Sir / Madam,

Below are comments on the August 15, 2019 proposed Accounting Standards Update (ASU), in the context of the 2016 ASU, primarily ASU No. 2016-13 (Topic 326; Credit Losses).

We concurred with ASU 2016-13 and the June 2016 joint statement from the Federal regulatory agencies. In fact, prior to June 2016 ASU announcement, we had commented in support of the Financial Accounting Standards Board (FASB) during the deliberation stage (in January 2016 comments to Mr. Golden, Chairman, FASB).

The proposal to accurately estimate the allowance for loan and lease losses (ALLL) is a long overdue development to help protect institutions and prevent a contagion across the wider economy:

- The choice of the Current Expected Credit Loss (CECL) standard that requires financial institutions to up-front recognize lifetime loan losses upon booking the loans instead of only accounting for these losses as they are incurred is a very positive step forward. The new CECL approach overcomes the glaring weakness of the incurred loss method — the lagged nature of credit deterioration and loss recognition — a change that we have long favored.

- This new approach will positively influence the credit culture of institutions to explicitly address the potential long term quality deterioration of loans that are booked. Further, such a change will encourage a closer coordination of the front-end sales and the back-end risk management cultures of institutions.

While the FASB did propose the CECL mandate it did not, however, endorse any particular approach or provide guidelines to achieve the CECL goal. Instead institutions are permitted to use any methodology to reach the prescribed objective. This flexibility is positive on the one hand, allowing for experimentation and the development of innovative technologies. On the other hand, the lack of a basic framework or overarching guidelines has contributed to implementation challenges to achieve the objective(s). Hence,

- Most banks, particularly the non money center institutions, are resorting to either retrofitting or re-purposing their existing models and tools to meet the CECL mandate. They are also
Many smaller banks, particularly community banks, have rallied against the CECL mandate and have sought the assistance of Congress to repeal the mandate altogether.

Recognizing the many vocal criticisms of the CECL mandate, the FASB recently extended the implementation deadline for the smaller banks; many are just beginning the process. We applaud the FASB’s decision to extend the effective dates of the proposed ASU. Specifically,

- The two-bucket approach as described and applied is understandable.
- We concur with utilizing the SEC definition of smaller reporting companies (SRCs) as the entities who could avail of the delay in the implementation deadline; we support basing the SRC eligibility criteria on the final Update date.

We are, however, not certain that the extra time will achieve the stated goal(s) because of the lack of guidelines on how to meet the CECL objective for credit losses.

Allowing for any method to achieve the CECL objective introduces uncertainty because many institutions find it difficult to project lifetime forward losses, owing to their inexperience with long range estimations and the lack of usable data. Institutions have to experiment with several methods before settling on one that they feel fits their situation while potentially satisfying bank examiners, minimizing their cost burden and, above all, minimizing any adverse effect on their income and capital. Any methodology implemented also needs to be reliable enough to guarantee the accuracy of their CECL estimate in predicting actual loss outcomes.

Besides the obvious burden of meeting the goal on the institutions themselves, evaluating and assessing the validity and accuracy of various methods will continue to exact a substantial cost on the bank examiners going forward, aside from the uncertainty of how any of these methods will fare under another economic stress.

RECOMMENDATIONS

Based on our on-the-ground experience addressing the issue, the basic data necessary to accurately estimate CECL as envisioned by the FASB are readily available to every institution; no external data are required.

- Monthly loan balances;
- Monthly loan pay downs;
- Monthly loan charge offs;
- Monthly loan recoveries;
- Loan ID; and
- Internal risk grades associated with each loan each month.

Our recommendations are based on over 25 years of experience, in the aftermath of the S&L crisis. We extensively investigated the loan loss reserving issue and identified the basic data necessary to accurately estimate loan losses that reflect the unique mix of each banking book and credit culture. The methodology we developed is scalable across the entire bank size spectrum and accurately projects losses for any term into the future, as well as the lifetime losses for any cohort of loan. Loss predictions — both to corroborate future losses and under rigorous back test conditions — have been demonstrated to be accurate.
Key points to note:

- Given that the purpose of CECL is to project the inherent losses of a bank’s own banking book, reliance on external data from peer groups or from commercial vendors is inappropriate. Such data do not represent the bank’s own portfolio, and could lead to inaccurate loss reserves.

- Voluminous multi-year data are not essential at the outset, when implementing CECL. While the quality and reliability of loan loss estimates will improve as more monthly data are collected over time, meaningful results can be derived with only one or two quarters of monthly data. With appropriate methodology that captures the variety of factors that affect loan quality, the judgemental application of Q-factors to improve the accuracy of results is obviated.

Attached is a brief outline of the attributes of our solution, to document that the CECL mandate is achievable. Bank examiners from the Office of the Controller of Currency (OCC) as well as representatives of the Federal Reserve have previously reviewed our methodology at a client bank. Please feel free to contact us if there are any questions on our methodology.

