What’s in a CECL Transition?

HomeStreet Bank and MST Advisory team up for phase one of the bank’s CECL transition initiative.

What's in a name?
That which we call a rose
By any other name would smell as sweet ...
- Will S., d.1597

From the beginning, lenders were warned the transition to CECL wasn't going to be easy. The FASB declared it both when they announced CECL and when they issued the CECL Guidance. The regulators backed them up.

The allowance accounting standard change from an incurred loss model to a current expected credit loss model essentially involves changing from estimating based on losses already experienced to estimating based on losses throughout the life of loans, including what is reasonable and supportable to expect in the future. That's a whole new ballgame.

Getting started

"The Guidance was released in June 2016 and by November we had made the decision to engage MST Advisory Services to start working on the transition," noted Pam Molvar, senior vice president and credit policy and risk analytics manager for Seattle-based HomeStreet Bank, which manages about $4 billion in loans. "I knew from experience that with a change of this magnitude you need the perspective and opinions of a third-party expert.

"I might have been able to do it internally," she added, "but I would have had to dedicate myself to the project and I don't have the time. I don't think it's feasible to do it without external resources of some type, and even if you did, you're still going to have to get your work validated by a third party".

Timing was an issue as well.

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The MST Advisory Services engagement follows a general template it calls its "CECL Blueprint." Phase one of the blueprint typically involves four parts: assess the institution's data, then the pooling, then prospective methodologies, and then determine how Q-factors will be applied.

Data

"Our first step is always to evaluate the institution's data, find out where they are with data, because CECL is going to require a lot of it, and it will have to be reliable," pointed out Shane Williams of the MST Advisory team working with Molvar and HomeStreet.

HomeStreet automated its allowance process in the first quarter of 2015 with the implementation of the ***MST Loan Loss Analyzer*** platform, so the first step advised for banks in the transition, adding software to manage the demanding amounts and manipulations of data required by CECL, was already in place. The bank's data was already in the system and being applied in its incurred loss allowance estimations.

While the HomeStreet data was complete, accurate and manageable, there was little loss data to work with. The circumstance is not uncommon as many lenders revised their lending practices following the Great Recession when so many loans were written off.

"We changed all our underwriting policies in 2009, and our data only goes back to that period. We didn't have sufficient loss data for all of our pools, in particular for pools where loans that had losses had already been downgraded to special mention or substandard. We weren't able to capture the migration to substandard that took place prior to 2009."

Molvar and HomeStreet are using a loss function curve to "solve the gaps," she said, estimating losses based on a further segmentation of their loan pools by risk rating, using the

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One consideration in preparing for CECL is involving departments in the institution that have not traditionally been involved in the allowance. For HomeStreet that meant getting certain data from Treasury.

"We need a weighted average life for various loan products to determine a life of loan for a given product or pool," Molvar explained. "Treasury was at first reluctant to provide the information. They were concerned that the processes they used to determine weighted average life would require a complex model validation rigor, which would impact their internal resource requirements. But, after discussions with Treasury and our auditors, stressing the importance that the data we use for the allowance has to be consistent with our ALM management, they understood and were supportive of the effort."

Pooling

Pooling is most likely to change under CECL, so the HomeStreet and MST Advisory transition team re-evaluated the bank's loan pools.

"We looked at various analytics," Molvar explained. "Do we have the right loan pools? What are the risks in our current pools? We analyzed the pools and determined that we needed to make modifications.

"In some areas where a large number of loans had been pooled, we realized the pools should be subdivided by risk levels," she continued. "We did so, gathering the data to support each new structure."

"We saw that their purchased loans would drive different pooling structures, because the underwriting had been done in different states based on different assumptions," Williams noted. "Some California lending was inherently different; new lines of business for HomeStreet, like hi-tech lending, that deserved extra attention."

"Part of what we spend time on," Williams said, "is eliminating potentialities, in methodologies as well as pool structures, all of which has to be documented."

Methodology

True to the theory of building on what the institution is already doing, an approach supported by the standard itself, it seemed appropriate that HomeStreet would stay with the probability of default/loss given default (PD/LGD) methodology it was already using for its incurred loss estimations. PD/LGD is generally considered a preferred CECL methodology in that it is a migration-based methodology and more accommodating to the inclusion of future expectations than other non-migration based methodologies.

"We begin every phase of our CECL Blueprint engagements by first assessing the respective institution's current state and preliminarily identifying what of today might be leveraged for CECL," explained Regan Camp, MST Advisory Services managing director. "There's no need to reinvent the wheel if you already have a solid foundation upon which to build."

"Management was comfortable with what they had," Williams added. "We can leverage that and build on top of it with additional features tailored to the more forward-looking CECL component."

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Shane Williams
Senior Advisor
MST Advisory Services

Still, due diligence required considering – and eliminating – other prospective methodologies.

"We looked at various options and ruled them out," Molvar said. "We don't have enough loss data back to 2009 to use a vintage approach. Also, data before 2009 is not that representative of our current portfolio. We are comfortable we can fill more data gaps with PD/LGD than with any other methodology."

Like many institutions, HomeStreet incorporates a loss emergence period (LEP) calculation into its current allowance methodology. Converting to CECL's life-of-loan approach will involve replacing the LEP, which determines the time it takes for a loan to default from an initial sign of financial difficulty, with a loss horizon period (LHP).

"The loss horizon period uses the weighted average life of loans in a pool to determine at a certain date how far in the future you should look for losses," Molvar said. "For example, with a commercial-industrial loan, our weighted average life is three and a half years. When you calculate that loan's expected loss we are determining that it will typically take three and a half years for a loan to realize a loss. You have to understand how the weighted average life and loss horizon period work in concert with each other."

Q-factors

Molvar also wanted to identify the lowest and highest loss rates for every pool, without consideration of weighted-average-life time constraints. Knowing the best, worst and range of performance in a pool, she said, was key to establishing the bank's Q-factor reserve ranges under CECL.

"Determining our Q-factor allowance has been very subjective. We were choosing ranges without quantitative measures. We will still use the nine prescribed factors, but improving how we determine those ranges between best and worst will give us a better sense of where we are before we make Q-factor judgments."

Employing weighted average loan lives and loss ranges, the bank will be able to look at a point in the future to frame their Q-factor discussions, and use correlation analysis to determine the impact of the various factors.

"In the past, we have used Q-factors to maintain an adequate reserve level. In the near future, the impact of our Q-factors on our estimations should be substantially reduced, due to the current and forecasted credit environment. With expected loss and the associated higher reserves, the reserves associated with the Q-factors should relate more to where we are and will be in the forecasted loss horizon range."

2 *Looking to phase two*

With the completion of phase one of its CECL transition in sight, HomeStreet looks most immediately to its auditors' confirmation of the validity of the work that has been done, then to phase two, including testing its CECL methodology with ***MST Shadow Loss Analysis***, a function HomeStreet recently added to its Loan Loss Analyzer platform. Running parallel incurred loss and CECL estimations will reveal the difference in the allowance between the two methodologies, allowing the bank to fully understand and adjust to the enterprise-wide impact of CECL, including on its capital requirements.

Will it also mean that HomeStreet will opt for early CECL adoption?

"No," Molvar affirmed. "We are estimating an increase in the reserve which means a reduction in capital; we plan to wait until 2020 to implement."

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