



## Is WARM Right For CECL?

regulatory CECL risk management

**Summary:** We have recently heard that some banks are considering using Weighted Average Remaining Maturity (WARM) for their CECL calculations. Is WARM right for CECL?

The official definition of an acronym is "an abbreviation formed from the initial letters of other words and pronounced as a word." Examples abound, but some of the familiar ones are NASA, SWAT and GIF.

As you ponder other acronyms, CECL may come to mind. While banks are in different stages of readiness, one thing we have recently heard is that some banks are considering using Weighted Average Remaining Maturity (WARM) for their CECL calculations.

This method calculates an annual expected charge-off rate based on multiple historical periods. It then takes that rate and applies it to the remaining balances of assets in a given group times the WARM. While FASB recently noted that this method could be used for less complex financial asset pools, bankers will need to consider some potential issues if starting down that path.

A key component of this method is the accurate determination of the WARM. Here, some bankers may look to "leverage" their Interest Rate Risk (IRR) work. After all, the average life is generally calculated and easily available, so it could serve as a basis for use in this calculation. Depending on how WARM is derived for IRR purposes, this may be an acceptable practice, but each bank must first review this closely.

Specifically, if your WARM was not derived from account level cash analysis with account level optionality considered, using it would fall short of the mark for CECL.

As an example, some may still be using "call report" based information in their IRR work to determine WARM. Unfortunately, this approach will not meet the needs of the CECL requirement. For CECL to be properly applied, note/account level cash flows need to be generated with proper accounting for differences in repayment terms, coupons and seasoning.

In addition to these considerations, banks must also determine if IRR groupings are on the same level of granularity as loss rates. For example, if you consider loan or risk grade as part of your determination of loss rate, then your IRR model structure must also be able to produce results at this same level of granularity or it will not pass the test. For many, this will require a complete reworking of the IRR model, as well as the recalculation of prepayment rates to match new categories.

The most appropriate approach in using a WARM method is to have your cash flows and resulting WARM derived from individual notes and to account for note level differences in optionality.

Also, probably one of the most overlooked limitations in using the WARM approach is that it does not allow for the transparent application of the forward look consideration of CECL, which is a bigger deal than perhaps easily understood.

The math around CECL and unexpected consequences of doing it wrong flow through the income statement, so banks need to get it right and understand these nuances.

If you have questions on WARM or CECL, we are here to help. Our CECL FITTM solution is backed by our bank, gives you the flexibility to select from all 7 methods, ensures that you choose the right one(s) from the start and delivers expert help along the way. Come on in because the water is WARM.

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