

# CECL Topics Today & What We Have Learned

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I N C O R P O R A T E D

# Remind me again, what exactly is the point of CECL?

(besides creating more regulation for smaller credit unions)

1. Housing market crisis in 2009.
2. Criticism that reserves set aside for loan losses were not forward looking enough.
3. Incurred loss method versus a forward-looking model.
4. Forecasted losses for the entire current loan portfolio.

# CECL applies to all potential credit risk exposures:

- Loans (includes participations)
- Investments
- OBS – Off Balance Sheet Credit Exposures

Off Balance  
Sheet Credit  
Exposures  
that are  
most  
common for  
credit unions

## Unfunded Lines of Credit

- Conditional versus unconditional
- Exception – Unfunded lines of credit that are conditionally cancellable
- Assumptions

**CECL is not forecasting new volumes, only current portfolio expected credit loss with the above OBS exception.**

# Technically, CECL applies to all investments with credit risk

## INVESTMENTS

In practice, based on historical analysis, what this means is that the answer will be zero for U.S.

Government issued bonds, GSEs, and NCUA/FDIC insured Investment CDs.

CECL will apply to municipal bonds, corporate bonds, private label MBS, CLOs, CDOs, and other types of securities investments with credit risk

# A FEW CECL MODEL TYPES

Probability of  
Default/Loss  
Given Default

Credit Migration

Vintage

Remaining  
Life/Weighted  
Average Remaining  
Maturity (WARM)



**WARM has become the preferred model  
for many credit union's loan portfolios**

# STEP 1

## Remaining Life / Weighted Average Remaining Maturity (WARM) model

High Level Mechanics – Step 1

Derive WARMs for each loan type

# EXAMPLES



MHSI CECL model builds forecasted monthly cashflows for each individual loan and prepayment speed adjusts those cash flows to derive WARMS.



NCUA tool uses industry “proxy” WARMS and applies them to the loan portfolio.



# STEP 2

## Remaining Life / Weighted Average Remaining Maturity (WARM) model

High Level Mechanics – Step 2

Calculate forecasted (estimated) loss rates

Typically, this involves some utilization and analysis of historical loss experience

However, what is the appropriate historical look back period? Short, medium, long term?

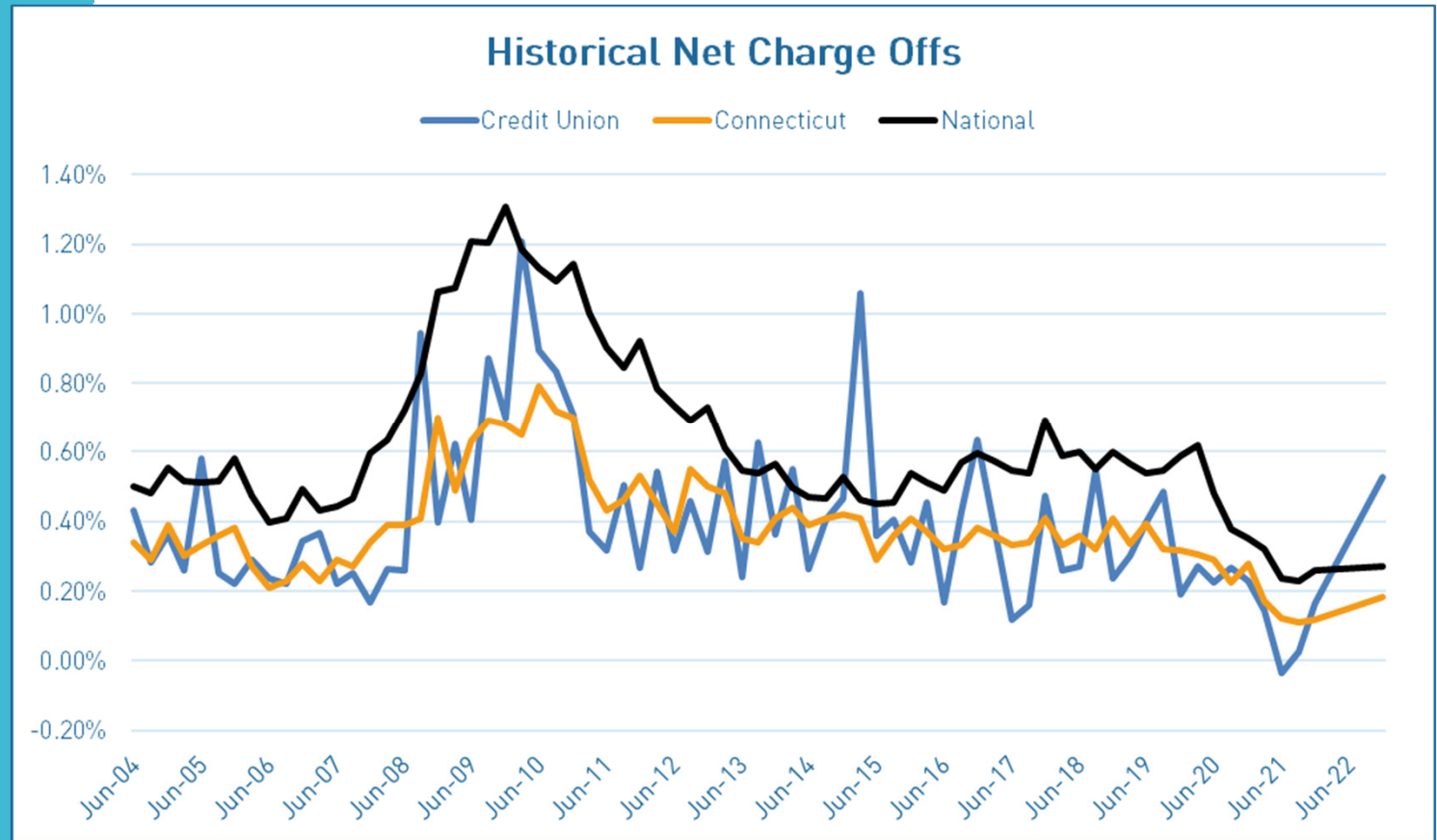
# Look back period considerations:

