Debt Balances X Through the Cycle Loss Rate X Remaining Contractual Life of the Portfolio + Qualitative Factor Adjustment for the Forecast Period). This Day 1 ACL reserve is based on economic conditions as of 01/01/20. These reserves are tax effected and fully charged against GAAP retained earnings but phased-in over three years for regulatory capital and accounting purposes (RAP).

	(A)			(B)		(C)			(D)			(E)
	2019 Year End Segment Amortized Cost Loan Balances			Loan Segment Through the Cycle (TTC) Annual Charge-off Rate		Remaining Contractual Portfolio Life			"Q" Factor Adjustment for the Forecast Period			"Day 1" CECL Reserve Amount
	($)			(%)		Years			(%)			($)
Day 1 Example	**A**	**x**	**[(**	**B**	**x**	**C**	**)**	**+**	**D**	**]**	**=**	**E**
	$10,000	x	[(	0.40%	x	3.5	)	+	0.20%	]	=	$160
					1.60%							

- Day 2 Reserves - The Adjusted Allowance for Credit Losses (AACL) applies to changes in conditions during Q1 including loan growth, net charge offs or changes in the economic outlook for the forecast period since the beginning of the quarter. These reserves are charged against earnings or retained earnings. Day 2 reserves are not eligible for amortization over 3 years for RAP but are eligible to be included in tier 2 capital for up to 1.25% of risk weighted assets.

Financial Services Group

Thomas W. Killian
Managing Director | Investment Banking
+1 212 466-7709
tom.killian@psc.com

Robert Albertson
Managing Director and Chief Strategist
+1 212 466-7946
robert.albertson@psc.com

	(E)		(F)		(G)		(D2)		(H)
	"Day 1" CECL Reserve Amount		Less Q1 Loan Losses		Q1 Net Loan Growth × CECL Reserve %		Change in "Q" Factor Adjustment for the Forecast Period		"Day 2" CECL Reserve Amount
	($)		($)		($)		(%) x (A)		($)
Day 2 Example	E	-	F	+	G	+	D2	=	H
	$160	-	$10	+	$14	+	(.40% x 10,000) 40	=	$204

Large increase in reserves due to Day 2 Q factor adjustment to account for dramatic decline in GDP and increase in unemployment

For illustrative purposes, we have assumed that the negative outlook for the forecast period due to the COVID-19 crisis will cause a dramatic increase in the Day 2 Q factor reserve of $40 for the forecast period at the end of Q1. This $40 increase along with net charge offs of $10 and reserves to cover loan growth of $14 results in a Day 2 reserve of $44 and total allowance of $204.

The COVID-19 crisis has prompted policy makers to offer three options for banks required to adopt CECL in 2020:

Option 1: Do nothing and adopt CECL as currently required and shown above with the Day 1 charge recognized in Q1, tax effected, and amortized over three years for regulatory capital purposes. The Day 2 charge would also be recognized in Q1 2020 through the income statement, tax effected and charged against retained earnings.

Option 2: Delay adoption of CECL under Section 4014 of the CARES Act until the sooner of year-end 2020 or the date when the COVID-19 national emergency period ends. Once CECL is adopted, the Day 1 and Day 2 charges would be taken unless the bank also adopts the CECL IFR as described below. The SEC has opined that banks that delay adopting CECL until later in the year will be required to restate all prior quarters to Q1 making this option less attractive. However, Brad Sherman (Rep. CA) has proposed a technical corrections bill permitting a delay in adoption of CECL until January 1, 2021. This would avoid the restatement of financial information for prior quarters in 2020, but shorten the two-year deferral period to one year starting January 1, 2021.

Option 3: Elect to use the CECL Interim Final Capital Rule (IFR) issued by the regulatory agencies on March 31 that allows banks to adopt CECL in Q1 2020 but delay for 2 years the recognition of the Day 1 and Day 2 regulatory capital impact. After this two-year period, the Day 1 CECL amount would be phased in over three years against regulatory capital and the Day 2 cumulative difference between CECL and the estimated incurred loss method amount would be phased in over three years against regulatory capital. A bank that adopts the CECL IFR must apply it in the first quarter that it files regulatory reports using the CECL methodology. The mechanics of calculating the Day 1 and Day 2 CECL reserves and regulatory capital using the IFR are shown below:

