You've Been Doing It All Wrong!

by Steve Brown

The internet is a wonderful place to learn about strange and wonderful things. It is also the world of helpful advice. There are standard resources like the "8 Questions You Were Too Embarrassed to Ask" articles, or "The Complete Idiot's Guide to...". Among the less polite is the "You're Doing it Wrong" meme, a snarky list of everything people are (supposedly) an absolute failure at doing. It includes parenting, exercising, making muffins, eating popsicles, cutting cucumbers, making people happy and making people sad. The list includes some 75 hot topics and this seems like only the beginning.

We're not sure your bank's loan loss reserve (ALLL) calculation will fall among the hottest topics on the list, but there are changes ahead. These changes seem to indicate that for most banks, whether you have been doing it all wrong or not, you will be doing it differently in the not too distant future. The upcoming change is the adoption of the Financial Accounting Standards Board (FASB)'s current expected loss model (CECL). Implementation is set for Jan 1, 2018 for both the domestic and international versions coming from the International Accounting Standards Board (IASB). The international standard differs somewhat from CECL, but both are based on the general premise of replacing a historical loss model with a forward-looking approach.

The CECL model was created to replace the current historical loss model because most experts believe the historical loss model was inadequate in calculating the necessary reserves for the losses that occurred during the recent economic downturn. It has been assumed that bank reserves will increase under the new proposed modeling.

While this assumption of increased reserves seems logical, an analysis of historical ALLL vs. charge-offs shows the ALLL levels have been historically much greater than actual loss experience. This indicates that financial institutions may have inherently kept a portion of capital reserves in their ALLL and that a large increase to current reserve levels may not in the end be required.

Now that both the international and domestic accounting rules boards have lined up with their intent and timing, it would appear inevitable that a new loan loss standard will be adopted. The final details will be ironed out before implementation, but what steps should a community banker take now to be prepared?

We suggest you continue to keep abreast of information regarding the final FASB standard. Reach out to experts in the field including your outside auditors, regulators or our experts. Then, assess your current ALLL process and expertise. If you are currently preparing your ALLL internally, ask whether you have the capabilities and manpower to enhance your current process to comply with the new requirements. Finally, make your current ALLL process as robust as possible. Enhance your granularity by evaluating your homogeneous loan groups, explore various look-back periods and prepare loss migration by grade.

One key aspect of the proposed CECL model relies on understanding the contractual cash flows of your loans including prepayments. That means you need to evaluate how you may be able to integrate loan level information from your other models (including your asset/liability model) into your ALLL process. If you believe the new expected loss model will require banks to hold a larger reserve, when assessing your capital requirements include the potential that your reserve may increase in the future.

In the end, keeping up with the latest from FASB may seem like a herculean task. Know that PCBB has been calculating and reporting ALLL for community banks for years and always with every effort to incorporate the latest and best practices as a part of our service. We are happy to help you with this issue, so give us a call if you'd like to find out more.

BANK NEWS

Cyber Theft

A report by McAfee finds cyber attacks on companies are costing the global economy an estimated $500B per year.

Work Demographics

Gallup indicates the following percentage of these generational groups in the workforce: 32% Millennials (1980-1994), 32% Gen X (1965-1979) and 33% Baby Boomers (1946-1964).

Data Leakage

Research by Cisco finds: 46% of employees say they have transferred files between work and personal computers when working from home; 39% of IT professionals have had to deal with an employee accessing unauthorized parts of a company network and 18% of employees share passwords with coworkers.

Risky Activity

Research by Cisco finds: 83% of employees admit to using a work computer for personal use at least sometimes; 78% of employees access personal email from business computers; 63% say they use a work computer for personal use every day and 13% of people who work from home say they send business email to customers, partners and coworkers using personal email. According to 74% of IT professionals in the US, this activity leads to the use of unauthorized programs that result in as much as 50% of all company data loss incidents.

New HIres

Research by Saratoga Institute finds about 35% of American workers quit in the first 6 months.

Expense Fraud

A report by the Association of Certified Fraud Examiners finds expense reimbursement accounted for 13.8% of asset misappropriation fraud cases and resulted in an average loss of $30,000 per case.

Economic Growth

The IMF projects the US economy will grow 3.1% in 2015. Meanwhile, Goldman Sachs economists now project the US economy will be 3.2% in Q3 of this year and 3.0% in Q4.