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 22rd. 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).

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<tr>
<th>(A) 2019 Year End Amortized Cost Loan Balances ($)</th>
<th>(B) Loan Segment Through the Cycle (TTC) Annual Charge-off Rate (%)</th>
<th>(C) Remaining Contractual Portfolio Life Years</th>
<th>(D) “Q” Factor Adjustment for the Forecast Period (%)</th>
<th>(E) “Day 1” CECL Reserve Amount ($)</th>
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<tr>
<td>$10,000 x (0.40% x 3.5) + 0.20%</td>
<td>= $160</td>
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- **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.

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

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