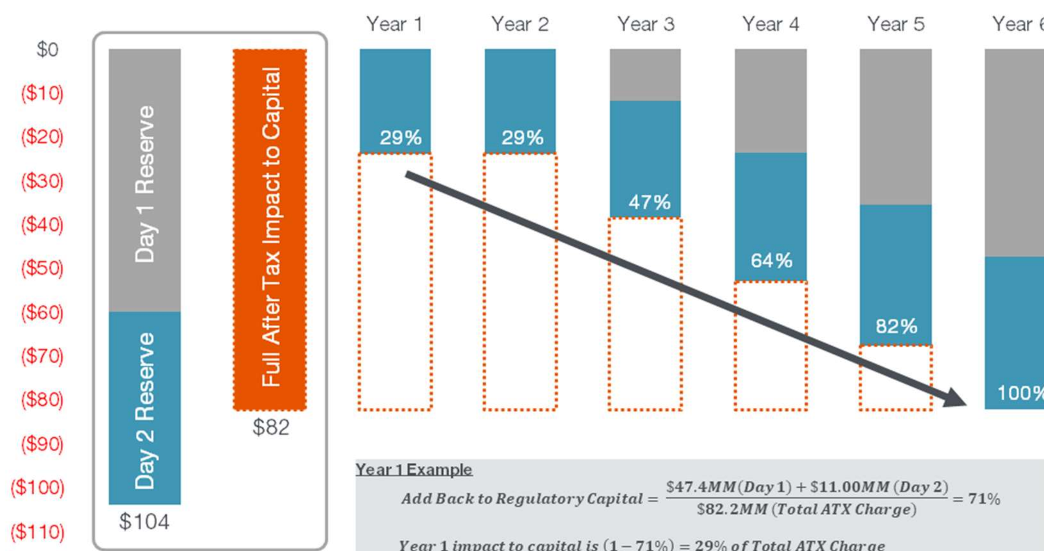
Allowance	$100.0	ATX Impact of Adoption	$47.4
Day 1 CECL Reserve	**$60.0**	Amount Allowable for CET1	100%
Pro Forma Allowance	$160.0	Day 1 CET1 Add-back	**$47.4**

Pro Forma Allowance	$160.0	**Scaling Multiplier**	25%
Day 2 CECL Reserve	**$44.0**	**Amount Allowable for CET1**	100%
Allowance 12/31/2021	$204.0	**Day 2 CET1 Add-back**	**$11.0**

Day 1 Add Back to CET1		Day 2 Add Back to CET1	
Year 1 100% Day 1)	**$47.4**	**Year 1 100% Day 2)**	**$11.0**
Year 2 100% Day 1)	**$47.4**	**Year 2 100% Day 2)**	**$11.0**
Year 3 (75% Day 1)	**$35.6**	**Year 3 (75% Day 2)**	**$8.3**
Year 4 (50% Day 1)	**$23.7**	**Year 4 (50% Day 2)**	**$5.5**
Year 5 (25% Day 1)	**$11.9**	**Year 5 (25% Day 2)**	**$2.8**
Year 6 (0% Day 1)	**$0.0**	**Year 6 (0% Day 2)**	**$0.0**

As shown above, the Day 1 CECL reserve amount of $60 is tax effected and added back to CET1 100% in years 1 and 2 and then phased out to $0 in year 6. For the Day 2 CECL reserve amount of $44, the IFR assumes a scaling factor of 25% (which includes a tax adjustment) so that the CET1 add back is $11 in years 1 and 2 and then phased out to $0 in year 6.

As illustrated in the chart below, the total CECL charge of $104 in reserves would have an after tax charge to regulatory capital (21% tax rate) of approximately $82 million. By selecting Option 3, the Day 1 reserve charge would be delayed for 2 years and then phased in over years 3 - 5 and fully deducted in year 6. The Day 2 cumulative difference between CECL and the estimated incurred loss method of $11 would be added back to regulatory capital for 2 years, then phased in over three years against regulatory capital and fully deducted in year 6. Overall, by selecting Option 3, the bank could delay the full deduction against regulatory capital until the start of year 6.



While the CECL IFR (Option 3) does not affect the GAAP recognition of CECL reserves, it does delay the regulatory capital impact for 2 years with the charges phased in over the remaining 3 years through regulatory capital. Banks that delay adopting CECL until later in the year (Option 2) pursuant to the CARES Act can still use the CECL IFR beginning the quarter they adopt. However, they will be required by the SEC to restate all prior quarter earnings assuming CECL adoption as of January 1, 2020 that makes this a less attractive option. However, if the Sherman technical corrections bill is passed, banks could adopt CECL as of January 1, 2021, thereby avoiding the need for prior quarter restatement in 2020. Some banks may opt for Option 1, as they have already devoted tremendous resources to adopt CECL and are prepared to do so without delay or use of the CECL IFR option. But those banks will likely be the rare exceptions.

Overall, if the Sherman bill is passed, we expect that many banks will pursue a combination of delaying their adoption of CECL (Option 2) until January 1, 2021 and electing to defer CECL charges against regulatory capital (Option 3). If the Sherman bill is not passed, the Option 2 deferral of adopting CECL is less attractive because of the SEC's requirement to restate interim financials. Regardless of whether a bank delays adopting CECL, we expect most will elect to use the CECL IFR (Option 3) to delay deductions against regulatory capital. Given the high level of economic uncertainty created by the COVID-19 pandemic, banks will be highly motivated to preserve regulatory capital so that they can better serve their customers and communities during these challenging times.

