Important Considerations for CECL Model Validation

Whether you are running an in-house developed CECL model or have partnered with a third-party provider, there will be ongoing model risk management aspects to take into consideration. Typically, institutions will want to validate their CECL model during the year of adoption. Our goal for this **on-demand** webinar is to walk you through what a CECL model validation entails, what your auditors and regulators may expect, and provide our insight on successful validations.

Find additional resources on our event page: https://www.claconnect.com/en/events/2023/important-considerations-for-cecl-model-validation

Here is a transcription of this session:

Brittany Stern:

Good afternoon or good morning if you're not on the East Coast like me. Wanted to welcome you to CLAs Financial Services Groups presentation on important considerations for a CECL model validation on behalf of my colleagues. And then we are excited to have you here to go over this with you.

So we'll start off with the legal requirements, if you will. This is for your reading purposes, just our required disclaimer. Next, since you are getting CPE for this hour that you're going to get to spend here with us, we are required to tell you our learning objectives. So what is our objectives for today? If these don't look like something you're interested in, stick around. I think we're going to still have some fun. Our goals today are to recognize what is expected from your institution related to a CECL model of validation, and then how your institution can prepare for that validation to make it as successful and impactful as you can.

I am joined today by two of my colleagues, David Heneke, he's a principal out of St. Cloud, Minnesota, and John Markfort, a principal out of Minneapolis, Minnesota. My name is Brittany Stern. I'm a principal in our east coast practice out of Baltimore, Maryland.

And last housekeeping item, if you will, humor me for a minute. Our agenda today. First, David is going to run down a discussion of current CECL statistics. And when I say current, I mean as of 12/31/2022. We're going to go through the key components of a CECL model validation, what you should expect to happen during your validation and what you should expect out of your validators. Next, we're going to talk through some good steps to prepare for that CECL model validation to happen in 2023. And last, I consider our bonus episode, just some bonus items to consider during 2023 post CECL adoption, if you will.

So we're going to kick this off with a polling question. I'll read it out to you real quickly, but it should be coming in to your screen in just a moment. What is your institution's expected impact on your allowance for loan losses with the adoption of CECL? Do we expect to kind of slide right in there with minimal to no impact, five to 20% increase, 20 to 50% increase? I know we put these questions together, don't hate us, but 50 to 100% increase? And then the last item is 100% increase or more.

I'm going to kick it to David real quick to give some insights that he's going to cover later on what his institutions have seen related to their adoption impact. David?

David Heneke:

Yeah, thank you Brittany. And as Brittany alluded to, we're going to go through here in a couple of slides some of what we're seeing for institutions that have already adopted by harvesting call report data that outlines what the impact was. And I'm just kind of looking at the survey results here in that it looks like the vast majority of our attendees, almost 42% or a little over 42% expect less than a 5% increase. About 31% expect between a five and a 20%. So we're looking at roughly about 73, it just changed on me a little bit, about 73% of you're expecting less than 20% increase.

And I would say anecdotally, and John and Brittany, feel free to comment as well as we've been working with our community financial institutions, I would say that's what we're also seeing when it comes to the discussions that we're having with clients.

And I'll get a little bit more into the detail of that when we get into the actual data of the institutions that have already adopted because there's a number of variables that you will need to consider when it comes to the adoption. But I think it's a good start before we get into the validation to at least give you all some benchmark of what we're seeing in industry so that you can begin to look at that when it comes to what your number is. And if you feel like you're in the ballpark of where kind of the industry has landed and the makeup of your loan portfolio is going to have a big part of what that number ultimately ends up being. As you'll see when we get to the data here in a little bit. So Brittany, back to you.

Brittany Stern:

Sure. And I would say another nuance that maybe we don't discuss as much is it all depends on what you're currently carrying in your allowance as part of your incurred loss model. We see so many variations between how many times of net charge offs or what percent of loans that you're carrying that, not that this data is it meaningful, but it is all relative.

All right. So one more polling question. Again, humor us. We want to talk about and kind of see where you are and your institution is in their CECL model validation journey. One, haven't started yet. What is this? This is my kickoff. Attending this webinar is my kickoff. We've started exploring options. Three, we've engaged a third party and expect this to happen sometime in 2023. Or number four, we have completed our first model validation already. John, I'm going to push it over to you. Any insight on what you've seen with your institution?

Jonathan Markfort:

Yeah, we've seen a big variety of work. People are, like you say, on their CECL journey, it feels like we've been talking about CECL for several years because we have been talking about CECL for several years and I think a lot of people were so focused on how do we tackle it, what methodology do we use? Let's make sure we have our proper data and we'll walk through a lot of that as we talk about the validation specifically. But really spending a lot of time on that calculation. And now that we've finally got past that point for many of those on the call here implemented January one, now what do we do? How do we handle it from a governance standpoint? So we're getting a lot of phone calls and a lot of questions about what this process looks like. How often do we have to have it, what are your expectations as external auditors? What are the regulators expectations?

