Credit Risk Ready Podcast

Host Linda Keith, CPA, With Paula King, CPA

Loan Coding, CECL, and the Pandemic

Hi, this is Linda Keith, CPA, with Credit Risk Ready, a podcast where we interview senior credit and lending professionals from community financial institutions across the United States, their regulators, and banking advisors to better understand and mitigate credit risk.

In this episode, we will zero-in on loan coding and how segmenting the portfolio, which was already an important aspect of CECL, is changing to accommodate the risk assessment and mitigation challenges of the pandemic.

Paula King, CPA, is my guest. She is the senior advisor for Abrigo Advisory Services and is the point person on creating their PPP loan forgiveness advisory services for hundreds of their bank and credit union clients. She advises on CECL and other credit processes, policies, and procedures. Her banking career spans 25 years and includes co-founding a bank, as well as positions as Chief Financial Officer and as Chief Risk and Compliance Officer.

Paula, welcome back.

Paula King:

Thank you, Linda. Good to be here with you. And it says a lot about my life that I'm excited to be talking about loan coding.

Linda Keith:

And me, too. Oh, my gosh. You know, loan coding is not the sexiest topic we have covered on the Credit Risk Ready podcast, but segmenting the portfolio was already getting more attention in the run-up to CECL. So how has something that was fairly routine become a critical area for improvement in light of the pandemic?

Paula King:

Great question, and I will say it did go from routine to non-routine very quickly. Pre-COVID, I was spending 100% of my time on CECL, particularly with our public clients, and pooling segmentation was very straight forward. We're going to pool all of our CRE owner-occupied, we'll pool our non-owner-occupied, we'll pool our business loans, our consumer loans, so it's very straightforward.

And then everything happened. Now we've even got some of our public clients coming back and wanting to revisit segmentation. And so how has it changed? You can imagine particularly we've got this nonessential versus essential business.

So we've got clients that are saying, "I've got a portfolio of restaurant loans. I've got a portfolio of hotel loans. Now they're all lumped in with CRE, for example. I think we need to look at breaking these out." So certainly a lot of thoughts, processes about industries and how to subsegment those to get more risk or more similarity of risk in their CECL calculation.

Linda Keith:

Well, and even when I think about restaurants, there are restaurants that already had plenty of drive-through capability and take-out capability and it was part of their mix, and others that didn't at all. So even within a particular segment, there are significant differences.

Paula King:

I would agree. In fact, I've commented in some of the excursions our family has had where we've gone through the drive-through. I've said, "I'm not even sure this restaurant needs to open the inside anymore." They're just so busy on the drive-through, right?

So your more high-end restaurants are suffering more than some of your fast food places. And, in fact, I would contend that a lot of your fast food places are probably doing better, right? But certainly those more high-end restaurants where now they can only have, say, 20% occupancy, in that range, and they have to social distance, that will be an issue. So yeah, we're definitely seeing folks looking back at the way they originally segmented and making some pretty serious changes. And so where they may have had, say, 10 segments, now they're going to 15-to-20 segments.

Linda Keith:

Well, and I think about restaurants, there are some drive-through restaurants, but they are located in a place where they used to have a lot of office workers come through, and now those office workers are home-based. And so I think it would almost be as a matrix. It's like, what kind of restaurant is it? Geographically are they someplace where they still have traffic or not? Have they already switched to the online or the pickup? Pizza places were always a place you could just stop by and pick something up. So even just restaurants, it seems like could be six or seven segments all by itself, if it was an important part of that bank's portfolio.

Paula King:

Exactly. We have to look at dollar amount, right? And then to your point, the different types of restaurants. Some institutions won't have that many different ones, but some will. And another example is geography. You mentioned that a few minutes ago. And so that's also a sub-segment folks are looking at, particularly in our larger institutions where they are more regional. And let's say they have some loans in a region that has not fully opened yet versus another region that has. So a lot of our institutions, if they're large enough to do this, are breaking out some segments geographically as well.

Linda Keith:

Well, and you know, once you do the breaking out of segments, the presumption is you then could do a different analysis on them. But I think of Washington State, which is where I am, and which place is a hotspot keeps changing, right?

Paula King:

Right.

