OPTIMIZATION AND RISK APPETITES - VOLATILITY VS ABSOLUTE COST

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CECL COUNTDOWN SERIES

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CECL OPTIMIZATION AND ABSOLUTE COST

The Current Expected Credit Loss (CECL) accounting standard, which was issued by the Financial Accounting Standards Board (FASB), provides for more timely recognition of credit losses. One of the key aspects of CECL is to select the right methodology to estimate the Expected Credit Losses (ECL) so that institutions can cover these losses by holding the right allowance.

Each CECL method gives us a different result. Banks and other institutions can optimize by checking which method will give them the lowest CECL result and then choose an appropriate one. This will give them maximum capital to channel into the markets, as consequently, they will need to hold the least amount of cash as risk capital. The lowest CECL estimate is also called Absolute Cost.

The challenge, when it comes to this approach, is the possibility that the next CECL estimate could be much higher. This will pose a liquidity problem for banks that do not have these kinds of reserves and would therefore need to make up for it by selling assets. Some banks may tackle this liquidity problem by creating an extra buffer of reserves over and above the capital CECL asks them to hold.

Source: CUNA News

Risk appetite management

While institutions might find it appealing to opt for methods that give the lowest CECL estimates, they will have to manage the corresponding risks by building a capital buffer. The size and scale of the buffer an institution creates around its CECL reserves would indicate its risk appetite. A zero buffer would mean a higher risk appetite where a bank may decide to deal with liquidity issues when it confronts them. A huge buffer would mean that the bank is averse to taking risks and wants to cover for any surprises that may arise.

Another way that an institution might choose to manage its risk appetite would be to calculate CECL using the current scenario and then calculate it for an extreme scenario (where factors like unemployment, housing, and gross domestic product are amplified). This will help them understand which method's results move the most and which ones move the least. Consequently, it indicates which methods are most sensitive to market movements and which ones are least affected. Banks can then pick methods, which do not cause drastic changes in CECL numbers and therefore manage their liquidity flows better.

Volatility of CECL results

As discussed above, certain CECL methods can produce more volatile results than others. Institutions that are looking to reign in this volatility might advise their Board of Governors on which method to choose to stay within their buffer limits. But if the board decides that they want to save as much capital as they can and channel it back into the markets, they might optimize and choose the method with the lowest result. The risk-averse nature of the board would ultimately decide how they deal with CECL volatility.

Institutions will realize that the way they manage their buffers is nothing but best practices when it comes to liquidity management and also optimization against the volatility of results. CECL has introduced a much-needed and improved measure of liquidity management on how banks function. Despite being an accounting standard that counts losses, CECL also has a predictive risk management aspect to it that has an impact on liquidity.

One of the reasons banks have got a couple of years to prepare for CECL is to familiarize themselves with the predictive methods and be ready for the liquidity implications by maintaining relevant provisions. It needs to be understood that under CECL, even if there are no historical losses, you would still make provisions for expected losses based on averages derived under the standard.

CECL, risk management, and return on investment

Most regulations, such as CECL, require more capital to be held in reserve to account for predictive losses. This means less capital for banks to put into the market and, thereby, significantly lower returns. The 2008 financial crisis ensured that appropriate regulations such as CECL were put into place so banks would have sufficient capital to deal with any market shocks. Measures were put into place to ensure that institutions managed their risks while making decent profits and staying in business. This financial safety net saw to it that it was that much more difficult for banks to fail and for depositors to lose all their savings. CECL regulators had the unenviable task of ensuring that the public was protected while allowing cash to flow through the economy. Under CECL, smaller banks faced a tremendous challenge when it came to maintaining reserves and managing day-to-day operations.

In the longer term, CECL ensures that banks maintain a good grip on their liquidity management through sound risk appetite practices. This development should potentially lead us to a robust banking system and an economy that works for all.