So we're seeing a lot of people across the board. One thing we'll talk about too is the timing of it. Should it be done, should have been done fourth quarter of last year as we get ready for implementation? Or should it be something that we tackle in 2023 here? So we're seeing a wide variety of where people are, some people are saying "Let's not do the validation until somebody forces our hand." And that might be the regulator or external audit for maybe pushing that for you as well. So we're seeing a large variety of where people are on their validation journey.

David Heneke:

Well, it's interesting John, that you say that because if you look at the poll results, we're about 25% across the board on all of our answers.

Brittany Stern:

Agreed, obviously very clear that all of us have started to thinking about it, started exploring options, and only 22% of us have completed our first model validation. So I feel like a lot of us are in the same boat.

So we're going to start the gist of the presentation. And before I kick it to David real quickly, just want to note we have our questions and our answers, questions open. We're going to be taking the questions live, so we'll read them out and try to address your questions as quick as possible. And we will save some time for the end to be able to get a chance to talk with you live or ask the questions. If there's anything we don't get to, we have teams messaging in and making sure we answer, but keep it going. We appreciate the questions and we plan to answer as many as possible if not all of them. So David, kicking it to you for some current CECL statistics.

David Heneke:

Terrific. Thank you, Brittany. So we're going to go through a few items here in regards to where adopters are landing when it comes to their increase as it relates to CECL. And if you take a step back and walk through the logic of what we're moving to, we're moving from an incurred loss model to the lifetime loss model. And conceptually you would expect to be either at or have a increase related to your allowance as a part of that adoption because we're theoretically reserving for a longer period of time than we were under the incurred loss method.

Now there are some exceptions to where you may be justified in showing a reduction by the fact that you can now include a forecast of recoveries into your computation, which you maybe weren't doing before, but in most cases you would expect to see an increase.

And that's what you're seeing here in this first slide is this is simply an aggregation as of 12/31/2022 of all of the institutions and it's primarily publicly traded banks because those are the institutions that have had to adopt and the breakout by percentage increase that you see as a result of what was filed on the call report. Now what Brittany alluded to earlier, I want to make sure that we all understand when we talk about where we're at currently in our allowance and what the subsequent increase is, that's going to be a big deal. And you'll see that when we get to a slide here a little later of what the allowance level as a percentage of loans was prior to adoption and after. And you'll see that in some of these institutions, the reserve levels were relatively low to what you typically see in a community institution in regards to the amount of allowance you have as a percentage of your loans.

And so you need to keep that in mind. The other thing as well as a part of CECL adoption that you also need to keep in mind is that a number of these institutions did a number of acquisitions, which as a part of adoption of CECL, when you look at the purchase credit and portfolio of adoption, that discount that gets created on day one as a part of the fair value marks related to the loans, that discount will get transferred or some of that discount could get transferred into the allowance, which should also result in an increase.

And so like we said from the outset, there are a number of variables, but this is what you're seeing across the board with the vast majority of the institution seeing a less than 50% increase when you aggregate this up.

So the next slide outlines the percent of the increase as a result, or by asset size and various asset stratas. And the one thing to note about this slide is the data is not very broad at this point because we're only looking at about 300 institutions that have adopted. And so therefore, you see that the less than 500 million dollar one that adopted, that only had if memory serves, two institutions in it. So it's not a very large population to draw statistically relevant conclusions. But this is to give you an idea of the data that is out there where we're seeing these land.

And the most, I would say one of the more relevant presentations or data elements here is what you see on this slide is this is what I alluded to before of where the blue line was the allowance to loans on December 31st of the year prior to adoption. And then the orange bar is the allowance to loans right after adoption. And so if you look at your allowance levels as a percentage of your loans and you're already hovering around say that 1.3, 1.4, 1.5 as a percent of loans, you may already be kind of where you need to be as a result of what we're seeing in the industry.

You'll need to go through that analysis and go through and understand how you're coming to that conclusion. But this is what you're seeing in the industry from a standpoint of the largest banks that have adopted. And primarily the thing that I was taken a little bit aback by in regards to when we were pulling this data together was the fact that you see those allowance levels prior to the adoption of CECL. And in most cases in a lot of these in institutions, they were below 1% of loans.

And the reality of the situation is as you look at large publicly traded institutions compared to privately held, you saw that disparity and it seemed that privately held institutions were given, for lack of a better way to say it, maybe a little bit more leeway in the amount of reserve that they could hold in response to in compared to what generally accepted accounting principles maybe dictated that you should have because it was all being driven by the qualitative adjustments. And everybody remembers the pain that we went through in 2009, 2010, 2011, and it seemed like we were all a little maybe shy to want to pull stuff out of the reserve because we wanted to make sure that we had enough in the event something like that were to happen again, because for a community institution, it's not beyond the realm of possibility to where you have one large loan, that one large loan that wipes out your whole reserve. So it's an interesting dynamic that you see when it comes to the privately held versus the larger publicly traded.

So the last few slides we have here are just some current levels as well as of December 31st, 2022. So I've broken out credit cards explicitly because we're going to talk about that here in a little bit because credit cards kind of skew the data because that is a big driver of some of these allowance levels. But these are broken out by five categories and the total allowance for loan loss as a percentage of loans based on the various asset stratas below. And you can see kind of where these institutions were at as a percentage of loans as of 12/31/2022.

