A Proactive Approach:

Preparing Your CECL Model for Economic Shifts

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Introduction

The Current Expected Credit Loss (CECL) standard represents a fundamental shift in how financial institutions account for credit losses. Unlike the previous incurred loss model, CECL demands a forward-looking approach, requiring institutions to estimate lifetime expected credit losses on financial assets. This proactive stance necessitates a robust modeling framework that can accurately capture and respond to economic fluctuations. This whitepaper, based on insights from the ARCSys webinar "A Proactive Approach: Preparing Your CECL Model for Economic Shifts," outlines key considerations and best practices for developing and maintaining a resilient CECL model.

The Forward-Looking Nature of CECL

A core requirement of CECL is to provide a forward-looking estimate of expected credit losses. This is a significant departure from historical loss models and incorporates three critical components when estimating losses:

- **Historical Loss Experience:** This involves analyzing past loss data from similar assets to establish a baseline. However, historical data alone is insufficient.
- **Current Conditions:** The model must be adjusted to reflect current conditions not captured in the historical loss experience, such as unemployment rate, severity of past due, or credit migration, to ensure the loss estimates are relevant to the present.
- **Reasonable and Supportable Forecasts:** This is the most crucial and challenging aspect of CECL. Institutions must use reasonable and supportable forecasts about future economic conditions to project how they will impact collectibility. This requires ongoing judgment and continuous updates to the model.

Data Density and Its Importance

The quality and depth of your data are foundational to building a defensible CECL model. A "data-dense" model refers to the richness and depth of available historical information.

Advantages of Historical Data

Ideally, a CECL model should utilize data that spans a full economic cycle, such as the period covering the 2008 Great Recession. This is invaluable because it provides a profound example of significant credit deterioration and recovery across various asset classes. Models built on such data can learn from actual **stressed loss behaviors**, providing a more robust foundation for estimating losses during future economic downturns. Without this historical context, a model's ability to accurately predict losses in a recessionary environment may be limited.

Limitations of Shorter Datasets

Relying on shorter historical datasets, such as data solely from the post-COVID-19 period (roughly mid-2020 onward), presents a significant limitation. This period was characterized by:

- Unprecedented government stimulus.
- Forbearance programs and credit relief.
- Rapid and unusual economic recovery.

These unique factors masked underlying credit risk and led to abnormally low net charge-offs for an extended period. A model trained only on this data may not be adequately prepared for typical recessionary behavior. Periods after COVID-19 have also been impacted by significant increases in inflation and rising interest rates, which further complicate the use of recent historical data alone.

Utilizing Third-Party Data

For smaller institutions or those with limited robust internal data, relying on third-party or peer data can be a practical necessity to meet CECL requirements. However, this approach requires careful consideration.

Critical Considerations

- **Comparability:** When using third-party data, it's essential to assess how closely the data aligns with your institution's specific risk profile, including underwriting standards, loan products, and borrower demographics.
- **Data Granularity and Consistency:** You must confirm that the historical period of the third-party data is consistent with your own and that the data is granular enough to allow for appropriate segmentation and methodology.
- **Source Credibility:** The third-party data provider should be reputable and reliable, and their methodologies should be well-documented and transparent.

Qualitative Adjustments

When significant differences are identified between your institution's portfolio and third-party data, it must be addressed through qualitative adjustments to the CECL allowance. These adjustments, or "basis point add-ons," should be rigorously justified and documented. Regulators will scrutinize these adjustments to ensure they are appropriate.

The Importance of Sensitivity Analysis

Sensitivity analysis is a practical technique used to assess the robustness of a CECL model.

Purpose and Scope

The primary purpose of sensitivity analysis is to **evaluate how robust CECL allowance estimates are to changes in key assumptions**. It involves examining the effect of minor changes in a single input variable on the model's output. The goal is to identify which factors have the most significant impact on the portfolio and understand the potential magnitude of future changes. This helps an institution:

- **Evaluate Resilience:** Assess how robust CECL allowance estimates are to changes in key assumptions.
- **Identify Key Drivers:** Pinpoint which assumptions have the most significant impact on the CECL allowance estimate.
- **Enhance Model Accuracy:** Provide insights for refining the model to improve accuracy and align with current conditions.

Examples of Sensitivity Tests

- **Changing economic forecasts for charge-offs:** Testing a baseline forecast against a minor recession or a period of prolonged low growth (stagflation).
- **Changing model inputs for historical data:** Incorporating different historical loss periods to see how the model reacts to different economic conditions.
- **Changing prepayments:** Adjusting prepayment assumptions to see the impact on the estimated life of the loans and the resulting allowance.
- **Changing interest rates:** Evaluating how expected prepayment rates, and thus credit losses, change when interest rates rise or fall.

Integrating CECL with ALM Strategies

The principles of CECL and Asset-Liability Management (ALM) are deeply intertwined, particularly concerning economic forecasts and shared assumptions.

Shared Economic Assumptions & Scenario Analysis

- **Unified Forecasts:** Both ALM and CECL models should use consistent economic assumptions across their baseline and stress scenarios. This ensures that the projected impacts on Net Interest Income (NII), Economic Value of Equity (EVE), and the CECL allowance are all based on the same underlying economic outlook.
- **Consistency is Key:** Inconsistency in economic forecasts between CECL and EVE modeling can lead to a fragmented and potentially misleading view of an institution's overall risk profile. Regulators expect and require a coherent framework.
- **Integrated Stress Testing:** ALM stress testing (e.g., interest rate shocks) must now explicitly integrate the corresponding credit loss impacts from CECL, providing a more complete picture of capital vulnerability.

Strategic Implications for Lending & Pricing

CECL's forward-looking approach has strategic implications that extend beyond just accounting.

- **Risk-Adjusted Pricing:** CECL forces banks to more explicitly recognize lifetime credit costs upfront. This can lead to better risk-adjusted pricing of loans, which improves profitability and aligns with the overall balance sheet.
- **Product Development:** ALM and CECL insights can guide product development, favoring loan products that align with the institution's risk appetite.

- **Portfolio Management:** ALM committees, armed with CECL insights, can make more informed decisions about loan concentrations, segment growth, and portfolio rebalancing based on comprehensive risk assessments.

Conclusion

A proactive approach to CECL modeling involves a deep understanding of the model's core requirements, a commitment to using high-quality data, and the discipline to consistently test and adjust the model based on economic realities. By integrating CECL with broader ALM strategies and maintaining consistent assumptions, financial institutions can not only meet regulatory requirements but also gain valuable insights that drive more informed and resilient business decisions.