- Statistical recency bias
- Full economic / credit cycle
- Both
- Other factors  
(example: change in underwriting practice)

# Pros and Cons of a short and long term look back period:

- Shorter look back period will provide a faster reacting forecast model to changing trends, but will be more volatile with potentially more “false starts”.
- Longer term look back period will be slower reacting, but less volatile.

Look back  
periods:  
2, 3, 4, or 18  
years?



## Current environment considerations

Does it make sense to use only my last two to three years of net losses given how low they have been.

What about the likelihood of an economic slowdown in the coming quarters (i.e., is a short term look back really providing me a reasonable forecast for what is potentially on the horizon)?

History says losses will not stay this low.

## Conclusion:

It makes sense to somehow incorporate both short and long term look back components.

# WHAT'S GOING ON

WHAT WE ARE HEARING  
FROM CREDIT UNIONS.

WHAT WE ARE HEARING  
FROM EXAMINERS AND  
AUDITORS

WHAT WE ARE SEEING

WHAT IS GOING ON IN  
PRACTICE

# OTHER

## ADDITIONAL CONSIDERATIONS, MISUNDERSTANDINGS, AND FALLACIES



# KEY FASB WORDS

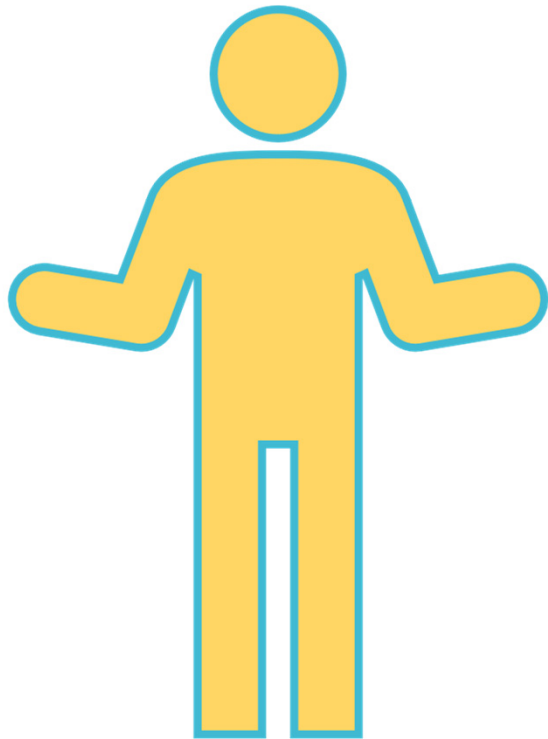
- **SUPPORTABLE AND REASONABLE**
  - Applies to model/methodology, assumptions, and Q&E factors.
- **EXPLAIN AND DOCUMENT EVERYTHING**
  - especially with Q&E factor adjustments.

# FINANCIAL MODEL

Like with other financial models and FI processes, need elements of control such as:

- Procedures
- Documentation
- Consistency
- Data integrity
- Reconciliation
- Eventually you will want to back test the results

To name a few



# MISUNDERSTANDING

## Question:

Why is the sum of my 36-month historical total charge offs higher than the CECL forecast, shouldn't the forecast be the same or higher?