Linda Keith:

So you might think King County, which is where we had actually the first death in the United States was in King County, and it definitely still has been one of our biggest areas of concern, but now we've got Eastern Washington with the farming areas getting into trouble. And Florida's now in trouble, but New York City isn't as much. So the segmenting helps and it's critical, but what the segments really mean, I'm not sure we can think very far out on it.

Paula King:

Well, and that's true. And so it's sort of a moving target at this point. And you don't want to get too crazy with your segments, but certainly industry is not going to change if you've got loans in specific industries.

Linda Keith:

Right.

Paula King:

Yeah, but you're exactly right. The hotspot changes. I'm actually in a hotspot now and I think a month ago we were not. So you're right. You could segment by geography, but then the next month you may need to totally redo your segments by geography, right? Because of all the changes.

Linda Keith:

So, could there be a different granulation of segments needed for CECL compared to what a loan management team might want to segment for purposes of their planning or monitoring? Can you have different segments for different things or does CECL require that if you're going to use it for loan management, you've got to be using it?

Paula King:

No, not at all. In fact, prior to the pandemic, one of the things we had to caution our financial institutions was that they wanted to segment according to the way their Chief Credit Officer wanted to do stress testing. Well, stress testing tends to be very granular. The CECL is an estimation of your largest accounting estimate on your balance sheet. So if you get too granular, then your model results could really be irrelevant. Does that make sense?

Linda Keith:

Yeah, it does. So two different reasons, two different purposes.

Paula King:

Yeah, and so what we try to do under CECL is to, say, be large and significant enough that you'll actually get some results from your model, but you still have to make sure that you combine similar credit risk loans. So it is definitely a challenge, but I would say from your loan management perspective, you can be as granular as you need to be. And I would encourage you to be granular, particularly in the situation that we're in right now.

Linda Keith:

Right, just don't feel like you have to be as granular in your allowance calculations.

Paula King:

Exactly.

Linda Keith:

Okay, that makes sense. So for those of you who have already implemented CECL, what adjustments are those clients making going forward compared to what they might've done in Quarter 1, 2020, for example?

Paula King:

Well, the segments are number one. So a lot of those folks are reaching back out to us to say, "We really want to revisit some of our more risky industries' geographies like we discussed." Certainly the qualitative piece is being impacted and the forecast piece. CECL includes a forecast piece and who knows what to forecast at this point. So that's really a challenge.

The first quarter, the pandemic had just started, so the ramifications of it really weren't as much in force, the unemployment rate, et cetera, by that March 31st timeframe. But now, we're in a totally different environment.

And then we've seen some positive results over the last couple of reports that have been out there, so it's just been a real challenge for people on the forecast piece.

Linda Keith:

And yet they have to do it.

Paula King:

They have to do it. And interesting, and this sounds very counterintuitive when you think about it, but a lot of our financial institutions have shortened their forecast horizons just because everything is in flux. But we've had some financial institutions that have said, "We're actually going to lengthen our forecast horizon because with all of these deferral programs that are going on now, we don't believe we're going to see the losses until further out."

Linda Keith:

Yeah, yeah.

Paula King:

Yeah. So, we're seeing some that are shrinking that forecast horizon, but on the other side of the coin, and these are some of the more larger institutions, we're seeing them actually expand it.

Linda Keith:

Well, and once again, that's a decision somebody needs to make and then document why they were thinking that way.

Paula King:

And that is right. The whole CECL process is really about your documentation because it's so custom by institution.

Linda Keith:

Well, and I can see I've got two major, well, three areas that I work in in the loan origination side, and one is business lending and one is ag lending. And then the third is lending to complex individuals, often wealthy, high net worth. Those are three different segments that are really impacted differently.

So as an example, I went to speak at the Bluegrass Banking Association in Kentucky about two years ago, and my topic was credit risk readiness in any conditions. And I remember having a conversation with the president of that association. He says, "Linda, our challenge is we really weren't bothered by the Great Recession. Kentucky just sort of took a pass."

Paula King:

Well, and the interesting thing about that, too, is the ag industry. A lot of the ag industry was not bothered by the Great Recession. Their cycle is different from the typical cycle where we talk about when was the beginning of this cycle. Well, we typically say late 2007 and it's continuing, but a lot of the ag industry had no problems during that period, as you said, during the Great Recession. Theirs came a little bit later.

