The Limitations Of WARM

regulatory CECL risk management

Summary: To some community banks, WARM looks like a simple way to extrapolate current loss rates over the required life of a loan for CECL. However, there are limitations to consider.

When it comes to hot things, chefs look to the Scoville scale to determine how spicy something is. On that scale, the jalapeno pepper is 5,000 units (strong), while the habanero (volcanic) comes in at 150,000, the Carolina reaper (dangerous) is 1.5mm and way at the top at 15B is resiniferatoxin (harmful).

Speaking of hot things, the Weighted Average Remaining Maturity (WARM) methodology has received a lot of attention recently as a route that banks might take to CECL compliance.

To some community banks that may be struggling to implement the new standard, WARM looks like a simple way to extrapolate current loss rates over the required life of a loan. It needs less data than many other methods and that is appealing. Of course, like some peppers where the heat sneaks up on you after the fact, WARM also has some issues.

Structurally, WARM uses multiple historical periods to calculate an annual expected charge-off rate. Then it applies that rate to the remaining balances of assets in a given group. It may be a good choice for a small bank with a very vanilla portfolio, but that does not apply to most banks. Most banks have loan portfolios that include complexity, and that is where WARM can burn.

First of all, WARM involves a less quantitative analysis than other methods. This may get a cool response from regulators who expect detailed, analytical stress testing.

It also depends on the same qualitative factors as the outgoing incurred loss accounting method which is not forward looking. That could lead to higher loan loss reserve levels than other methods, since it doesn't depend on the loan-level details that show a portfolio's true risks. In a recession, certain WARM weaknesses may be even more evident.

Then, there is the issue of prepayments. WARM depends on estimates of prepayments in the portfolio. While banks may already use these estimates for other aspects of banking, CECL requires additional calculations and documentation. Banks that decide to use WARM will need a good amount of expertise to handle this new requirement.

It also has limitations as economic conditions change. WARM adds challenges around explaining changing credit conditions and measuring Q-factor adjustments as loan production and interest rates shift over time. For banks leaning into WARM, know that you must also be ready to address these issues as they arise.

Now we aren't saying WARM isn't a method to consider, but rather we warn it is probably only a viable method for loan portfolios that have little to no optionality. As such, the challenge for most financial institutions is that their assets just do not match that characteristic and that factor alone could lead to regulatory or accounting audit issues later.

In short, CECL is a new process with 7 different methods, so confusion is rampant. It is critical for banks to understand the limitations of any method under multiple rate, prepayment and structural environments, before moving forward with your CECL choices. To learn more about WARM, read our previous BID article on this method. We are also happy to discuss the ins and outs of WARM and CECL with you, as you continue to explore this accounting change.

CECL SOLUTION - WITH YOU, EVERY STEP OF THE WAY

CECL is one of the biggest challenges for community bankers these days. Our experts are ready to guide you every step of the way through this integration with no software to maintain. Learn more about our CECL Solution.