
Model Validation Changes Under CECL – Moving from Incurred Loss to Expected Loss

- John Hurlock, President and Founder, Smarter Risk Management, LLC

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Model validation has been going through a maturing process since the 2011 Interagency Guidance (2011-13) was issued and began to be applied to the Allowance for Loan and Lease Losses (ALLL) model. Every model is different, and there have been some misunderstandings and misinterpretations of what validation means for ALLL. These divergent views could get amplified when the industry enacts CECL, and could result in a lot of non-value added extra work and headaches. Let's begin with the current ALLL model, which focuses on the Incurred Loss approach.

Incurred Loss

Incurred Loss is exactly what its name implies. FASB puts it this way, "Current GAAP requires an 'Incurred Loss' methodology for recognizing credit losses that delays recognition until it is probable a loss has been *incurred*. This model has been criticized for restricting an organization's ability to record credit losses that are expected, but do not yet meet the 'probable' threshold." Think of the ALLL model as a real time study of your credits - and really principally your loans. These are pools of loans you recognize as having correlated default characteristics but you have not individually recognized the defaulting credit because it is either immaterial or just hasn't surfaced yet by displaying missed payments, reduced collateral values, etc.... The credits you know about you have (most likely) already downgraded, and, if they are material, you are determining the Loss Given Default (LGD) individually. For the pool loans, you look to the recent past along with outside factors such as unemployment, and determine (by using historical averages) what you have lost in order to determine

what you are currently probably going to lose in the pool.

With this type of "absolute" model, validation techniques like sensitivity analysis, backtesting or stress testing aren't usually applicable. I won't go into definitions of sensitivity, backtesting or stress testing in this article, but I do encourage you to look them up to get a better understanding of why they aren't applicable to the ALLL model. The sensitivity of this model is to variables such as the number of lookback periods you use or the length of your loss emergence period. Backtesting isn't easily applied because the model is applied to the current portfolio and the current economic conditions. And stress testing is not applicable to the ALLL model because, plain and simple, what are you stressing? Are you stressing your historical data? "What if we had lost 10% instead of 2% three quarters ago?" Or are you stressing collateral value? (Stress testing is applicable for the individual impaired credits.) Or are you stressing something else - maybe economic values? The

current Incurred Loss model lives in the present and uses past data to recognize losses being incurred.

Expected Loss

CECL, or the Expected Loss model, creates a future view of the (static) asset side of the balance sheet at a specific point in time, much like Asset Liability Management (ALM) does, but without the rollover and growth rates. In essence, what are the losses expected to take place over the life of the earning asset (loans and investments)? Now we begin to introduce future based concepts like Net Present Value (NPV) along with more granular views such as vintage loss analysis, which can - and most likely will - have sensitivity analysis, backtesting and stress testing techniques applied to them. While we still wind up with an absolute value to be reserved for, it is likely we will have ranges around that value identified and used in discussion as to why the amount we are reserving for is the correct one. For example, the NPV has the projected interest rate as a factor. This could be incrementally adjusted up or down to see the impact on the value of future losses. Or stress testing could use different vintage periods to determine the impact of a worsening economic picture.

What about validation and maturity of the process of validation? With the current ALLL model, financial institutions wound up reacting to the 2011 validation guidance and learned how to apply it to their model. Is it an auditing function? “Wait, we already do that!” Or is it the credit quality component? “Wait, that’s what Loan Review does!” The answer to both is no. Validation, however, is becoming a standardized process with the focus on the model and how it calculates, as well as how it works in determining the reserve.

CECL is lurking just around the corner and validation will be an important component. There is the opportunity to be proactive and prepare for

validation as you implement your revised or new approach to determining reserves.

Below are some points to keep in mind as you go through implementation.

- ★ Rewrite your Reserve policy and include discussion regarding your approach for Expected Loss.
- ★ Identify the components that should be subject to sensitivity analysis and stress testing, and define how the results will be used.
- ★ Define a backtesting strategy and how you will use it.
- ★ Encourage your software vendor to make available a test environment using actual data. If they already have one, learn how to use it within defined parameters for sensitivity, backtesting and stress analysis.
- ★ If you have an Excel model, make certain it is transparent and logical to follow through the calculation process.
- ★ Document your transition plan.

For CECL, with all of the newly collected data and future based analytical approaches, financial institutions have the opportunity to plan for validation while the model is being adopted. This makes the validation more efficient and effective, as well as supporting the decisions made throughout the ALLL determination process. In short, this makes it less costly as well.

Validation is going to become more robust and complex with the movement from Incurred Losses to Expected Losses. Being proactive makes all the difference when it comes to challenges and surprises. There are certain activities where being boring and predictable is not a bad thing.... This is one of them.