The Fed's SCALE CECL Tool - Benefits and Challenges

The Federal Reserve has recently released a new tool, referred to as the **S**caled **C**ECL **A**llowance for **L**osses **E**stimator or "SCALE". SCALE is an Excel-based tool that was developed to assist in calculating a CECL reserve and is intended for smaller institutions with less than $1 Billion in assets and limited loan portfolio complexity. The tool is designed to help mitigate the challenges smaller institutions face with some of the more complex components of calculating a CECL reserve. In this article we summarize the tool, and discuss some of the challenges and limitations in relying on SCALE to calculate a CECL reserve.

What is SCALE

SCALE is a tool developed by the Federal Reserve for smaller, less complex institutions with assets less than $1 Billion. The SCALE tool allows a community financial institution to calculate a CECL reserve by leveraging peer data to alleviate some of the more common challenges these institutions face. While the previous incurred loss method for calculating an Allowance for Loan and Lease Losses (ALLL) reserve typically necessitated a reserve forecast for a one-year period for most loan segments (depending on loss emergence periods), CECL requires a life-of-loan loss estimate that has proved challenging for institutions with limited resources and loss history. SCALE attempts to alleviate these challenges by relying on peer data reported by institutions with greater than $1 Billion in assets in their Call Report filings (Schedule RI-C Part II).

Components of SCALE

The tool addresses both loans that are expected to be individually assessed and loans that are pooled.

Individually assessed loans – For loans that do not share risk characteristics with other financial assets, institutions are required to evaluate expected credit losses on an individual basis. The process under CECL for these loans is similar to the incurred loss process. The SCALE tool includes a worksheet for entering the CECL reserve that would be calculated outside of this tool.

Pooled loans – SCALE is primarily intended to address pooled loans. There are 3 components to the tool:

1. **Life of Loan Loss Forecast** – the biggest challenge in calculating a CECL reserve is moving beyond the historical one-year forecast period used in ALLL to the longer life-of-loan estimate used in CECL. This typically requires estimating losses for a reasonable and supportable forecast period (e.g., 2-3 year; it depends on the loan type) that necessitates some level of quantitative analysis followed by a reversion to historical losses. SCALE attempts to mitigate this challenge by utilizing peer Call Report data of actual CECL reserve forecasts filed in Schedule RC-I Part II. It is important to note that this peer data is NOT just historical loss data, but rather is the actual CECL reserve reported by these institutions for the life of the loans, and it includes a reasonable and supportable forecast component as well as any potential qualitative adjustment. Community financial institutions applying the SCALE tool can use the entire national bank universe to create their peer data, or have the option to create a custom peer group.

2. **Adjustment to peer group CECL forecast based on institution specific loss history relative to peers** – SCALE has a built-in, somewhat simplistic tool for adjusting peer group reserve forecasts based on institution and peer group actual historical loss experience. Essentially, it compares the institution's historical average losses over a specified historical look-back period to the peer group and applies the difference as an adjustment to the peer group CECL reserve forecast. The adjustment is applied at the total loan level in the tool and not at the segment level.

3. **Qualitative adjustment factors -** The tool includes a worksheet for inputting any qualitative adjustment factors at the loan segment level that the institution is responsible for calculating outside of SCALE.

Benefits of SCALE

The implied benefit of SCALE is that assumptions related to the reasonable and supportable economic forecast period, prepayments, and potentially certain qualitative adjustments, are already included in the Call Report peer data. This theoretically solves the largest pain point for smaller institutions in having to develop the forecast assumptions. The tool also allows community financial institutions to rely on current qualitative adjustment factor processes used in the incurred loss ALLL calculation, where relevant.

Challenges and Limitations

In its presentation and Q&A session introducing SCALE, the Fed emphasized numerous times that the tool is not a regulator-preferred method for complying with CECL, and management should carefully consider whether the tool is appropriate for their community financial institution. The Fed also emphasized that institutions adopting this method will still need robust documentation, including support for the appropriateness of selecting the SCALE method, the selection of peer groups, and the development of qualitative factors. We believe there are 4 primary challenges and limitations in relying on the SCALE tool in its present form:

1. **Peer group selection** – while utilizing peer data may be necessary for many institutions with limited loss history, it is critical to ensure a customized peer group is identified based on factors such as geographic location, loan portfolio composition and credit culture. Identifying this peer group can prove challenging. Ensuring a CECL reserve that is tailored to the unique risk profile of the institution is of paramount importance.

2. **Lack of transparency in peer group forecast assumptions -** as noted, the peer data utilized in SCALE is the actual CECL reserve with a built-in forecast component rather than just historical loss data. Therefore, the peer data already includes a reasonable and supportable forecast component as well as any potential qualitative adjustments. However, there is a lack of transparency in how these forecast assumptions were developed for the peer group. Is a peer bank overestimating its loss estimates (i.e. being overly conservative with the forward-looking forecast)? Are these peer assumptions based on regression models correlating historical loss data to economic variables? What qualitative adjustments are already included in the peer group forecast?

3. **Loss Adjustment Tool –** the tool for adjusting the peer group reserve forecast to institutions specific loss history lacks precision, especially for institutions with limited loss history. This could lead to greater potential for inaccurate credit loss reserving.

4. **Qualitative Adjustments** – SCALE still requires expertise for developing qualitative adjustment factors. While institutions may rely on what they already have in place for ALLL, modifications to accommodate CECL will likely be required.

VBC Conclusions

For smaller and less complex institutions with limited historical loss data and resources, we believe SCALE warrants consideration. However, we would caution institutions to avoid simply implementing the tool in its current form without careful research and analysis around peer group selection, the loss adjustment tool, and the qualitative adjustment process. Furthermore, and as emphasized by the Fed, while usage of SCALE for the CECL reserve will be considered in compliance with GAAP requirements, institutions will be required to maintain robust documentation and support around model selection and assumptions.

VBC has resources and expertise to assist smaller, less complex institutions with implementing the SCALE tool and can also provide more robust CECL solutions – both as an advisor on model selection and as a third-party modeler – for more complex institutions where the SCALE tool is not suitable.

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