And the interesting thing when you dive into this is consumer lending, at least at present time seems to be the biggest driver of where you see some of the increases or where you see institutions have larger loss rates, primarily because ... you'll see that in credit cards. You'll see that in the other consumer category where real estate lending is more consistent, that you'll see when we get through the trends here.

And so here's the trends since adoption of all of the institutions that have adopted CECL. And what's interesting about this data set is when you look at the start and kind of where we were and then to where we are now, you see that spike that happened as institutions started to ramp up because of COVID and expected credit losses that were going to come out of that, you'll see that ramp up and then the charge-offs really never came. And so then you see the release of the reserves starting to come back down to where we're at today.

But from a trend perspective, as I alluded to before, if you look at these various levels, the residential real estate, the residential commercial real estate, those categories have remained fairly consistent once we've gotten through, I'll say kind of the COVID bump that happened in early and late 2020, but you'll see that top bar the other consumer just this last quarter, you're starting to see that tick up as far as what larger institutions are putting away for their reserves.

And just for your information, these are the actual ratios. We put these in those slides so you have access to them if you're curious to see what those actual numbers were on a quarter by quarter basis. The first slide was the visual representation of that. And then finally the last slide we have just broken out is these are the credit card reserve levels as a percentage of loans based on the various asset stratas as well. And the one thing that I find interesting about this particular chart is kind of the disparity amongst the various institutions in regards to where their allowance levels are at for credit cards. And I think that's the thing that I take away from this data as I look at it is this is kind of holistic and industry-wide for those that have adopted.

But when you kind of drill down into the individual institution by institution level, there is a lot of variance. And part of what may be driving that variance is the fact that the CECL standard is not prescriptive in regards to how you compute the allowance. Because we could walk into five different institutions, all five could be calculating it in a different way and all of them could be right because isn't one defined prescriptive methodology. And that's why as a part of this, and we go into the next section here where we start talking about the validation concepts, it's going to be very important that you understand why you selected the methodology you selected and be able to explain why this is best suited to your portfolio because those are some questions that will come up as a part of a validation.

And so with that, I'm going to turn it over to John, and John is going to start walking us through some of those key components of a validation so that you can be ready to address any questions that come to you as a part of where your ultimate calculation ends up. So John, you can take it away.

Jonathan Markfort:

Perfect. Excellent. Thanks David. A couple key things that you touched on. The great thing about CECL gave a lot of ownership for management teams to determine what methodology is the best for you from an external audit standpoint, from regular standpoint, and maybe even internally, maybe it gave some angst just to see how many different methods people are using. We have seen some reversion to a few different methods and I think we'll see that over time as well.

We know one thing we'll talk about as this process goes on is to be agile, nimble. We know things are going to evolve and change. I've even had conversations with clients that had a methodology and a process in place for the last three years running parallel and said, "We think on a go-forward basis, we want to switch that. And what's our process to switch the methodology?"

So really wanted to help walk through the validation process of defining what those methods are, how ultimately management determined it was reasonable and the right approach for you. That's going to be a big component to the documentation as we walk through this. I'm sure a lot of folks on the phone are pretty worn down, again talking about CECL getting ready for it, amping up, gearing up, get everything in place for that January 1st implementation date. Maybe some are still kind of tweaking that number, really making sure that you're comfortable with that number. Obviously still using that 12/31 data as the basis for it, but really making sure you get essentially one shot at that initial entry there. ?So we know a lot of work's gone into it and just making sure that everything is well documented and that's what we'll spend a lot of time here walking through what the components of the validation are.

Again, what are some of the external folks, regulators, external auditors, what are some of their requirements and then ultimately, how do you tackle it and what are some of the key things that we're seeing within it?

As David was talking about some of those fluctuations that we've seen in the market, I think we'd all love if CECL came in when there wasn't ... during the pandemic, when it wasn't during a technical recession or whatever we want to debate what we're in right now, rising interest rates, potential volatility, and maybe some collateral types and some segmentations there. We would've loved it if things were normal and just a typical 40 basis points of charge offs and we'd kind of move on from there in typical delinquencies.

So we know there is a lot of noise within the market. I think we're seeing that as we talk with our clients and seeing where the ultimate numbers came out and then some of that volatility that we saw within some of those larger institutions too and I think a lot of those consumer segments as well.

All right, so again, spend a lot of time leading up to this point now. Now let's talk about where do we go from here. Now that we have a sophisticated model in place, it creates more risks and more overall governance around that process of what that looks like and how do we tackle it. When you think of that model risk management and validation process, if things get heightened, the more inputs that we have going into our models, more sophistication we have in our forecast assessments creates more volatility. And so we want to make sure that we have well-thought-out assumptions and processes in place to make sure that we're making our output as close to our expectations as the information that we have at that time.

Before we dig into some of the details, and we have quite a few slides here as well, the number one question we get is how often do we have to have a validation done? And number two, who can perform it? So the inter-agency guidance is pretty clear and pretty prescribed on the who can perform it. It can be done internally if somebody within the organization has the ability to understand the methodology used and the documentation that management's using for it. Again, somebody in independent of the CECL calculation itself.

