Q Factors Matter More For CECL

regulatory CECL risk management

Summary: The purpose of Q factors doesn't change in the adjustment from Incurred Loss to CECL. However, there is a big difference in how the CECL standards treat Q factors.

A whopping $68T in US wealth will be handed down to heirs and charities over the next 25Ys, according to Cerulli Associates. Those calculations were probably tricky to do, but perhaps not as difficult as the math required by banks when they do work on their ALLL.

Perhaps even trickier in nature are the qualitative factors banks must deal with under the current Incurred Loss model, as well as with the newer CECL calculations coming online shortly. There are some differences, however, in ways that are important for community bankers to understand.

The purpose of Q factors doesn't change in the adjustment from Incurred Loss to CECL. As before, if it's reasonable to expect that a group of loans might sustain losses that are different from actual, historical losses, then Q factors are one way to adjust the base loss rate for that loan pool. Q factors are an expected, necessary part of the model and analysis, historical losses, and recent loss trends are crucial but not enough in estimating losses.

The list of things that count as Q factors doesn't change either. The possibilities include changes in international, national and local economic and business conditions; the nature and volume of loan terms or portfolio; concentrations of credit, among others.

Regulators can also look at the bank's financial assets, including past-due or adversely classified assets; the value of collateral; and changes to the bank's lending operations.

There is, however, a big difference in how the CECL standards treat Q factors. Under CECL, Q factors must be consistent, reasonable and supportable. While that sounds similar to Incurred Loss, it is much more clearly defined now.

This means that the assumptions used must be consistent with the assumptions in the institution's other models. For instance, economic conditions are a Q factor, so institutions will need to use the same assumptions for this Q factor as with other business.

What this means more practically is that it is no longer acceptable for credit managers on one side of the bank to use one economic forecast, while financial managers use another. The rule change technically means being reasonably close is not going to work going forward, so be aware of this critical nuance because it is an impactful one indeed.

Another quick point to make is that Q factors must be used where limitations exist in CECL models. That means banks will need to be sure that staff understand such limitations, can account for them and can explain them to regulators and auditors. Models used under the Incurred Loss method did not usually require the same robustness to the level of detail needed under CECL, so be sure you are prepared to avoid issues.

Finally, to determine Q factors, financial institutions must also know if a given economic condition (or other change) correlates with its loss history. For instance, if farm loans tend to do poorly in shallow recessions and models forecast a shallow recession, then it is reasonable and supportable to conclude that farm loan performance may dip during that upcoming period.

For more information on Q factors or CECL, feel free to contact us or visit our CECL resource library. We are here to help.

CECL FIT^{TM} - 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.