The Challenges Of CECL And Optionality

by Steve Brown

You may not have thought about it, but astronauts in space need to be very resourceful. After all, you can't just open a door and take out the trash in space. Gross but true, urine is already recycled for drinking, but there are now efforts to incorporate yeast with it to provide nutrients to astronauts and even form a type of polyester for 3D printers. Makes you want to jump on a spaceship and head to the stars!

In banking things can be tough, but at least you don't have to turn urine into polyester like Buzz Aldrin. That said, the industry is buzzing around the Current Expected Credit Loss (CECL).

As banks have heard, CECL requires that you record "life of loan" loss estimates for unimpaired loans at origination or purchase. This replaces the current "incurred loss" accounting model and it also poses significant compliance and operational challenges.

Before bankers can make decisions about the specific operational approaches one might use to comply, you must understand the significant differences between how the current approach and the new CECL approach treat the life of a loan. We say this because how you structure your loans under that new approach can be very complicated.

Banks that hold loans (and securities) with maturities beyond the next year or two will be particularly affected by CECL. Many community banks hold large allocations of assets with long maturity dates - usually real estate loans. This adds to the complexity of it all and to the workload.

For example, since real estate loans generally have maturities of 10-30Ys, borrowers want the ability to pay off or refinance these loans early. As such, the bank essentially is "giving" an option to the borrower to do so. Under the rule, bankers must account for this when valuing the loan life.

As that sinks in, consider that assumptions regarding the loan's likely prepayment rate are critical in determining the loan's life. That life in turn is critical to estimate expected loss.

As that also sinks in, consider that prepayment rates also fluctuate with interest rates. As market rates rise, a given loan with a given rate is less likely to prepay and when market rates fall that same loan is more likely to prepay.

So, all of this prepayment shifting around means banks will have to pay particular attention to how they will incorporate this optionality into their loss calculations.

It also means banks will need to approach single-family residential (SFR) and commercial real estate (CRE) loans differently (as well as other types of loans held in the portfolio).

SFR - For single-family loans, separating loan balances into different coupon groups may be a workable strategy, because each group will have a different prepayment rate. Grouping coupons from 3% to 4%, for instance, and between 4% and 5%, lets a bank apply different expected repayment rates. Each group then pursues or avoids repayment under different interest rate scenarios. The downside of course, is that a bank can end up tracking an impractically large number of groups.

CRE - Separating commercial real estate loan balances into distinct coupon-range groups may not sufficiently value the volatility of the prepayment option. This is because CRE loans don't always have homogenous amortization or maturity structures. A loan with a 25Y amortization and a 10Y balloon payment would prepay differently than a loan with a 15Y amortization and a 5Y balloon payment.

So, how do community banks handle these loans under CECL? Start by sharing the BID with your colleagues to keep them in the know as things shift around. Then, look to Guidance on Interest Rate Risk Best Practices for measuring prepayment optionality. Doing so will help you track likely prepayment, which is vital in valuing the prepayment option and expected losses.

If you are looking for ways to prepare for CECL, you can read up on that in our June 15th article or contact us today to hear about our CECL solution. Then, you will have plenty of time to think about your next recycling project.

BANK NEWS

Higher Rates

The European Central Bank (ECB) has indicated it will take a page from the Fed and move to slowly rein in its EUR2.3T bond-buying program given stronger economic conditions.

Paused Rates

Investors now expect the Fed will hold off on raising the federal funds rate for the rest of this year, in order to see what impact the recent hurricanes have on the economy. The majority still expect the Fed to begin unwinding its $4.5T balance sheet beginning this month however.

Fintech Competition

Credit card reader and financial technology (fintech) company Square has filed an application with the FDIC to open a banking charter in Utah as an ILC. This is the third fintech to seek a bank charter, following SoFi (online student, mortgage and personal loan platform) and Varo Money (online mobile banking, deposits, credit cards).

Digital Upgrades

Bank of America announced a variety of digital upgrades to its services including contactless ATMs, budgeting tools and its Zelle payment option. The bank reported 1B digital interactions with its customers in Q2 2017.

Online Lending Hit

The Wall Street Journal puts forth the idea that the huge Equifax data breach could cause online lenders to more closely scrutinize information provided for their loans, increasing processing times.

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