For the vast majority on the phone, we know that whoever within the institution who's involved with the process are the ones that really understand it and know it. And maybe others within the organization may not have that background, but it certainly can be tackled internally. Obviously there's a lot of other folks that can perform it for you as well. But again, making sure that they're independent of the function and the other agency guidance was pretty clear about some of the independence for external auditors as well. So your external audit firm's going to take a look at the overall impact, the financial statements, but the validators are going to go in and dig more deeply into the model there as well. So it talks about that independence aspect as well.

The other question I mentioned is how often does it need to be done? I wish it was more prescribed in the inter-agency guidance, but I think we're taking a look at other models that you have, whether it's interest rate risk or BSA AMLs or any other models, capital stress testing, those sorts of things. Generally, we're speaking every two to three years is kind of what we're going to start out with. But then that might change. And I think the two big drivers are going to be, again, the external audit forces and maybe some regulator forces. The other thing-

Brittany Stern:

Hey John, if I could jump in and join you for a second. Hi. Just a reminder that if, I also think two to three years is a great starting point, but if you anticipate a significant change in your model, you should probably anticipate to get it revalidated.

So I was having a conversation with a few of my clients and they anticipate maybe making some changes and tweaks in their model over the next coming weeks until they file their quarter one, 2023 call report. So that was just one other nuance to throw in there, that if you do anticipate a large change or a significant change in your model, are you changing vendors changing a big portion of your calculation, maybe going from a warm method to a probability of default, you should anticipate that based on those changes that would trigger getting an updated validation data.

Jonathan Markfort:

Absolutely. And the other key things to consider is how's our portfolio, has it changed and do we want to change the way we segment it? Because that may increase some of those key assumptions that are driving the output as well. So lots of factors that could change that frequency. That's a really great point, Brittany.

All right, walking through a couple of the key components, what are the regulators asking for? What is the validator going to ask for? And as we mentioned before, a lot of folks have spent a lot of time on the calculation itself. Sometimes when we're sending out requests lists to go through the validation, the first thing we ask for is what are your policies? What procedures do you have in place? And I know a lot of people have been working on those to make sure that they're board approved, that they have the key aspects to it. But generally it's one of those things with may got pushed behind because we've spent so much time on the calculation itself. So make sure we have a strong policy in place.

A couple of the key things very similar to the occurred loss method that we have expected within there is the documentation of the methodology selected, maybe some consideration about different methods that were considered and ultimately how governance approved the one method that you ultimately chose.

We do see different methods for different loan segments, so that also should be prescribed within that policy of how linking the portfolio risk within the loan portfolio to the specific method and how you ultimately felt that was the best method for you.

A couple other key pieces. The loan segmentation, a lot of times we're seeing based off of call report codes, generally speaking, they have similar loss characteristics. We are seeing a wide variety in segmentations, both geographics and others just on internally. The other key piece that we're seeing within segmentations is related to participations as well. Maybe they're outside of market or have different loss characteristics there. So however management determined to break down the loan portfolio to have documentation supporting that piece as well.

Processes for determining when a loan is collateral dependent. We are still seeing individually evaluated loans within the system. So having some definitions around that piece, what key attributes or key triggers may justify management digging into some of those pieces. Documentation of the qualitative factors and economic forecasts that are used within the model, what sources are they from? What's acceptable? That's used within the model. I think the vast majority of our questions, these data is we don't have any historical losses. Delinquency is maybe picking up a little bit, but still historical lows. So qualitative factors, how do we tackle them? And it's a similar concept to under the incurred loss method, kind of a similar areas that we would follow or we expect to see taking into consideration. And then we'll walk through those as well. But just a documentation of that within the policy on how that's done.

David Heneke:

Hey John, if I could add a couple of comments on the portfolio segmentation piece, because I think you did a really nice job of teeing that up regarding similar risk characteristics, but I think we would want to address that depending on the size and complexity of your institution, the segmentation could be fairly broad or it could be fairly granular depending on what you see as the driver for when you're going to take losses.

So in a perfect world, we would segment all of these portfolios by a data element loss driver that was reliable that we could say, "Well, if this driver does this, then that means we expect our losses would be X." Right? Well, we don't live in a perfect world and that oftentimes is very challenging to try to align what those drivers are and what we think losses can be.

And just as kind of an anecdotal example, I was working with a client and asked them as we went back through their charge offs and said, "Well, what actually led to this charge off?" Well, the answer in that particular case was the business owner was going through a divorce that led through the downfall of their business. And it seemed as I had more and more of these conversations that the driver of the losses tended to be either a result of divorce, an individual losing their job or the death of a business owner seemed to be the most common answers we got.

And so conceptually then you may need to, in a perfect world, you'd say, "Well, what's the likelihood if you think these are going to be drivers of loss that your clients are going to go through a divorce?" Well obviously that's not practical. And so that's where I bring that up as an example to say, when you're having these conversations and thinking about it internally, if you don't see any disparity in terms of charge offs that are actually realized in a portfolio, if you bifurcated on a very granular level, it may not be necessary to do that bifurcation at that level because you're not getting any better results or any better data from going to that granular level.