Special thanks to Weison Ding, Director, Financial Services Group and Alex Bondroff, Director, Investment Banking - Financial Services Group for their important contributions to this report.

Robert Albertson is a Managing Director and Chief Strategist in the Financial Services Group at Piper Sandler.

Previously, he was Principal and Chief Strategist of Sandler O'Neill & Partners, L.P., where he headed the investment strategy group. He provided strategy for institutional investors, consulted with clients, and worked closely with the firm's executive committee. Albertson was founder and president of Pilot Financial, a global financial sector investment fund focused on European, Latin and U.S. banks, brokers and specialty finance companies.

Albertson was director of U.S. Bank Research (1987-99) and global coordinator for financials research (1997-99) at Goldman Sachs & Co., where he led a team of analysts covering the U.S. banking industry and established initial research coverage of banks in Europe in the 1980s and several Latin American banks in the 1990s. He also spearheaded research efforts on Internet banking and the impact of technology. For a 15-year period Albertson was rated in independent surveys as one of the securities industry's premier research analysts specializing in the financial sector. Prior to Goldman Sachs & Co., he was managing director of U.S. Bank Equities Research at Smith Barney.

Albertson has been a frequent commentator on Bloomberg, CNN, CNBC, Fox Business and the Nightly Business Report and his comments have appeared in numerous print news media.

He is a member of the Bretton Woods Committee, the Official Monetary and Financial Institutions Forum think tank, a former president of the Bank & Financial Analysts Association, and a regular speaker before banking industry and supervisory organizations, including the Federal Reserve Bank and the Bank for International Settlements. He is on the board of the American Financial Exchange that has produced a LIBOR alternative for banks.

Albertson holds a Master of Business Administration degree from Harvard Business School and a bachelor's degree from Carnegie-Mellon University.

Thomas W. Killian is a Managing Director in the Investment Banking Group of Piper Sandler & Co.

Previously, he was a Principal of Sandler O'Neill & Partners, L.P. His 41-year career in commercial and investment banking includes seven years of commercial banking experience with NationsBank, structuring and arranging leveraged finance transactions; two years with Salomon Brothers, transacting capital markets and advisory assignments for a variety of major corporations; five years with J.P. Morgan, managing financial advisory and capital raising activities for banks and thrifts in the Western region of the United States; and 27 years with Sandler O'Neill, advising banks, thrifts, and insurance companies on a variety of capital markets, strategic advisory and M&A assignments.

He represented Sandler O'Neill in conferences with the Federal Financial Institutions Examinations Council, the Federal Reserve, and the Federal Deposit Insurance Corporation among others to discuss capital structure, CECL, Dodd-Frank and Basel III related issues. His articles have appeared in Bank Accounting and Finance, U.S. Banker and Modern Bankers, a publication of the Peoples Bank of China. Mr. Killian holds a Bachelor of Science from the University of North Carolina at Chapel Hill, where he was a John Motley Morehead Merit Scholar, and a Masters in Business Administration from Northwestern University's J.L. Kellogg Graduate School of Management.

General Information and Disclaimers

This report has been prepared and issued by Piper Sandler & Co., a registered broker-dealer and a member of the Financial Industry Regulatory Authority, Inc. The information contained in this report (except information regarding Piper Sandler & Co. and its affiliates) was obtained from various sources that we believe to be reliable, but we do not guarantee its accuracy or completeness. Additional information is available upon request. The information and opinions contained in this report speak only as of the date of this report and are subject to change without notice. Contact information for Piper Sandler & Co. and the author of this report is available at www.PiperSandler.com

This report has been prepared and circulated for general information only and presents the author's views of general market and economic conditions and specific industries and/or sectors. This report is not intended to and does not provide a recommendation with respect to any security. This report does not take into account the financial position or particular needs or investment objectives of any individual or entity. The investment strategies, if any, discussed in this report may not be suitable for all investors. Investors must make their own determinations of the appropriateness of an investment strategy and an investment in any particular securities based upon the legal, tax and accounting considerations applicable to such investors and their own investment objective. Investors are cautioned that statements regarding future prospects may not be realized and that past performance is not necessarily indicative of future performance.

This report does not constitute an offer, or a solicitation of an offer, to buy or sell any securities or other financial instruments, including any securities mentioned in this report. Nothing in this report constitutes or should be construed to be accounting, tax, investment or legal advice.

Neither this report, nor any portion thereof, may be reproduced or redistributed by any person for any purpose without the written consent of Piper Sandler & Co.

© 2020 Piper Sandler & Co. All rights reserved.