In summary, we recognize that implementation of CECL may cause an initial structural increase in loss reserve requirement of under-reserved institutions. However, with more loss estimates over time, institutions should be able to ameliorate any initial loss volatility induced. Further, volatility of losses can assist in determining the appropriate level of risk capital necessary. Accurate loss estimates for any loan term and associated risk capital can also assist institutions to accurately price loans rather than be subject to market pressures. Even small institutions that are not publicly traded will benefit from accurate prediction of their losses.

We respectfully request that the FASB provide additional direction/ guidelines to support technically sound implementation of the 2016-3 ASU.

Thank you for your consideration of our comments.

Sincerely,

John Abraham, Ph.D.
President
PortfolioView™: The CECL Solution

The June 2016 regulatory guidance on the Current Expected Credit Loss (CECL) approach has been a radical change in how the financial industry is required to account for the Allowance for Loan and Lease Losses (ALLL), beginning in 2020. CECL requires financial institutions to provision for loan losses over the entire life of each credit exposure at the incidence of booking, instead of the current ALLL approach when the losses are incurred.

Due to the wide latitude allowed in achieving this objective, the general response by the industry, accounting firms, and advisory firms has been to repurpose existing methods in wide use and utilize Management’s judgment to estimate the CECL lifetime losses using “reasonable and supportable” forecasts. While these approaches are implementable, they are flawed solutions due to their dependence on the incurred loss concept: incurred losses are a lagged loss recognition of impaired loans, and do not capture loan quality deterioration that occurs well before the incidence of default.

PortfolioView™, Financial Analytics’ risk management system, resolves this drawback by capturing the earliest deterioration in any portfolio, and projecting these quality transitions into the future until the exposures are off the banking book. The system can analyze any slice of the wholesale or retail portfolios along any dimension, including asset type, collateral type, geography, industry code, vintage, internal or external credit scores, risk rating, and by any combination of these slices. The system supports “roll forward” analyses of any selected consecutive or overlapping data span.

**PortfolioView uses the institution’s own data history, a proprietary data structure, and a set of algorithms to accurately estimate CECL**

**Output: Expected Cumulative Loss Profile as of 2020**

**Example Input: Eight Consecutive Quarter Pools of Internal Loan Data Over 10-year Horizon**
FINANCIAL ANALYTICS

ACCURATELY PROVISION FOR EXPECTED LOSSES

PortfolioView calculates the expected losses by utilizing internal information unique to each institution, incorporating data that vary with economic cycles consistent with the institution’s own loan review oversight and historical loss experience. The system outputs thus reflect the credit policies and risk culture of each individual institution.

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<th>Risk Class</th>
<th>Year 1</th>
<th>Year 2</th>
<th>Year 3</th>
<th>Year 4</th>
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Cumulative losses track a typical bond yield curve and can assist in precise loan pricing for any loan term

ACCURATELY ALLOCATE RISK CAPITAL AGAINST UNEXPECTED LOSSES

PortfolioView can simultaneously calculate the volatility of losses — the unexpected losses — which is the basis for allocating risk capital. By providing a precise capital cushion against excess losses, the system eliminates the necessity to comply with prescriptive “one size fits all” regulatory capital mandates.

<table>
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<tr>
<th>Risk Class</th>
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<th>Year 3</th>
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Volatility associated with each discrete expected loss — the measure of capital-at-risk — can assist in precise loan pricing for any loan term

www.financialanalyticsltd.com
ENHANCE VALUE THROUGH RISK-ADJUSTED PRICING

Accurate loss and risk capital measures, in addition to internal funding costs, enables the institution to precisely price loans for any slice of the loan portfolio, such as segment and risk class.

PRECISELY CALIBRATE & MANAGE CONCENTRATION RISK

Capital-at-risk — rather than notional values — is the accurate measure of concentration risk. With PortfolioView’s precise measures of capital-at-risk for every product and slice of the portfolio, Management can calibrate their desired concentration levels to suit their business goals.
AN EARLY WARNING SYSTEM FOR PROACTIVE PORTFOLIO MANAGEMENT

As the loan data are continuously updated, PortfolioView’s algorithms are able to capture early signals of portfolio trends — typically 12 to 30 months in advance of when these trends would become evident to Management or regulators. Given that inflections in loss trends may portend either deterioration or improvement in portfolio quality, PortfolioView’s advance early warning ability enables Management to swiftly and appropriately design their response.

SUMMARY

Using sophisticated algorithms, PortfolioView incorporates obligors’ credit quality, cash payments, cash draws, prepayments, write downs, and recoveries, including the benefits of potential diversification across portfolios and geographies. In doing so, it integrates any and all internally available risk-related information to generate CECL-compliant expected and unexpected loss measures for both commercial and consumer portfolios. With intimate knowledge of every slice of the portfolio, Management can identify and grow low-risk, high-profitable segments while rolling off high-risk, unprofitable segments, thereby maximizing long-term value.

PortfolioView is a robust CECL-compliant credit risk management system that provides the foundation for a fortress balance sheet.