NAF ASSOCIATION WEBINAR

CENTERSTREET FINANCE

Spinnaker CONSULTING GROUP

FASB-CECL Are You Prepared

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Disclaimer

This presentation is not intended to be a highly technical presentation on preparing for the demands of CECL, rather a discussion of what needs to be accomplished prior to the deadline(s).

The presenter's experience is primarily in the auto finance segment, but CECL affects any consumer or commercial finance companies.

What is the FASB up to?

In a change to take effect on January 1, 2020 (not that far away) 100% of *expected lifetime losses on a pool of receivables* must be reserved in the same period as originated.

Other Dates

- The reporting date for SEC Entities is Jan 1, 2020 (previous slide)
- The date for Public Business Entities (PBEs) is Dec 31. 2021
- The reporting date for non-PBEs and Credit Unions is probably being delayed (given relief) until Mar 31, 2022 by FASB

So, how does this affect me?

- This is just an accounting issue, right? I'm in sales, credit, collections, etc., why do I care?
  - Because your company must be ever vigilant in selecting which receivables are placed on the books!
  - Drain on Equity could be very large, especially for growing companies

It’s all about loss prevention

There are only 4 variables in a finance company:

1. Coupon (interest rate) on the loans
2. Cost of funds
3. Administrative costs
4. Losses

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And while protecting your company, stay 100% compliant with all the rules of the BCFP (Bureau of Consumer Financial Protection) , FTC, etc.

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Only the most well run, well-automated, well-capitalized companies may survive

Important Considerations

Where is your company now?

1. Have you been keeping up with static pool (vintage) losses?
2. Has your company retained historical performance data?
3. Do you have good modeling talent?
4. Are you willing to hire consultants?

Simply Put, Accrued Losses Replaced by Lifetime Losses

There is a perception in many circles that lenders' failure to have accurately predicted their losses was a large contributor to

The Great Depression

Not the 1930s, rather 2008-2011

That this "weak" reporting misled investors and lenders – either knowledgeably or unknowingly - effectively understated their capital as a result of those understated losses

AND, this situation MUST BE FIXED!

The Sought After Result

- More accurate reporting of expected losses, and thereby
  - More accurate EQUITY reporting
- Difference?
  - Instead of reporting losses as accrued over the life of a loan/lease, calculate the *LIFETIME* losses to be incurred in a pool of loans/leases and post that figure as the Provision for Loss in the period of origination of the pool

And So?

Assume originations of $10,000,000 in January 20XX in a non-prime finance company

