Top Five Places Where CECL Calculations Can Go Wrong

regulatory CECL

Summary: Time is of the essence in implementing CECL, as there are many decisions and details involved. One of the most important areas to assess is your institution's calculations. Once you have calculated your loan loss reserve, you will want to be sure you have addressed the top five areas where these calculations can go awry. Here they are.

During the time of the dinosaurs, a full year included 370 days. With the moon's gravity continuously slowing down the Earth's rotation, our days are getting longer — by approximately 1.7 milliseconds per 100Ys.

Even though bankers have more time in their day, with CECL implementation coming, there are many considerations and decisions to make. So, time is of the essence. Not only that, but certain steps can take more time than others.

One of the areas that can take extra time is calculations. You will have data from more than one source, including internal data sources. Consolidating and analyzing the data once it has been uploaded into the model should be given adequate deliberation and review by the different departments within your institution, including lending, finance, and credit.

While reviewing the data, be sure that you and your CECL team keep an eye out for any calculation mishaps. We found five top places where CECL calculations could go awry.

1. **Life is incorrectly calculated.** CECL requires that the full life of the loan's expected credit losses are documented at the time of origination. This includes scheduled and unscheduled amortization. Material errors have also been found here due to core data being improperly used in calculations of life. Have you taken into account prepayments? Do these vary by pool and are the prepayments applied appropriately? The answers to these questions will affect your CECL calculated life and so they should be asked early in the process. This will give you a much better idea of your actual losses.
2. **Homogeneous groups lack sufficient loss history.** Review whether your loan pools have the loss history needed for CECL calculations. How many charge-off events have these pools experienced historically? Of those, how many were for the same loan? Look at the number of accounts charged off historically. Oftentimes, the term for these loans is 3-5Ys. That timeframe reflects the volatility of the pandemic, which is unprecedented and not representative of true historical losses. In this case, you will need to use a broader data set. Using external industry peer data representative of the institution is helpful here, where the loan pool characteristics are similar.
3. **Lookback periods for losses are too short.** When you don't have enough loss history for your CECL calculations, you will likely have a hard time with lookback periods as your lookback should include 2-3 economic cycles, with each economic cycle averaging 5.5Ys. This may feel like a big ask, but you need to be sure that you expand your look back so that your loss rates include a larger subset of factors that could impact your reserve. This practice will provide you with more robust calculations and allow you to better understand the future risk implications on your loan portfolio. Plus, the regulators expect it.

4. **Lack of support for qualitative factors.** Once you have your lookback period properly adjusted and have a calculation that makes sense, you may want to justify it by looking for the qualitative factors that support it; using a plug to achieve a preset result. This could end badly. Qualitative factors that would most likely affect your loan loss rate should be used upfront. From there, you can use assumptions based on your geographic area, loan loss rate history, and other factors to adjust the calculation, not the other way around. Then, make sure you have documentation for these assumptions and check them against other business documents, such as your strategic plan, to show a tight link between all of your assumptions on qualitative factors throughout your institution.
5. **Forward-looking forecast is an arbitrary adjustment.** As with all stages of the reserve calculation, it is critical to use the right data from the beginning. Not deriving your forward-looking forecast from an economic outlook will lead you to a sub-optimal Forward Look result. You will need to apply a reasonable and supportable forecast to the estimated outstanding loan balances during a reasonable and supportable forecast period.

We hope that you have prioritized CECL and are moving forward in the process. Knowing these top five calculation mishaps will help you along the way to get you where you need to be more quickly. If you find that you need more assistance or just don't know where to start, we can help you get started with CECL very quickly. Simply contact us today.

FLEXIBLE SOLUTION TO FIT YOUR CECL NEEDS TODAY AND TOMORROW

We know that not every banker has the same needs. So CECL FIT is flexible to adapt to fit your portfolio. Start small with CECL FIT® at the basic tier and you can grow into a larger tier, if you need to later. Learn more about our CECL solution today.

ECONOMY & RATES

Rates As Of: 09/27/2021 05:29AM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.03	-0.01	-0.06
6M	0.05	-0.01	-0.04
1Y	0.09	0.01	-0.02
2Y	0.30	0.09	0.18
5Y	1.00	0.22	0.63
10Y	1.51	0.19	0.58
30Y	2.03	0.08	0.37

FF Market	FF Disc	IORB
0.08	0.25	0.15
SOFR	**Prime**	**OBFR**
0.05	3.25	0.07