The Challenges Of Optionality And CECL

regulatory CECL risk management

Summary: Optionality can be challenging with CECL. We provide some tips to address the optionality of prepayments for your CECL calculations.

Summer is now in full swing with kids out of school, so you might be thinking about vacationing. Over the next 3 months, 50% of Americans will travel, spending up to 3 weeks' pay to have fun. Enjoy your next vacation and know you have earned it.

Before you head out on vacation though, there is much to consider when it comes to CECL. As you work through various elements of this rule change, you may start to see some real challenges--particularly when it comes to applying optionality.

As you consider optionality and its impact on CECL, you will need to start by grouping your loan assets into categories. Doing so will help you identify which ones have optionality and which ones don't. This is critical for the proper calculation of CECL. For example, if you have a large commercial real estate (CRE) portfolio, you should find your bank has more optionality than those with a large auto loan portfolio. While optionality certainly makes CECL more complex, it does not have to take more time - as long as you manage it properly.

Another key difficulty as you work on CECL is that most credit loss models were not originally designed to consider a life of loan concept, much less optionality/prepayments. That can be a huge issue for community banks, so take special care to understand that not all models are created equally.

More specifically, pay special attention to the functionality of the models you review. It is critical not to realize later in the game that a model which may have seemed fine at the beginning of this process doesn't have the features needed to appropriately account for prepayments. This is a really big deal, because as market rates move, prepayments can be a major factor, as cash flows shift and change (sometimes sharply) over the life of a loan.

Let's say you found the majority of your loans are CRE, where the customer has an ability to prepay all or some of the loan (embedded optionality). Let's also say your current loss estimation model doesn't appropriately account for those prepayments over the life of the loan. To ensure the proper derivation of prepayment assumptions, here are a few tips:

1. First, if most of your assumptions will be based on your institution's history, you will be in a much better situation. It is most helpful if you have prepayment rates based on your own expectations and experience (even if light), coming from such documents as your financial statements, rather than industry generated data where possible.
2. If you don't have the history internally, you will need to use external data for the prepayment rates. If this is the case, make sure to tie it back to your institution. Think about how it relates to your institution and detail this information well.
3. You will also need to remember that external historical information only tells you the optionality given different rate environments. This is important. Note that the historical average prepayment amount is not

relevant to calculate today's CECL reserve. So, you will again need to use key assumptions with your loans to calculate a relevant prepayment rate.

No matter your situation on CECL, we are here to help institutions just like yours figure it all out. Contact us today.

THE LATEST UPDATE ON AICPA CECL GUIDANCE

The AICPA CECL Task Force has just posted its key takeaways from its series of meetings (of which we were the only bank participant). We will be providing our thoughts on these takeaways through a series of BIDs coming soon.