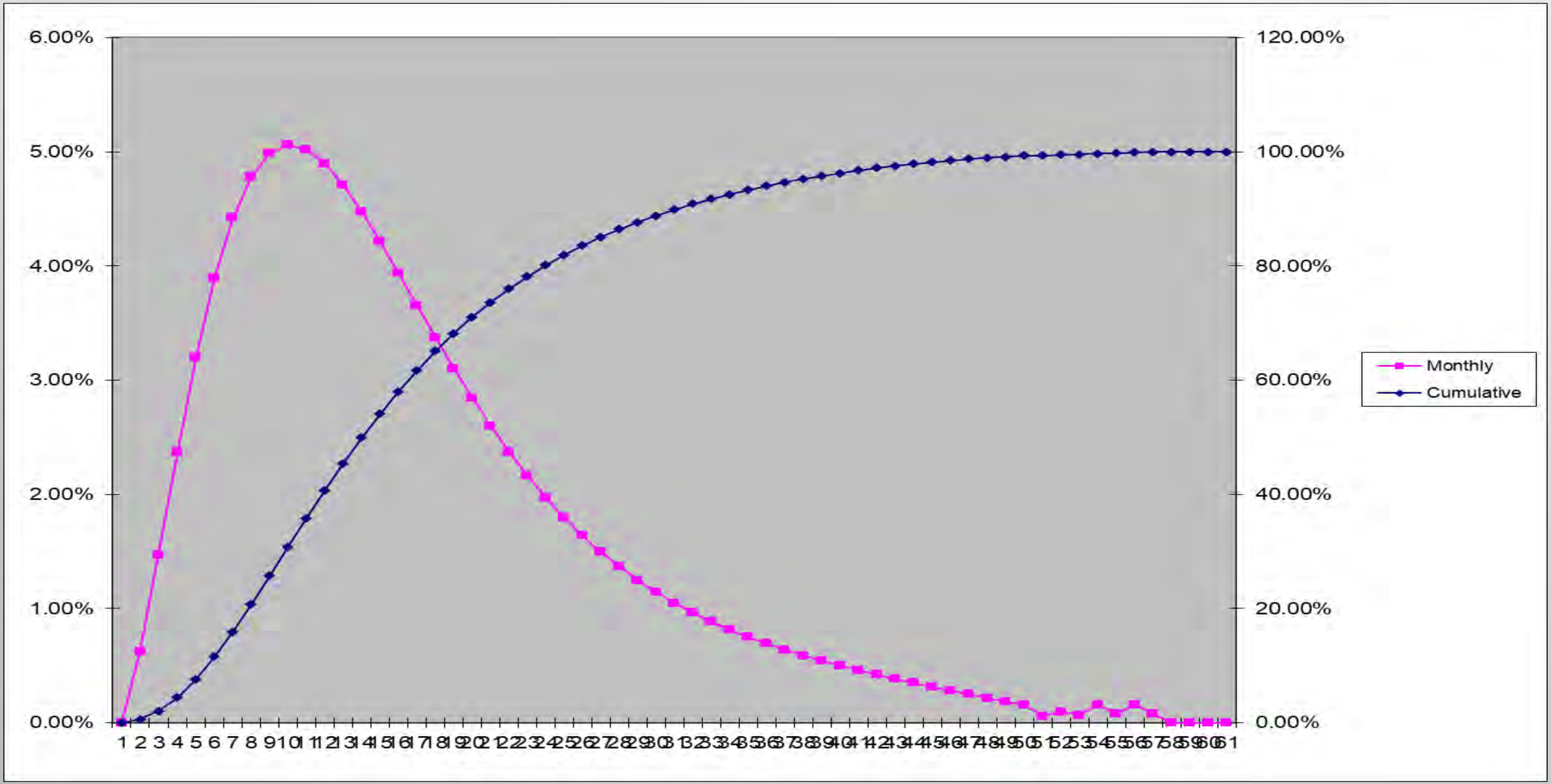
Weighted Average Term is 60 months

Assume lifetime losses over the life of the pool at 10% or $1,000,000

Under old rules, the company would review its historical loss timing data – curves – and plot out the expected losses over the life of the portfolio.

A common loss provision currently is to record the first 7 months expected loss, say $207,612

Typical Auto Net Loss Curves



Month One Income Statement

Interest Income (15% APR)		$125,000
Loss Provision (7 months)	$207,612	
Cost of Funds (5% annual rate)	41,667	249,279
Gross Profit (Loss)		($124,279)

Have no fear, this pool will end up performing just fine over its life and will generate a gross profit of around $1,357,500

However

Under CECL, the entire lifetime expected losses will be posted for the month of origination. So, same facts as previous slide –

Interest Income (15% APR)		$125,000
Loss Provision (lifetime)	$1,000,000	
Cost of Funds (5% annual rate)	41,667	1,041,667
Gross Profit (Loss)		($916,667)

The P&L "hit" is $792,388 worse under CECL!!

In Spite of that Bad News

By the end of the 60 month life of the portfolio, the gross profit for both cases remains:

$1,357,500

So, is this even a big accounting deal? Same lifetime profit, so who cares?

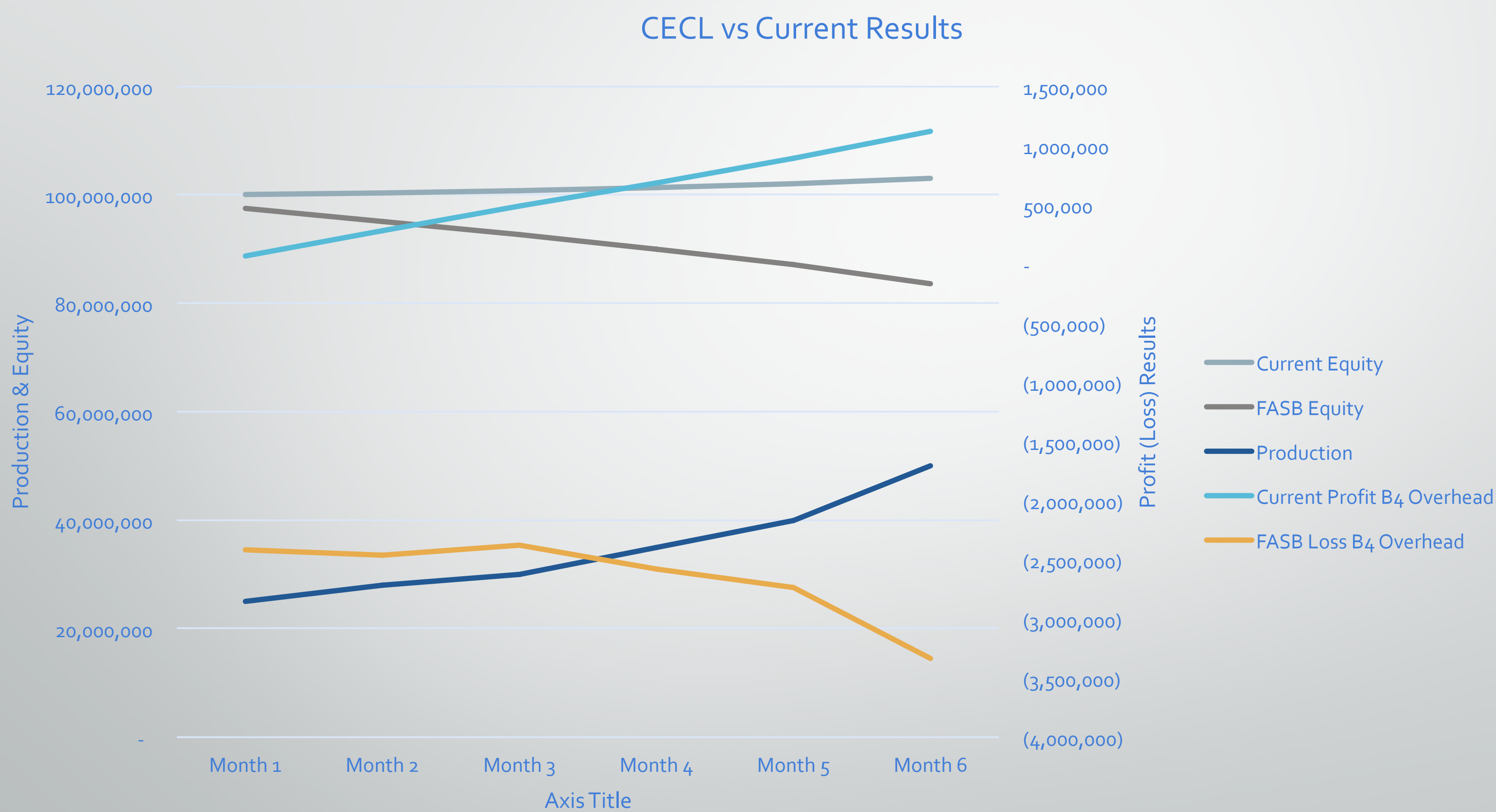
By the way, for a prime lender, the proportional results are the same, just smaller numbers. However, a LARGE increase in loss provision is painful in any case