## Answer:

Not necessarily. Remember the "Current" part of the definition (i.e., current portfolio into the future, no new volumes considered). A 36-month historical charge off look back takes into account all of the new volume during that 36 months as well, so it is not an equivalent comparison. It is not a valid CECL comparison.

# FALLACY

## Question:

My total loan volumes increased but my total CECL calculation for ALLL went down. How can that be, it couldn't go down when my total loan volume goes up, could it?

This is a little specific to the MHSI CECL solution Monthly CECL Builder worksheet, but I can see how it would be applicable to other solutions.



## FALLACY EXAMPLE

### Answer:

Changing loan portfolio mix and forecasted loss rates.

**Example:** Longer WARM real estate loan volumes go down, but shorter WARM unsecured loan volumes go up and could cause the CECL calculation to go down.



# TAKEAWAY

CECL is now a forecast model which means there could be numerous changing variables

(i.e. various different widgets that can affect the outcome)





## CONSIDERATIONS AND FALLACY

### Question:

What if the look back period that I am using to derive expected (forecasted) loss rates in the future has no loss experience (or very minimal) for a particular loan type?

## CECL Builder as of 03/31/2023

Please use the following dropdowns to build your customized CECL methodology & scenario for each category  
Enter any qualitative adjustments in the respective column (optional)

Category	Current Balance	Methodology	Scenario	Expected Net Losses	Qualitative & Environmental Adjustments	Total
1st Lien	9,214,486	Remaining Life State Rates	Reversion to Long-Term Rates	34,637	-	34,637
Commercial		Remaining Life	Reversion to Long-Term Rates	-	-	-
Commercial RE		Remaining Life State Rates	Reversion to Long-Term Rates	-	-	-
Credit Card		Remaining Life National Rates	Reversion to Long-Term Rates	-	-	-
Jr. Lien	10,356,402	Remaining Life	Reversion to Long-Term Rates	78,949	-	78,949
New Auto	15,232,967	Remaining Life	Reversion to Long-Term Rates	1,864	-	1,864
Other Secured	6,575,081	Remaining Life	Reversion to Long-Term Rates	42,655	-	42,655
Payday	-	Remaining Life	Reversion to Long-Term Rates	-	-	-
Share Secured	77,142	Remaining Life	Reversion to Long-Term Rates	-	-	-
Student	2,914,371	Remaining Life	Reversion to Long-Term Rates	-	-	-
Unsecured	2,280,356	Remaining Life	Reversion to Long-Term Rates	4,826	9,500	14,326
Used Auto	7,958,070	Remaining Life	Reversion to Long-Term Rates	10,328	8,000	18,328
<b>Total</b>	<b>54,608,875</b>			<b>173,260</b>	<b>17,500</b>	<b>190,760</b>



**HAVING PEER LOSS RATES  
AVAILABLE IS VERY HELPFUL AND  
MAY BE ESSENTIAL**





## ADDITIONAL ADVANTAGES OF HAVING PEER LOSS RATES AVAILABLE

- Bigger pools mean less volatility.
- Potentially more representative of the expected loss over the medium and long term. Particularly with RE.
- Can use fractions of peers to better represent the credit union's specific loans (use in combination with own experience).

**However,  
start by  
analyzing  
your own  
data first**

**It is highly recommended to start by analyzing the credit union's own loss experience so you can have the understanding of how your loss experience compares to the peer group.**



# NOT ALL CREDIT UNION FOOTPRINTS ARE ALIKE.

## SOME DIFFERENCES:

- Membership base (seg groups, etc.)
- Geographies
- Underwriters
- Underwriting standards
- Other differences

## SUMMARY:

The optimal answer is to analyze your own historical loss experience and have available peer loss information to assess the results and potentially fold into the analysis where needed.

# QUALITATIVE AND ENVIRONMENTAL ADJUSTMENTS

- Supportable and reasonable
- Strong quantitative, qualitative, or both
- Documentation

# QUALITATIVE AND ENVIRONMENTAL ADJUSTMENTS

- Often times the larger the Q&E adjustment, the more durable the support and reasonableness factors will be required.
- Small modeled loss estimates and large Q&E adjustment often will equal more substantial support required.

## CONCLUSION:

Ideally, make Q&E adjustments where needed to a strong analysis foundation, not Q&E adjustments just to increase the expected loss amount.

## LAST THOUGHTS AND CONSIDERATIONS

ALLL funding is now determined by a forecast model that should have all of the elements of similar financial models (methodology description, assumptions support, etc.)

CECL is generally expected to make the ALLL calculation more volatile as funding needs account for the estimated losses of the entire portfolio running off into the future.





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