But Are you REALLY Ready FOR CECL?

A Validator's Perspective on CECL Implementation Success

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After years of buildup and debate, CECL is finally becoming a reality. As models face scrutiny and processes are put to the real-world test of implementation, a number of clear themes are emerging – perhaps the most notable being the stark contrast between the experiences of those who treat CECL as a regulatory box-checking exercise and those who commit to going deeper to uncover true strategic insight and value.

While it may have been easy to predict which of these two approaches would result in fewer headaches and a richer and more meaningful outcome, seeing examples of both play out thus far has nevertheless been instructive. Here are some of the most important insights, observations, and validation focus areas to keep in mind for the remainder of your implementation journey.

But Are You REALLY Ready FOR CECL?

1) Assumption Management

Managing your CECL model assumptions is not a set-it-and-forget-it exercise. Institutions should plan for a formalized review of their assumptions – including everything from forecast horizons and probability weightings to prepayments and qualitative ("Q") factors – and engage in periodic sensitivity testing of those assumptions.

One vital aspect of CECL that is relevant across several areas is the need for thorough documentation of your model, policies, processes, and procedures. When it comes to assumption management, this includes defining key assumptions, including quantitative and qualitative support, describing ongoing review/approval procedures, and defining ongoing monitoring and sensitivity testing.

In terms of validation focus, institutions should ensure that the validation rigor aligns with any internally defined model risk management expectations they may have established, including expectations for model documentation, policies, and procedures. Key activities include:

- Evaluating assumption development and support efforts
- Confirming the presence of formalized assumption review and approval procedures
- Assessing the sufficiency of assumption performance monitoring (including quantitative approaches, defined thresholds, and the handling of exceptions)
- Evaluating the framework for assumption sensitivity (parameters, testing frequency, communication, etc.)

2) Prepayment Assumptions

Particularly for those institutions employing a discounted cash flow methodology for CECL, prepayment assumptions stand as a potentially significant factor in their results, with a variety of internal and external sources to consider. Institutions should have a plan for comparing forecasted prepayments to actual experience while keeping in mind that their approach to prepayment assumptions for CECL should ideally be consistent with those used for IRR, liquidity, profitability, and other measures.

VALIDATION INSIGHT

While we have observed some institutions choosing not to apply prepayments to increase their low loss results or add a level of conservatism to their approach, the review perspective on this practice may change, as examiners and validators may view this as an indication that the model is not working well and performing as intended.

The validation focus with respect to prepayments should include:

- Reviewing methodologies, logic, and documentation
- Evaluating how assumptions are applied to the model

- Judging the reasonableness of the results considering the economic scenarios used
- Assessing the use of overlays or overrides
- Confirming the accuracy and completeness of model documentation, policies, and procedures

3) Qualitative Factors

An institution's qualitative framework should be clear, repeatable, and have a basis in sound logic. In general, examiners and model risk practitioners expect fewer qualitative factors ingrained in the model, and those present to be less impactful. The leading practices right now tend to utilize more of a metric- and/or range-based approach, and regular sensitivity testing should always be part of the mix.

> **VALIDATION INSIGHT**
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> While the use of qualitative factors will still be expected for CECL, regulators and model risk management practitioners may view ongoing and consistent dependence on these overlays or overrides as indicators of model weakness and may be discouraged.

The focus of the qualitative factor validation should include a review of each individual qualitative adjustment factor with an eye on adherence to CECL requirements, impact on the total loss, and reasonableness in light of historical evidence. Your validator should thoroughly test and replicate empirically derived qualitative factors during the validation and review all qualitative adjustments to ensure they are sufficiently sensitive in future periods. As with prepayment assumptions, model documentation with respect to qualitative factors should sufficiently describe logic and use, and the procedures should define ongoing review and approval processes.

4) Performance Testing and Ongoing Monitoring

Among the weakest components of most institutions' CECL regimens, performance testing should be performed both initially and ongoing by you, your vendor, or your validator at a pre-determined frequency using pre-defined performance indicators and thresholds. Areas to test include:

- Input-Output, including population and characteristic stability
- Back-testing, including both in-sample and out-of-sample goodness of fit
- Sensitivity, including outliers and leverage points

- Model Updates, including documentation
- Monitoring Plan and Governance, including performance indicators, thresholds, and escalation

Ongoing monitoring can be performed internally or externally, but the key is to not leave this important step until the end as an afterthought. Not surprisingly, those institutions with well-established model risk management programs have tended to fare better in this area.

> **VALIDATION INSIGHT**
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> As a starting point, consider repeating some of the tests performed during the implementation phase. In addition, consider designing tests that can reassess any weaknesses or limitations that might have been identified during the implementation phase.