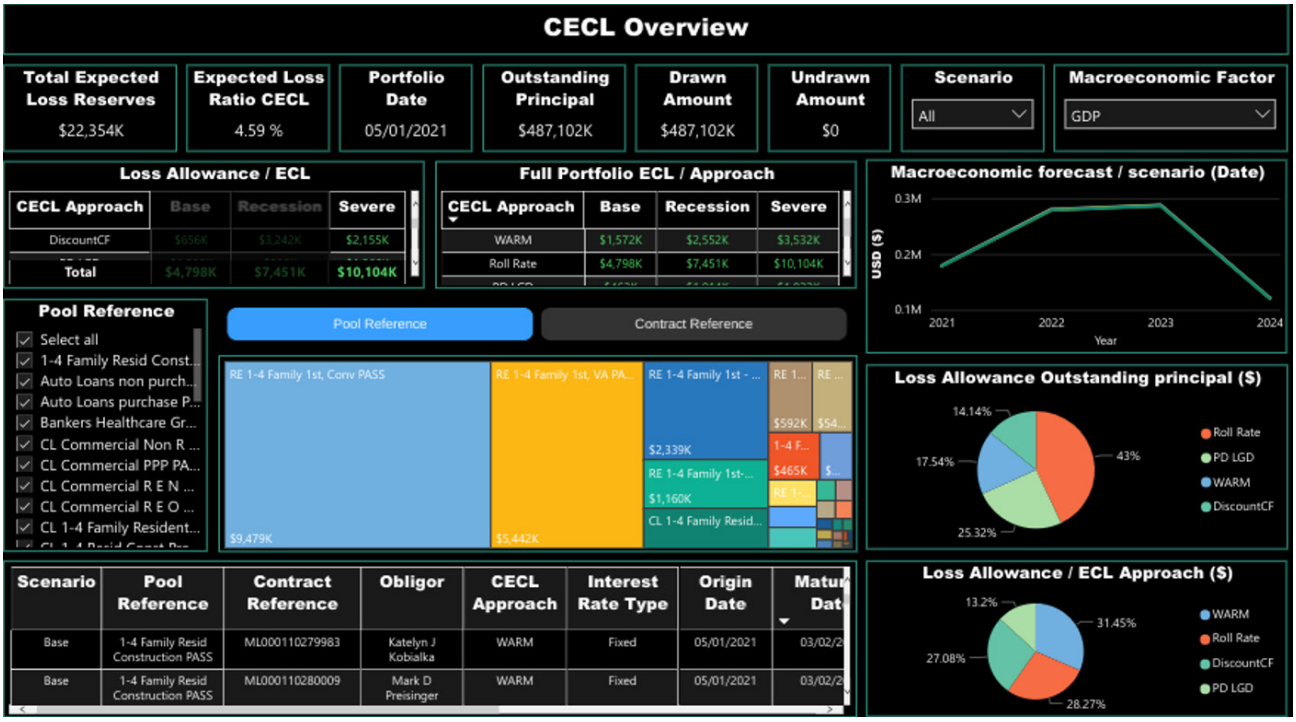
CECL Express can help...

CECL Express is a turnkey solution that fully satisfies all elements of the new CECL accounting standard. The system provides all non-loan data, including:

- Yield curves and Fed data
- Linked reports on losses from the FFIEC and NCUA
- PD and LGD curves
- Macroeconomic data

Banks and credit unions need to only provide the underlying loan details for the system to provide fully auditable ECL results for multiple calculation methods, including:

- Vintage
- Roll Rate
- Discounted Cashflow
- WARM
- PD/LGD



CECL Express provides more than valid ECL results. The system computes results for all methods and all loan pools, allowing the bank to optimize its CECL configuration and avoid the worst impacts of the new standard.

Visit ceclexpress.com for more information about the most efficient route to optimal CECL compliance.

