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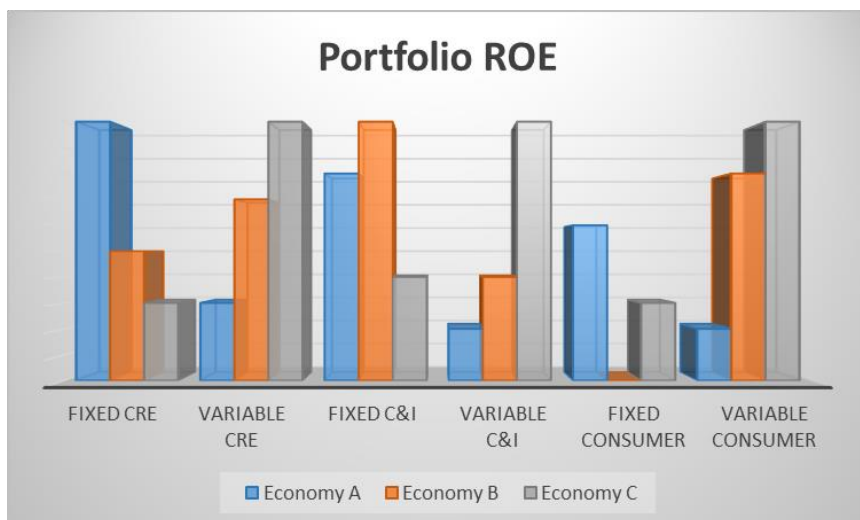
Stress Testing CECL Data: The Competitive Advantage Community Banks Are Looking For

If you aren't preparing for the introduction of the current expected credit loss (CECL) allowance model, you are already falling behind. Sources close to the FASB decision tell us that the final ruling will be out later this year, with an implementation date as soon as late 2017 or early 2018. The difference with CECL from the current, incurred loss model is the tremendous amount of historical credit information that banks are expected to capture and maintain. For smaller banks without a dedicated data warehouse that is able to manage this information, efforts need to be quickly underway to develop a process to capture and store this data in archived spreadsheets or one of the dedicated ALLL platforms available on the market.

The good news for community banks is, how you use this data once you capture it can create a significant competitive advantage for you in your market. In addition to the volumes of data that will be required for banks to develop probability of default and loss given default estimates for every segment of their loan portfolio, CECL is also expected to require banks to develop an economic forecast based on their geography, portfolio composition, and macro-economic outlook; and, apply that forecast in determining their level of loan loss reserve. For the most forward looking banks, the loss given probability of default (LGPD) estimates can be stressed using the economic forecast by adjusting variables that would result in one or more changes in Loss at Default (i.e. real estate value decline, inventory obsolescence, evaporated liquidity), or likelihood of default (i.e. unemployment rate, foreign competition, declining cash flow), and using the results of the stress test in a pricing model or return on equity (ROE) calculation to provide a picture of the most advantageous loan portfolio mix for the expected economic situation. By applying a bank's stressed loss information to the ROE based loan pricing measure for each portfolio segment, and combining that information with their economic forecast for the most likely short and long-term scenarios, banks will be able to position their portfolio composition today to outperform their peers.



As the simplified chart shows, in the current economic scenario (Economy A), this bank would be inclined to stock up on fixed rate CRE, which is currently providing a return well above any of the other portfolio segments. However, if this bank's forecast indicates that the expected scenario going forward is Economy B, then by aggressively pursuing fixed

rate C&I and variable rate consumer this bank can expect to create a significantly larger profit in the long-run. If however, Economy C is the most likely scenario to occur, the bank would be wise to set the market today on high quality variable rate loans regardless of type.

For banks that are utilizing a return based pricing model today to price loans, optimal portfolio composition can be calculated by running the stressed LGPD and economic data through the model, and charting the results. For the other banks not currently employing a return based pricing model, portfolio optimization can be achieved through spreadsheet analysis which calculates the stressed returns in each economic scenario. In either case, there are many advisory resources like FSRA, available to help in CECL preparation, economic forecasting, and portfolio optimization. Those banks that take advantage of the significantly expanded data that they are required to collect will have a distinct advantage over the competition in developing the most profitable portfolio possible.

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