And the other thing to keep in mind too is that if you get too granular, you end up with really unusual results. Like I was working with a client and they wanted to bifurcate by collateral type and then also bifurcate by risk grading. Well, they had one particular category where when they did that, they had five loans in one bucket and one of those loans they took a full loss. So when you did the computation, it was saying we're expecting a 20% lifetime loss rate.

Well, when you looked at the portfolio as it currently was constructed that existed in that category, the average loan to value of those loans was about 60%. So does it make sense to apply a 20% lifetime loss rate based on an event that happened that is no longer representative of that portfolio?

So it's just make sure you're having those conversations when you're going through this as a matter of policy and talking about what similar risk characteristics means because you can find yourself getting into a position where you end up with results that just don't make logical sense.

Jonathan Markfort:

David, I think that that's a great point. And we've had other scenarios where, raise your hand if you had access liquidity the last couple years, and I think a lot of folks would be raising their hand right now and maybe look to diversify that loan portfolio and maybe we're in new segments that they hadn't been in the past or maybe have different underwriting criteria based off those segments. So might be [inaudible 00:31:14], but maybe you changed some of those underwriting parameters. Does that make sense to segment those out specifically as well?

We may gloss over segmentation in general, but I think it is a key aspect of how comfortable are we with that process and really aligning them as best we can. You get two small buckets to have 38 different segments may be just from a operational standpoint, too much. And to David's point, we're where one key loss may drive the rest but want to make sure it's at the right level as well. So it's a maybe case by case scenario within those areas.

A couple other things that we would expect to see within the policy. What reporting systems are used? Is it internally done? Is it a third party model? How comfortable are we with that model? So some of that model risk management components within there. We'd like to see a reference to an institution's determination on collectable loans, kind of that reference to that charge off policy. How are some of those key aspects within there?

A couple other things, what's the role of internal audit within the function and the validation process? And I know we talked about the frequency there and each regulator and examiner may have different frequencies of those other reviews. So definitely check in with them and see what their expectations are there for you as you're billing out your policy. And a couple other things, debt securities, the evaluation of held [inaudible 00:32:53] securities, and then also unfunded commitments within the policies. So just a couple highlights from there.

Brittany Stern:

And John, we do get a lot of questions from our clients frequently about, hey, do you have a sample policy or where is this prescribed? I think it is important we note the SCC and I recognizing that we're not all SCC registrars. Please don't yell at me. The SCC has put out SAB staff accounting bulletin 119 and that does give some guidance and some reference, so feel free to view that at your own leisure.

Jonathan Markfort:

Absolutely. And then portfolio segmentation, we discussed that in length, but don't want to fly by. We think it's a key driver in your ultimate results there. Digging into the historical loss calculation, and this may be the area where we're most familiar with given the incurred loss methodology and how we ultimately get to those, but there's a couple of things that we want to take a look at here. Again, based off the aggregation that you have in the loan segmentation, how far back are we going? How accurate is our data? I think when we talked about five plus years ago was the first question was let's make sure we have the right data that we're going to need depending on the methodology going forward. So I think a lot of the times we said, let's make sure that that data is there, that it's accurate, that it's all encompassing, that it's complete. So when we go into production, we are comfortable with some of those pieces there.

So taking a look at the model, depending on which model of methodology that you're using, how is it transferred into the system? Making sure that's mathematically correct. A lot of times we're seeing peer data used within those historical losses just given that you may not have that historical loss information at your organization. So how do we incorporate some of that peer data to help fill the gaps? Maybe it's a new loan segment that we have and we don't have our own historical information going back as far as we would like. So really digging into that to make sure that we're comfortable with it and it's reasonable given our lost characteristics or expectations within our own area.

Loan data validation. I think this is going to be a big piece as well. And when you think of CECL, really comes down to a data validation. We want to make sure how is information taken from our core, maybe taken from third party if we have participations, how is that data ultimately loaded within the model? So we could talk about the data validation aspect for probably quite some length, but the key piece that we're taking a look at from a validation standpoint is what are the key drivers and what are the key attributes that are used within the model itself?

So a couple things too. We generally would expect if we're getting down to a loan level detail, rate maturity date, term collateral type, some of those key segment segmentation aspects, but other things may be coming into the model on a periodic basis. If we're updating FICO scores, if we're updating estimated loan to values, those will ultimately have a big impact on the ultimate results.

So how comfortable are we with that? What's our reconciliation process with it? What's our review process from a control standpoint? Within the data validation aspect, we don't want to minimize the amount of time and effort that's gone into making sure that the plumbing is working. If we're using a third party vendor, we know it's a big lift. We want to make sure that the data that we're using, little garbage in garbage out adage, that we're taking that into consideration.

I know I talked about the estimated loan to values. We see how often are those being updated? How often are our FICO scores being updated? So I kind of worked my way back, whatever key input that the model is using, how do we make sure that we're comfortable with all those assumptions that are used within that area?