CECL COUNTDOWN SERIES

ABOUT
CECL EXPRESS

- CECL Express is a turnkey, cloud-based solution, designed to provide banks and credit unions with optimized results and reporting that fully meet the 'Current Expected Credit Loss' accounting standards.
- CECL represents a major change in what is expected from financial institutions in their reporting of, and provisioning against potential credit losses.
- Smaller financial institutions are expected to implement forward-looking credit models to estimate losses they may experience.
- Selecting inappropriate 'Expected Credit Loss' (ECL) models will create a need to hold far more capital than is required, directly causing a loss of Profit and Loss (P&L). Data used within these models must also be reported for audit purposes.
- January 2023 will see the first official reporting period for the beginning of CECL. Banks and credit unions must have a framework in place, which is fully tested and reports results based on that data. In practice, this means selecting, implementing, and testing the system in the first half of 2022.
- For Finastra core systems, the integration has already been built. For customers with these systems, their CECL results are ready to be calculated and reported.

GreenPoint> Financial

ABOUT
GREENPOINT FINANCIAL

- GreenPoint Financial is a division of GreenPoint Global, which provides software-enabled services, content, process and technology services, to financial institutions and related industry segments.
- GreenPoint is partnering with Finastra across multiple technology and services platforms.
- Founded in 2006, GreenPoint has grown to over 500 employees with a global footprint. Our production and management teams are in the US, India, and Israel with access to subject matter experts.
- GreenPoint has a stable client base that ranges from small and medium-sized organizations to Fortune 1000 companies worldwide. We serve our clients through our deep resource pool of subject matter experts and process specialists across several domains.
- As an ISO certified company by TÜV Nord, GreenPoint rigorously complies with ISO 9001:2015, ISO 27001:2013, and ISO 27701:2019 standards.

Marcus Cree

MANAGING DIRECTOR AND
HEAD OF FINANCIAL TECHNOLOGY AND SERVICES

Marcus has spent 25 years in financial risk management, working on both the buy and sell side of the industry. He has also worked on risk management projects in over 50 countries, gaining a unique perspective on the nuances and differences across regulatory regimes around the world.

As Managing Director, Marcus heads GreenPoint Financial Technology and Services and has been central in the initial design of GreenPoint products in the loan book risk area, including CECL and sustainability risk. This follows his extensive experience in the Finastra Risk Practice and as US Head of Risk Solutions for FIS. Marcus has also been a prolific conference speaker and writer on risk management, principally market, credit and liquidity risk. More recently, he has written and published papers on sustainability and green finance.

Marcus graduated from Leicester University in the UK, after studing Pure Mathematics, Phycology and Astronomy. Since graduation, Marcus has continually gained risk specific qualifications including the FRM (GARP's Financial Risk Manager) and the SCR(GARP's Sustainability and Climate Risk). Marcus's latest academic initiative is creating and teaching a course on Green Finance and Risk Management at NYU Tandon School of Engineering.

Sanjay Sharma, PhD

FOUNDER AND CHAIRMAN

Sanjay provides strategic and tactical guidance to GreenPoint senior management and serves as client ombudsman. His career in the financial services industry spans three decades during which he has held investment banking and C-level risk management positions at Royal Bank of Canada (RBC) Goldman Sachs, Merrill Lynch, Citigroup, Moody's, and Natixis. Sanjay is the author of "Risk Transparency" (Risk Books, 2013), Data Privacy and GDPR Handbook (Wiley, 2019), and co-author of "The Fundamental Review of Trading Book (or FRTB) - Impact and Implementation" (Risk Books, 2018).

Sanjay was the Founding Director of the RBC/Hass Fellowship Program at the University of California at Berkeley and has served as an advisor and a member of the Board of Directors of UPS Capital (a Division of UPS). He has also served on the Global Board of Directors for Professional Risk International Association (PRMIA).

Sanjay holds a PhD in Finance and International Business from New York University and an MBA from the Wharton School of Business and has undergraduate degrees in Physics and Marine Engineering. As well as being a regular speaker at conferences, Sanjay actively teaches postgraduate level courses in business and quantitative finance at EDHEC (NICE, France), Fordham, and Columbia Universities.