Linda Keith:

Exactly, and I was talking to one of the senior folks, and he says, "We're a little bit embarrassed to say how well we're doing." This was like in 2008-2009. He says, "Because we're doing great. And you know, there's so much trouble."

Now, this time, though, it is different, and here's what I see as the difference is. I'm curious about your take on it, Paula. Number one, it really is nationwide, although it's hitting different states at different times, but the pandemic is nationwide. It is every sector in some fashion, whether it is their employees, whether it's work from home, or in the ag industries, their processing plants, their markets, who can they sell to?

You've got people pouring milk into the ground because their clients were the schools that were closed. And yet there were people who were really needing milk, food banks and such. And then this came on top of the whole trade war tariff issue that was really hitting some types of farming hard. So farmers at this point are just taking it from every direction and they are not getting a pass on this particular recession.

Paula King:

And I would agree, Linda. If you think about the Great Recession, really what caused a lot of that was some of the problems within the mortgage lending realm, right? And some of the larger banks and some of the regulatory deficiencies, I guess I would say. And so you saw more of that in your traditional commercial clients, right?

With this one, to your point of all the examples you gave about the commodities, the milk, et cetera, we're all going to be in this one. I mean, every sector with some certainty is going to be impacted. You think about just office space. I've heard over the last couple of months companies saying, "We kind of like this remote working, and we were paying X amount of dollars a month on X thousand square feet of office space. We think we're just going to stay remote."

Linda Keith:

Yeah.

Paula King:

So when you have loans that are secured by office space and some of those vacancy rates are going to be impacted as well. So, I would agree it's across the board in this situation.

Linda Keith:

Which means we just have to keep paying enough attention, even though we really all want to just go home and play an innocuous video game or go for a walk in nature. We actually do have to keep paying enough attention.

Well, let me hit it one more piece with you because you mentioned qualitative adjustments and those have always been important. And banks have varied, I think, pretty dramatically on how nuanced they tended to make them. But how do you recommend that they change not only in what qualitative adjustments they make but also in how well they document their thinking?

Paula King:

Right, so I think the tried-and-true indices are still the ones to look at: the unemployment rate, the GDP, the basic ones. If you've got specific types of segments, for example, one-to- four family residential, you may want to look into some housing starts and things like that, more local information. But the funny thing about CECL is we tried so hard to quantify the qualitative, and in a stable environment that was fairly easy to do, but I'm going back to that management judgment. Who knows what to adjust your reserve for as it relates to the economy?

You know what you know today, and you know what some of the tried-and true-economists are projecting, but I think there's still that level of management judgment within those qualitative factors that you've got to look at. You've got to consider obviously the makeup of your loan portfolio, even if at this point you don't have a lot of past dues, because of the deferral programs you will, right? So you've just got to do some judgmental thinking by segmenting, by coding appropriately, by drilling down more into some of these targeted businesses, and make some judgmental calls on that piece of it.

Linda Keith:

Well, my husband and I are real estate investors, residential real estate investors, and we own rental properties. And so far, every month about the 5th we go, "So did we get our rents this month? Did we get paid?"

Now, so far, everybody's paid. So far so good. And so we're in the same position as banks are. So far so good. We know that several of them probably will be fine. There's one who he's a musician.

Paula King:

Oh my goodness.

Linda Keith:

He's a musician whose side gig was a barista.

Paula King:

He's not doing any gigs right now, is he?

Linda Keith:

No. Now he lives right next door and we get to hear his music all the time. So that's cool.

Paula King:

Well, he may have to pay you in music.

Linda Keith:

He may have to do that. And I do know his parents are helping him because he's recently out of college, right? But I chatted with him and he said, "Yeah, one of them is laid off right now and so forth." So I'm watching him. I think that that one might go, but every month that we get all the payments, we're just going, "Yes, nice!"

Paula King:

Yeah, that's about all you can do with this point. I think, the problem with this pandemic is we're going to see things happen later than sooner, right?

Linda Keith:

And we can't guess it. We can't guess.