David Heneke:

And John, that's a fantastic point because that then goes back to the conversation we had about segmentation then as well because if we want to segment by say, FICO scores, but we have no comfort that our FCO scores are accurate and it's not a data element, we're checking for accuracy, we probably shouldn't use it, right?

Jonathan Markfort:

Absolutely. And estimated loan to values, if tax assess values were 100% accurate, if Zillow valuations were 100% accurate, it'd be a great world we could rely on those. It would save us a lot of steps when our appraisal reviews, but we know they're not a hundred percent accurate. So how comfortable are we with whatever are the key drivers?

All right. Going through the forecast period, this is the area we're doing a lot of questions along with the qualitative factors. We always have heard that it needs to be a reasonable and supportable forecast. Well what does that mean and how do we get comfort with what's reasonable and what's supportable? That's a very open-ended question that we get a lot of the time. So what we're seeing in practice is management teams are using different forecast periods maybe for different loan segments and making sure that they are aligned well and well documented depending on what methodology that you are using, whether it's the warm methodology or discount on cash flows.

Some of those forecast periods are to the end of the term of the debt or the life of the loan there, but we really make sure that any forecast that we're including within it is supportable, and we only know what we know today. We want to make sure that we're taking all available information into it. We also wanted to see, I think another question that we get often is how do we consider default rates and loss rates within the model if we're getting maybe from a third party, how is that driving that forecast period as well?

We want to make sure that management understands how those key assumptions are included within the system and how they're driving the ultimate results because we are seeing maybe some confusion in the industry of exactly how those are being calculated. We want to make sure that when examiners come in and external audit firms or validators come in and we say, "Well, where'd this come from? How are you comfortable with these ultimate numbers?" The response isn't, "No, we get it from a third party and we feel really good about it." It may be a really great number, but we want to make sure the management understands the background and ultimately how those are being calculated.

David Heneke:

And I think that's a great point, John, because I could say from personal experience in working with some clients that are using third parties, that it's not that the third party computation is wrong, it's just a lack of understanding of, to your point, of how the computation is done. I mean, had one client I was working with that was working with a third party that went through and did all of their inputs and they were relying on that system to generate the forecast adjustments, which it seemed to be based on some sort of statistical regression analysis that based on their forecast of unemployment, we're going to expect that we're going to see an increase of X percent in our losses.

So they went through and did all their inputs, didn't feel like they really changed anything, and their allowance number that the system was spitting out was a million dollars higher than the last quarter and they couldn't figure out why.

And so once again, that's not to say the number was wrong or wasn't being computed correctly, it just went to that lack of understanding of what lever did they pull that generated that change and making sure you understand what is causing that. And this is also, what we're talking about here really gets to the size and complexity of your organization and that this type of level of analysis when it comes to your forward-looking and your current state adjustments will vary based on your loss history and the size of your institution. Because one of the things that we've found out as we've been working with clients on the smaller end, smaller community institutions is that your charge-off history is very volatile.

You tend to take a small number of large charge-offs, whereas larger institutions tend to take a large number of smaller charge-offs in relation to their portfolio as a whole, which then allows larger institutions to do statistically relevant analysis to say, "Well, if unemployment goes up 100 basis points, we know that our charge-offs will likely go up 200 basis points or whatever that number is."

Whereas with a smaller institution, it's much harder to draw those comparisons or that relevance of those two items. And so there will still tend to be some element of management's best guess when it comes to these adjustments. The key thing from our perspective, or at least from my perspective when I go in and do these and talk to clients about it, is that I expect to see directional consistency in regards to what your narrative says of why you think things are going to be better or worse when it comes to your adjustments. And then secondarily, I'd expect to see then, if you think they're going to be worse, I'd expect to see additions. If you think they're going to be consistent or better, I would expect to see it remain flat or a reduction. And that's all then based on what historical period you're comparing it to.

So if your historical loss period is a period of very low charge-offs and you think we're going to experience charge-offs similar to what we saw in '09, '10, and '11, then you're going to have to significantly qualitatively adjust for that because of what historical period you're comparing that to.

Another common question we get is, well, how do we even begin to quantify what these numbers could be? Because some of it's just like management's best guess, like I mentioned. Well, what we've seen some clients do is they've looked at their history and said, "Well, what was the worst year of charge off we've ever had as far as a ratio to these loans?" And then use that as their guardrail to say, "Well, unless we believe it's going to be worse than the worst charge we've ever had, we know that our annual loss rate's going to fall somewhere in this spectrum." And then trying to quantify where on that spectrum, it falls based on your assessments of the industry information as well as adjusting to current state.

Brittany Stern:

And John, to add one more thing to what David mentioned and when we're putting in, when management is putting in assumptions as it relates to forecast period, forward-looking, current state, those assumptions that you're putting into there should be consistent with the other assumptions that your institution is using, whether it be your ALM modeling, your stress testing, all of those. So making sure that we're moving in the same direction.

It would be hard for us, if we were coming in to validate your model, if management was saying, "We expect the future to look great, everything's hunky-dory, fabulous," and then in your ALM model or your stress test, excuse me, stress testing that you're saying that you think delinquencies are going to go up and you're looking into a recession. So you want to make sure all of the models at your institution are moving in the same direction.

