How Far, How Wide: CECL and Data

An interview with Steve Wagner, Partner, Crowe Horwath LLP

As lenders begin to prepare for CECL, their thoughts turn to data. They know they're going to need a lot of it, a "significant increase in the types and ranges of data that such organizations need to capture and retain in order to properly estimate future credit losses," according to Crowe Horwath LLP's white paper, *Adapting to CECL – Taking Stock of the Data Requirements*.

Not only more data, of course, but more kinds of data: economic data, credit and risk ratings, peer and industry data. And borrower and loan data will need to be deeper and broader, and proven consistent and accurate.

To get some insight on how lenders are addressing their data needs for CECL, MST talked with Steve Wagner, an auditor and partner at Crowe Horwath, and a recognized CECL subject matter expert who has been working with financial institutions on their CECL implementation initiatives.

MST: *We're a couple of months from FASB's issuance of CECL guidance. What are the lenders you talk with doing about it so far?*

Wagner: Generally speaking, they're assessing risk. For example, for consumer lending in terms of credit risk, we're thinking about FICO scores or debt-to-income ratios, or loan-to-value. Once you hone in on the credit drivers specific to your portfolio, then your data people can look to see how far back in history you can go relative to that driver.

Some lenders are realizing that they could have completely different data needs depending on the lending product. The driver for commercial loans might be debt service coverage, so how good is our data there? Or internal loan grades, so how far back can we go and have we changed our loan grading so that consistency is an issue?

MST: *Where do lenders find data?*

Wagner: The larger institutions, in the $10 billion plus category, have data warehouses or consider external or proxy data that may be available. Most lenders with less than $10 billion in assets are looking to their core systems. But many core systems override previous loan data fields when taking in new data, and there are limitations with core systems. A lot of data is captured in reports, such as loan grades, external loan reviews, internal and external reports, historical files used for financial reporting purposes, financial statement files; however, this data may not have been historically audited nor may lack consistency.

MST: *CECL will apply to all financial assets, more categories of debt than just loans. What kind of data will lenders need to estimate under CECL for things like debt securities?*

Wagner: I expect concerns about securities will be minimal in comparison to loans. Most community banks and credit unions have limited exposure with securities, for example, government securities, which I hope are not a loss concern. They can look to services like Moody's for historical defaults. For securities like unrated municipal bonds, they won't have internal loss experience, so they won't estimate by issue as much as by pooling all their munis, and again, looking at Moody's type data.

MST: *We've seen some pretty extensive lists of types of data lenders will need. We've compiled one of our own here at MST, not to say that every institution has to have data in all these fields, just that this is a range of fields a lender might consider.*

Wagner*:* Yes. They can be used as a checklist of considerations rather than requirements. Lenders will have to look at each major loan product they have and decide which data fields have the biggest impact on credit quality or the estimated life of the loan. The lists address many types of loan and most lenders focus on only five or six.

MST: *Beyond amount and type of data, what else should lenders be concerned with?*

Wagner*:* Consistency and accuracy are critical considerations. There will be a lot of bridge building during CECL implementation. Let's say you have an internal loan rating system for your commercial loans. You have

data for five years back but you changed the rating system a couple years ago. That would cause consistency issues; you're not comparing apples to apples.

Accuracy is a huge issue for lenders if you don't have controls in place to ensure all the data gets into your system, for example, prepayment speeds that might be important in some models. Much of this has not been audited historically, so the questions are, "Where did you get this data and how do you prove it is accurate?"

MST*: So what are you advising these institutions discovering they don't have enough data or data of sufficient quality to do?*

Wagner*:* What a lender will do should be based on its risk profile as defined by management, its auditors and regulators. A low risk organization with good data for at least two years could be okay, given that they have another four to five years to add to their data stockpile before CECL implementation. Still, using a small data sample could create more volatility as compared to a longer look-back analysis.

Some will use data aggregators to supplement internal data. Their auditors will question how that data relates to their institution, so using peer data will require you to do a lot of reconciliation.

A third option we're seeing is the use of debt rating agencies for default rates based on bond ratings. This requires reconciliation as well, but might be more directional to your loan grading and internal ratings than peer data.

MST*: What are the keys to forward-looking estimates?*

Wagner: Since the credit crisis, loans have generally performed well. A high percentage of lenders have suffered no losses in construction and development since the crisis. The standard says you need to base future estimations on history, and you might need to project five, seven, even 10 years out for loan cash flows. After say 2-3 years, projecting future cash flows will become more subjective which will require a decision on the best way to revert to the historical mean. So predicting that future on your recent past might be difficult. A second challenge centers on how you build your CECL model and how you pool your loans. If you restructure your loan pools for CECL or change your underwriting standards, you may

not have an apples-to-apples comparison, which makes predicting off the past difficult.

There's no easy answer. It will require judgment. Lenders will likely use Q-factor adjustments to add to their allowances to be better prepared for a potentially more challenging future. In terms of critical economic data, I think lenders will have to look to their boards and management team to consider which economic data is most applicable to credit quality. Is the auto plant the town's largest employer so are we looking at new car sales or employment conditions nationally? Are we driven by oil and gas and price of oil is the most relevant data consideration for credit quality? It comes back to the risk assessment.

A lot of it is common sense; we just didn't have to think through it in the past. And application is more difficult than assessment. How do I project when real estate will be getting overheated?

I think your auditors and regulators will want to see that you really thought through your projections, that they're not just opinion, that you have information that supports your position. Look for reports that are considered reliable and are released consistently so you can maintain the same sources, and not just a report that supports your opinion.

MST: *Any final thoughts?*

Wagner: As you think about data input, think about accuracy, consistency and auditability. You might have a lot of fields of historical data but how comfortable are you with someone looking at them? And how consistent is your data? And how can it be proven that it's right? Where did you pull your numbers from and are they right?

Overall what we're seeing is that people are now familiar with the CECL standard and considering what to do. The main thing at that point is to sit down with your lenders, credit and data folks and determine your risk drivers. Understand your history first. Most people are doing that now. They haven't moved to the forward-looking phase. You need to get your historical view clear, then figure out the most appropriate model based on that: input, process and output. We're still in the input phase.