Paula King:

We can't. We cannot. That's sort of how much judgment do you put into the qualitative? And you kind of have to go with what you know, but the fact that CECL now has the forecast piece in it, then I would just say, rely upon the FRED indices, rely upon the FRB economist's projections, some of your more mainstream-type projections. And that's all you can do. And just document where you got the information from.

Linda Keith:

Right. Well, and in one of the other episodes, Bill Conerly, an economist who predicts a square-root recession, by the way, so I highly recommend that you get a chance to listen to that one. But one of the comments he made was that in something that he follows, I think it's the Wall Street Journal, they do an average of the forecast of, I don't remember how many economists, but a huge number of economists. They do this survey every quarter, I think it is. And he said that usually if you'll just take the average of the survey. Instead of trying to follow one person, you take the average of the survey, that's probably going to be about right. He said most recently the survey varied from people who thought that the GDP would drop by 5% and people who thought the GDP would drop by 58%.

Paula King:

Which would be a strange average, right?

Linda Keith:

Yeah, and he just said, "When they are so far apart, clearly what that means is we don't know."

Paula King:

We don't know. And all we can do, again, it's an estimate. It is your largest estimate, but it is still an estimate, and you're not going to get it right, so you just have to do the best with the data that you have available at the time.

Linda Keith:

And document, document, document.

Paula King:

I can't stress enough.

Credit Risk Ready Podcast With Paula King, CPA

Loan Coding, CECL, and the Pandemic

Linda Keith:

Well, Paula, thank you so much for helping us with loan coding and CECL, and the fact that it is an estimate and we need to write down what we're thinking. And then we just, as we change it, we need to write down why we changed it.

Paula King:

As you said, document, document, document. Thank you, Linda. I've enjoyed my time with you.

Linda Keith:

Fantastic. Thanks so much.

Thanks for joining us on the Credit Risk Ready podcast. Subscribe, comment, or share on social media to stay connected and spread the word. Join me next time as we bring our bank, our customers, and our communities through the recession safe and sound. Take care.

About Paula King

Paula King, CPA, is Senior Advisor for Abrigo Advisory Services, part of a team of subject matter experts assisting financial institutions nationwide in the interpretation and application of Current Expected Credit Loss (CECL), credit processes, policies and procedures, and model validations.

Paula has held executive positions, including as Chief Financial Officer, in the banking industry for more than 25 years. As a former CFO, Paula has extensive experience in the design, preparation, and reporting of the allowance for loan and lease losses, including ensuring compliance with regulatory and audit requirements, and creating allowance policies, procedures, and processes. In addition, she has served on internal credit committees and worked with loan operations and lending staffs to improve credit processes and enhance the capabilities of a variety of core loan systems.

Prior to her banking career, she was associated with a regional public accounting firm and specialized in bank audit services.

Paula has been responsible for SEC and financial reporting, strategic planning, and has served as Chief Risk and Compliance Officer. She is a bank co-founder and served as a member of the board of directors through its merger with another financial institution and has been a de novo bank consultant to boards and senior management teams.

Credit Risk Ready Podcast With Paula King, CPA

Loan Coding, CECL, and the Pandemic

About Linda Keith

Linda Keith, CPA, draws on her 30+ years of experience consulting with and training lending institutions, background in public accounting, 15+ years as CFO of the family residential construction company, experience as an Examiner with the Washington State Auditor's Office, and as adjunct faculty in Accounting Principles and Managerial Accounting to help lending and credit professionals say, "Yes," to good loans.

Of course, you know those are not consecutive years or she'd be over 100 by now!

Linda is known by her clients to be both practical and funny. In fact, there is a move afoot to change the 'P' in CPA to stand for 'Playful'. The fact is, people absorb ideas and learn better when they are having a little bit of fun. So, Linda brings the fun along with her practical knowledge and depth of understanding to provide credit analysis training and presentations that make a difference.

She is the founder of Lenders Online Training, a virtual classroom approach to improving tax return and financial statement analysis capabilities; the host of the Credit Risk Ready Podcast; and a consultant/trainer on credit risk to banks and credit unions across the country.

www.LendersOnlineTraining.com	Online training on credit analysis
www.LindaKeithCPA.com	Resources for banking, Ask Linda Blog
www.CreditRiskReady.com	Podcast: Assessing, Managing and Mitigating Credit Risk and Download of the Credit Risk Readiness 2018 Study