Jonathan Markfort:

Those are great insights. I get the question a lot too is the validation day one, we don't have that history. CECL's implemented January 1st. What's it going to look like in the future? And I said the same thing, just like Brittany said there. We're going to take a look at the trends and take a look at over time how those qualitative factor adjustments maybe moved up and down.

Historically, we didn't like to pull back on those qualitative factors, and I think in a new CECL world, we're seeing more fluctuation as long as the narrative supports it, as long as there's some power behind it as well to make sure that it is moving in the right state. We are seeing more fluctuations within some of those key assumptions there. All right, and Brittany, I'll kick it over to you. Continue on with the validation pieces.

Brittany Stern:

Thank you. I feel like you and David stole my thunder as it comes seeing a third party vendor, but that's fine. Don't worry guys. So this part of the validation, we're breaking into kind of two parts. One, if you're doing your model in-house, and two, if you're using or have engaged a third party to do the math of your model.

Your model validation will not include both of these from this perspective. So we're going to start on the right side because hey, why not. In-house if your institution has done, maybe you made an Excel model, it's a warm method on your own, what should the model validation look at from that perspective? So your model validators should come in and check the mathematical accuracy of your Excel spreadsheet or ... I say Excel, but it could be an Access database, whatever it may be.

Check the mathematical accuracy of your model of reviewing your institution's internal controls. Do you have documented controls over the access of that model? Who can touch it? Is it locked down? Who knows where it is? Who can get in there and break it, if you will? I, for one, you open up an Excel model and you see the hashtag ref the whole way across and you've broken something. Is it locked down from a user access? Does John, David and Brittany have access to that model? Or is it locked down so that only I have access?

And then change management. How do we make updates if we find something that needs to be updated? Who tests those updates? How do we then come back and check the mathematical accuracy of those updates? So making sure you are owning all aspects of that model? What you would expect out of your third party? Should you be using a third party to do this?

So then skipping over to the left side of your slide, third party management. So as we've talked about previously, even if your institution has engaged a third party to be your CECL model vendor, management owns the inputs, the outputs, the assumption and everything that goes into it. So as a validator, we would expect that management has somehow documented their understanding of the model, how they gained comfort over the mathematical accuracy of the model and how you're comfortable that third party has put together a product that you understand and can stand behind with your regulators and your auditors.

What does this include? Normal vendor management. Do you have your third party vendor's [inaudible 00:48:16] reports? Have you reviewed it? Has their model been validated? That will be part of your vendor management to making sure that their model has been validated for mathematical accuracy.

In addition, that management has a governance process over inputting the data into the third party model that you're testing it, reconciling it and have controls over that. And then user access as well. Who has access to the model and what are the change controls of the third party to ensure, kind of like we talked about, the in-house that they update properly.

I'm going to keep moving a little bit just because we only have 10 minutes to go, but David or John, jump in if you want to mention something.

So two of the last significant components of a model validation will include the institution's back testing and then maybe also some back testing on the backs of the validators. So we would expect that institutions do back test their model over the course of the year. And what does that mean? It's making sure and monitoring that the model is reacting to what's going on with the portfolio and the institution that it's acting as you would expect. Have delinquencies gone up, maybe our model goes consistent with that or have we had large charge off? What are the changes that go forward with that as well?

And then making sure, down to a gram granular level if you can, from a perspective of these loan segments, we added significant new loans to these segments. We would expect the ACL to increase consistently with that. And you should document this back testing, I would say, on a monthly basis as you are continuing to tweak.

Unfunded commitments and investments. I'll just first kick this off that the concept of unfunded commitments is not necessarily new. It was part of previous, but most of our institutions had documented that any allowance under the incurred loss model, under unfunded commitments was the material. I'll speak a little bit to some of the credit card portfolios that I have experiences with. And then David's going to jump on in a second to talk about some of his line of credit experiences.

So your institution should document their understanding of unfunded commitments and how those impact the future. So as a reminder, any liability for future losses on unfunded commitments should be on that liability side of your balance sheet. And you should from a, well, sorry, back to credit cards. So credit cards from that perspective, gain an understanding of what your credit card portfolio and the drawdowns look like on any given year. Do you typically have 5% or 10% drawdown each year? And that will help you bifurcate your portfolio and break it down.

Another way to bifurcate or break down your credit card portfolio would be to find a way to differentiate your borrowers. Are these transactors or revolvers? Do they pay off their credit card bill every single month? And is there any significant risk with that? Or more so, are your risks of future unfunded commitments more lie with your revolvers and your borrowers that continue to maintain a balance and draw down on that. David, kicking it to you to give a little bit of line of credit insight?

David Heneke:

Yeah, certainly Brittany, and it's kind of similar to what Britney alluded to in the credit card space. And I think the main thing that often gets overlooked in regards to how this computation comes together is that CECL is meant to be a total commitment evaluation, not just the amount that is on the balance sheet for loans that have funded.

