Best Practices To Apply Q Factors For CECL

regulatory CECL risk management

Summary: The deadline for CECL has not been extended and January 1, 2023, is coming up fast. Are you ready? One specific area of focus for many bankers is using Q Factors consistently. While Q Factors aren't new, their expected application in CECL is more involved. Here are four Q Factor best practices to prepare you.

Belize is the home of the 2nd largest barrier reef, the Great Blue Hole. It is actually a large, underwater sinkhole and reaches 984 ft in width and 410 ft deep. Despite its depth, the remarkable visibility allows divers to see underwater caves and rich marine life, including Caribbean reef sharks. If diving is how you roll, you will want to check this interesting spot out.

Even if you aren't a diver, as a banker, you know that as we roll further into 2022, the Current Expected Credit Loss (CECL) implementation date is getting closer. While there are many areas to cover here, one important area of focus for community financial institutions (CFIs) is consistency. Of course, using Q Factors is not new. But, with CECL, the application is more rigorous. CFIs will not only need to document their key model assumptions with quantitative support. Early adopters also report that the logic used to support qualitative factors (Q Factors) is expected to be applied consistently within the institution. So, here are some **reminders of Q Factor best practices**, to make sure you are well prepared for your next audit or regulatory exam.

1. **Review Q Factors.** As you know, Q Factors are used to capture risks in your institution's portfolio that are not reflected in your model. The list of these factors hasn't changed from the 2006 Interagency Policy Statement. If needed, take time to review them to ensure you have covered all your bases.
2. **Use model limitations.** Q Factors should be used where there are limitations in the CECL model and these areas need to be documented appropriately. Discuss model limitations with your CECL specialists to determine which Q Factors capture the most meaningful model limitations. Many CFIs with focused niche lending have increased concentration risk. Does your model allow you to modify that risk as your portfolio grows or if material paydowns occur? Be sure to document the answer to these types of questions because your regulator will be asking them.
3. **Consider loss history correlation.** As you review your institution's loss history with your Q Factors, remember to consider certain economic conditions (or other changes) that may correlate with your loss history. For instance, if farm loans tend to do poorly in shallow recessions and you are forecasting a local shallow recession, then it is reasonable to conclude that farm loan performance may decrease during that forecasted period. Your CECL adjustments should reflect that, along with your other systems, such as ALM and stress testing.
4. **Ensure consistency throughout business practices.** Any resulting considerations and modifications captured in the CECL documentation should also be consistently captured in your other business practices. For instance, if one of your Q Factors is the change in lending policies and procedures due to the economic effects of the pandemic, this Q Factor should be reflected in your policy documentation as well.

Furthermore, any Q Factor adjustments should be applied consistently from one period to the next. Developing a scorecard or matrix, which shows changes in economic indicators and the resulting adjustments to your financial institution's Q Factors, is one way to demonstrate consistency. One best practice is to use scorecard ranges, to allow for flexibility. This allows you to apply Q Factors easily, consistently, and as anticipated, for greater efficiency as well as increased transparency for management, the board, auditors, and regulators.

How can you show consistency with new markets or a new type of lending?

What if you are doing a new type of lending or you are growing at a faster pace than in prior years? Or you don't have a lot of loss history?

In these cases, you may also be able to utilize peer or industry metrics, as a way to support your Q Factor adjustments. For example, favorable performance against peers may signal a smaller adjustment than an unfavorable performance, which may require a larger adjustment. The same can be said for more subjective categories, such as loan policies and staffing. Looser lending practices compared with peers may signal a larger adjustment to Q Factors than a more conservative approach.

As we reach the final stages of preparation for CECL, it is imperative to use Q Factor best practices. Your auditors and regulators will look for this, so you might as well make it easy by doing this from the start. If you need help, contact us today. We have been helping clients through CECL implementation and know what is needed.

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ECONOMY & RATES

Rates As Of: 03/29/2022 01:51PM (GMT-0700)

Treasury	Yields	MTD Chg	YTD Chg
3M	0.59	0.24	0.53
6M	1.08	0.39	0.89
1Y	1.66	0.68	1.29
2Y	2.37	0.95	1.65
5Y	2.51	0.80	1.26
10Y	2.40	0.59	0.90
30Y	2.50	0.35	0.61
FF Market	**FF Disc**		**IORB**
0.33	0.50		0.40
SOFR	**Prime**		**OBFR**
0.28	3.50		0.32