MOODY'S ANALYTICS

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# COVID-19 Impact: What Banks Need to Know Now About CECL Adjustments

As the COVID-19 pandemic continues to alter the economic landscape, banks are working harder than ever alongside their customers. Credit teams have worked around the clock on both the distribution of federal relief funding and massive loan modification programs. This effort has fallen most heavily on community banks, as the shutdown has been felt most keenly by their small business customers.

A major challenge financial institutions of all sizes are now facing is in understanding how to appropriately reflect the current economic changes in their allowance. A company's loss history may be inadequate, with no events matching the speed and severity of the pandemic shutdown. Modern risk models, built on recent economic shocks, don't typically rely on data from the last comparable crisis, which was the 1918 influenza pandemic. Fortunately, portfolio adjustments that account for such rare and extreme circumstances can be used to address these shortcomings of modern risk models.

A well-considered adjustment function can be initially overlain on risk models to enhance an institution's established allowance process. Once the models have incorporated actual data from the lockdown, the overlay adjustment can be removed. The industry will then see new stress test scenarios with specific pandemic or lockdown parameters as the crisis recedes.

## Accounting for the Macroeconomic Variables

The Current Expected Credit Loss (CECL) reserves filed by public banks are yet another measure of the severity of the economic impact of the pandemic. These results reflect the often-grim forecasts for the macroeconomic variables that affect CECL risk models. Models that have previously used the housing crisis data as their worst-case loss scenario must now grapple with economic conditions that are significantly worse. Public banks may need to modify their models' forecast mix of upturn and downturn scenarios to reflect the current downturn.

For lenders still using the incurred loss standard, the established allowance process may not incorporate quantitative macroeconomic impacts. This can be a significant concern, as current commentary focuses on the larger public institutions and their CECL forecasting choices. Luckily, there are ways to bring these macroeconomic variables into the allowance process without relying on models.

One method is to examine the historical relationship between unemployment and net-charge-offs at all levels. Unemployment is the easy first choice for scrutiny, since it affects credit quality across asset classes. Approaches can be refined by blending other macroeconomic variables such as the Baa spread, commercial real estate vacancy rates, oil prices, or a house price index. Such relational adjustments may not be as robust as rigorous, regression-based analyses but they can be a step forward for institutions looking to become more quantitative in their allowance process.

## Location Matters

Institutions must also recognize the regional impacts of the crisis. The variance among metro regions is large and can become larger still when the lending footprint is expanded into rural areas. However, once understood, local effects can be overlain on national-level metrics to improve the allowance process.

One possibility is to build a geographical z-score that differentiates the impact by US state and metropolitan area, based on a weighted blend of observed local COVID-19 statistics. This sort of framework would allow institutions to create a more granular geographic overlay, providing adjustment at the loan level depending on available data.

## Federal Relief Program Participation

The crisis has prompted banks to increase their participation in federal relief programs. The Paycheck Protection Program, Economic Injury Disaster Loan, and Main Street Lending Program now target customers rather than the lending institutions themselves, and leverage local lending teams to distribute the funds.

The goal for community banks and other institutions is to get these funds to their customers to help reduce or eliminate their risk of default. Overlays can take success here into account, while also refining these stimulus adjustments to differ on a per-industry basis. A manufacturer may be able to idle with paychecks covered for some time; restaurants may find it much more difficult to reopen, even after relief funding.

Proactivity will be the key to successfully adjusting an allowance framework for this crisis. In the most successful institutions, customer outreach programs have contacted 90% to 100% of their commercial portfolio. These institutions gain a more direct understanding of credit risk for their contacted borrowers, while reaping a bounty in local economic information that can ground assumptions for the rest of their portfolio. Without such outreach, institutions will be left to wonder about those customers that never came in to apply for relief.

Addressing these points should begin now. Institutions should document the assumptions and quantitative aspects of any adjustment framework. Examiners will also want to see proof of deliberation by senior management, as well as approvals at all levels. While current events are forcing institutions to step outside of normal allowance processes, management always needs to demonstrate both skepticism and thoroughness.

Read more about Adjusting Your Allowance Framework for COVID-19 and Related Stimulus Programs.

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