Two common methods for model testing are (1) **sensitivity testing**, wherein the sensitivity of the final loss estimate is tested to each of the critical data inputs at the segment and bank levels and mean reversion is tested where feasible, and (2) **benchmarking**, wherein the quantitative and qualitative components of the model are benchmarked against historical data over the most recent business cycle or prior recessions.

5) Model Documentation

One of the most important things to keep in mind in any discussion of model documentation is that vendor documentation is not the same thing as model documentation. Technical documentation from vendors can run the gamut of quantity and quality, which makes it challenging for an institution to create cohesive model documentation based on vendor-supplied information alone. Key model documentation standards include:

- Purpose/objective
- Assumptions and limitations
- Description of management decisions using model results
- Design, theory, and logic
- Mathematical specifications

- Comparisons with alternative theories
- Rigorous assessment of data quality and relevance
- Testing that demonstrates the model is accurate, robust, and stable
- Interpretation of outputs with limitations delineated
- Back-testing or out-of-sample analysis and sensitivity analysis

Here again, it pays to not save this step until the last minute.

> **VALIDATION INSIGHT**
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> A potential framework for CECL model documentation could include (1) approval and revision history; (2) executive summary; (3) model governance; (4) framework architecture; (5) loans; (6) securities; (7) reporting and disclosure; and (8) appendices. Institutions with more formalized model risk management programs tend to have standard templates for this purpose and commonly have better documentation as a result.

In terms of validation, some key focal points for CECL model documentation include:

- Clearly recorded data sourcing and cleaning procedures
- Evidence related to the selection of the model design and methodology
- Evidence to support all assumptions in the model
- Evidence related to life of loan, qualitative factors, and macroeconomic scenarios
- Weaknesses and limitations, noting if the model is not designed to reflect extreme scenarios
- Consideration of alternate methodologies, including the reasons why they were rejected
- Readability – the documentation should be written so that anyone with banking expertise is able to reasonably understand how the model functions

6) Getting Ready

Having a gameplan for your CECL model validation is crucial, so ensure you've covered these key steps:

- Your model has been implemented and tested

- You have performed and documented a dry run
- Your CECL governance framework has been established
- Your CECL model documentation is complete

VALIDATION INSIGHT

For insightful guidance related to general model risk management, consider reviewing the **OCC Model Risk Management Handbook** (August 2021). For more CECL-specific audit information, you may refer to the **AICPA's ACL Audit Practice Aid** (2019).

Note that auditors and examiners will expect your model to be validated prior to going live. Be prepared to answer the tougher questions during a validation. Anticipate annual validation and note that your model will change as CECL modeling expectations evolve. Finally, take care to see that your model documentation reads like a blueprint that would reasonably allow someone to fully understand and replicate the model. And remember:

- Testing and documentation take time, as does validation and remediation – don't wait until the last minute
- Keep validation scope in mind – while providers are offering different levels of rigor, this model is not the place to skimp
- Data matters – quality internal and external data have an outsized impact on CECL model reliability and results
- Governance – now is the time to formalize your model risk management program or leverage your existing one
- Testing – understanding how your model works under varying conditions is critical

VALIDATION INSIGHT

As noted earlier, the most successful institutions look beyond regulatory requirements and take the opportunity to leverage CECL for a competitive advantage. A few areas where CECL can provide a strategic advantage include efforts to improve overall data governance and management, identifying key drivers of potential credit losses, and establishing a more robust quantification of credit risk. It can pay to try and make the most of your CECL experience.

For More Information

To learn more about how your institution can solidify its CECL readiness and leverage CECL strategically, contact **Mark Haberland** or **Mike Guglielmo** at Darling Consulting Group.

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During his tenure at DCG, Mike has served in various capacities, including director of financial analytics. In addition, he is a technical resource for the ongoing development of many of DCG's quantitative and strategic risk management products and services. Prior to joining DCG, Mike managed the ALCO and strategic planning processes for a regional bank in the northeast. Mike is a graduate of Fairfield University with a degree in economics.

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Mark has over 25 years providing balance sheet and model risk management education and consulting to the community and mid-size banking space. A frequent author and top-rated speaker on a wide array of risk management topics, he facilitates educational programs and workshops for numerous financial institutions, industry and state trade associations, and regulatory agencies. He is also a member of the Financial Managers Society's Finance Council. Mark has been with DCG since 1997 holding many roles, including leading the operations of the firm's Financial Analytics Group for many years. In his current role, Mark's passion for teaching and collaboration drives his desire to work with bankers to strive for excellence within their organizations. Mark lives on the North Shore of Boston with his wife and two children. He is a graduate of St. Michael's College in Vermont with a degree in accounting.