And so, one of the things that as I've been working with clients related to say like agriculture line of credits where you'll have big draw on it when the planning season starts and then big pay downs when the crops are sold at the end. And so you see this volatility in the balance that is outstanding. Well conceptually under the CECL framework, and if we think about it as a total commitment, it really ultimately should be transfers between the liability that Brittany alluded to, that represents our expectations of losses on the unfunded commitments and then the allowance for loan loss that is netted against our loans.

And so when you think about it conceptually that you need to think about how much of those lines do you think people are going to utilize and then apply your lifetime loss rates to that. So if I use a quick example, if I have a agriculture line of credit that is not drawn on at all, but I think when the planting season comes, this farmer is going to draw 90% on that line, I would take the unfunded commitment, multiply it by 90%, and then multiply it by my lifetime loss rate to get my liability. Well then when the farmer draws on that line, my liability will go down. And I would say my expectation of any excess that I'm going to draw on is zero because they've drawn on it. So my liability will go to zero, but then I need to bulk up my reserve for the fact that now they've drawn on it.

And so you'll see this interplay depending on the nature of your portfolio if you have situations like that where you may see some fluctuation in regards to that. But this is something we wanted to bring it up because this is often, this and investments are somewhat overlooked in the context of CECL primarily because we've spent so much time focusing on getting the loan stuff and rightfully so, because loans is the biggest part of this calculation. So we want to make sure that this is right, but this is also going to need to be addressed at least to show if you believe it's immaterial to your financials, you're going to need to support that and prove it. And that's probably more on the investment side than the unfunded commitment side because this does, although CECL ASC 326 explicitly only ties to held the maturity securities available for sales securities and how those are handled related to other than temporary impairment was also adjusted as a part of CECL or as a part of CECL coming out.

And so that is one where you're going to want to look at your investment portfolio and bifurcate by levels of risk to where the likelihood that you would not receive all the principle back if you hold them to maturity. And so for most of our clients we work with, they're investing in pretty safe investments that are either implicitly or explicitly guaranteed by an arm of the US government. So this could be like treasury bonds, Freddie Mac, Fannie Mae backed mortgage backs. I think a narrative would probably sufficient there to say these have very minimal credit risk that wouldn't then rise to the level of us needing to book any reserve. But you may have some municipals, some private label mortgage backs that do share some credit risk or do bear some credit risk that you'll want to understand and make sure you reserve for.

I mean, the concept is basically the same as other than temporary impairment, except now it's not a permanent impairment. You'll book a reserve like you would for an allowance that can go up or down based on your assessment of the investment portfolio.

Brittany Stern:

Thanks, David. All right. And keep the questions coming. We're trying to answer them as best as we can. And quickly want to touch base on things to do in 2023 to prepare for your CECL model validation. First. I know a lot of our institutions that we've worked with are like, "Oh, well, we're waiting to do the board adopted policy until after the model validation." The validation will would expect that your policy be adopted by the board and be ready if it's not done. That will be a recommendation within your validation. So get to working on that, have a good draft and have it get to their board if you can.

Prepare a CECL adoption package. And what do I mean by that? Your adoption date most likely was January 1st, 2023. Pull together that calculation, the journal entry, the governance over the original entry, how you report it to your board of directors or your committee or what other governance that you need to report it to and have all of that prepared in a package ready to hand to your regulators and hand to your auditors.

Secondly, I guess adding to that, have open conversations with your regulators and auditors. What do they expect from your CECL model validation? How often do they expect it? When would they want it done? Any other things you need to be aware of. Third party vendor management, which we discussed a few minutes ago. Making sure if you are using a third party vendor for your CECL model, ensuring you have your documented vendor management over that, you might want to include that as part of your CECL adoption package.

And then the last two items, internal controls, processes and procedures, making sure your institution has documented your internal controls over validating and reconciling the information that goes into the model and the information that comes out of the model. What are the internal controls? Your auditors and regulators and validators will be interested to understand that.

Last but not least, and I know we have one minute to bring it home, just a little bonus episode of other 2023 considerations. Add your CECL model or the internal controls related to it, to your internal audit plan, just as the incurred last model would've been in the past, making sure you're discussing with your auditors and regulators, their expectations on how frequently you validate the model and when they would want it done. As I mentioned, talk to your auditors and regulators.

Internal back testing. I had previously said doing this monthly, but definitely wanted doing this over the course of this next year, maybe monthly isn't the best item, depending on the size and complexity of your institution, but making sure you understand how the model is flowing over the course of the year. And then be prepared to adapt. Just as we have spent the past 10 to 12 years preparing for CECL, we don't necessarily know the expectations of auditors and regulators going forward because maybe they haven't come in to audit it yet and you don't know it until you see it. So just making sure we stay vigilant and prepared to update to base on the expectations of those auditors and regulators.

And I guess just to close it out, we are exactly at 1:00 PM East Coast time. On behalf of David, John, and I, we really appreciate you dialing into this, asking your questions and leaning in. I think we had a significant amount of questions. I hope we were able to answer all of them. If you do have any follow up questions, all of our contact information is here. Feel free to reach out. And again, thank you for attending and being part of this. We really appreciate it.