It’s all about TIMING

- ✓ In an environment of steady or decreasing volume, CECL can actually produce a temporary <u>increase</u> in equity when compared to the present GAAP method.

- ✓ In an environment of increasing volume, the steeper the rate of increase, the more painful it is as the large loss provisions eat away equity month after month
  - ✓ CASH FLOW is NOT affected –
  - ✓ But the Balance Sheet is drastically affected.

Aggressive Growth – CECL vs Current



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Where do you feel the Pain?

- When negotiating Lines of Credit
  - "I notice that your equity has been shrinking. Can you explain that?"
- When raising additional equity capital
  - "Your company doesn't appear to be making money. Can you explain that? I'm not sure that this would be a good investment for us."
- To both questioners, "No problem, it's just due to CECL."
  - "Oh, I see," ....but do they?

What about Federal Tax?

- Finance Companies keep their accounting records on the accrual basis (rather than cash basis) in practically all cases. One of the reasons is that the loss provision is deductible for tax purposes.
- Perhaps there will be an advantage then with the “early” recognition of the lifetime losses. It’s too early to say as FASB is ahead of the Department of Treasury in this instance.

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What to do?

1. Get Started Today!
2. Gather past periods' loss information
3. Obtain and study industry data
    1. Call reports for banks, etc
    2. Standard & Poors, Moodys, Fitch, Kroll Bond Rating Agency (KBRA), each of whom publish loss performance data on Asset Backed Securitization bonds
    3. Company websites – GM Financial, Santander, & others
4. Study economic forecasts – how will the economy affect results in your institution's opinion

What to do (continued)

5. Apply the above information to your company's historic results and generate new model of expected losses
6. Many consulting organizations stand ready to lend assistance – most large CPA firms, companies such as Sageworks, Accenture, PCBB, etc.
7. Mainly, your methodology must be defensible to regulators, investors, and upstream lenders

Special One Time Adjustment

All of the preceding has dealt with going forward from the applicable date with new originations. What about loss provision/loss reserves already on the books?

Although rarely acceptable in accounting practice, an adjustment to Equity will be made just prior to initiation of the new loss recording method.

Not only must you model the future, but also going back over every open pool of loans, recompute the magnitude of losses remaining in the existing portfolio of loans and make an adjustment that involves only Balance Sheet accounts, namely Equity and Loss Reserve.

As the existing loss reserves may not have been trued up (marked to market) for a long period, significant analysis and modeling will also be required to arrive at this adjustment of equity. And, the existing loss reserve going forward must also take into account economic expectations as well as historic loss performance.

For example, if a recession is expected, you might anticipate that delinquency and defaults will exceed the historic performance during the recent “good” times.

Significant Modeling Talent is Necessary

If your company is not working on CECL currently, or does not appear to be taking CECL seriously, you should be feeling a little bit of anxiety. If your company reports to the SEC, or produces an audited Financial Statement, your company just has to be ready – there is no realistic alternative………………

So as you contemplate that, just remember to get ready for the fall sports season:

Go Cowboys!

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