

## **CECL:** Adapting to Adopt

Chris Henkel, Senior Director, Advisory Services Anna Krayn, Senior Director, Regulatory & Accounting Solutions



### **Speakers**



### **Christian Henkel**

**Senior Director** 

**Advisory Services** 

- Based in New York City, Chris leads a global team of risk consultants who work closely with banks, insurers, and other financial institutions
- » Has 20+ years experience in commercial banking including expertise in risk modeling, allowance for credit loss quantification, stress testing, and portfolio management.
- » Has a BA and an MBA from the University of Texas with concentrations in Finance and Accounting
- » Graduated valedictorian from the Southwestern Graduate School of Banking at Southern Methodist University, where he also served as a credit risk management instructor



### Anna Krayn

### **Senior Director**

Risk & Accounting Solutions – Americas

- Leads team responsible for solution structuring across Moody's Analytics products and services focusing on impairment, stress testing, and capital planning solutions for financial institutions
- » Advisory services experience as an engagement manager leading projects with financial institutions across the Americas in loss estimation, enhancements in internal risk rating capabilities, and counterparty credit risk management.
- » Was a rating analyst with Moody's Investors Service before joining Moody's Analytics in 2008
- » Holds Bachelor of Science degree in finance and international business and MBA from Stern School of Business at New York University (NYU)

## Agenda

- 1. State of the Industry
- 2. Deriving ECL Measures for Community Banks
- 3. The Ultimate Test of the Approach



### State of the Industry

## Where are we starting from?

A Word on Incurred Loss Approach Today



### Complexity Scaled to Sophistication....

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Simplicity is always great until it gives you the wrong answer or someone asks a simple question you can't answer! When the "answer" drives decisions towards bonuses, dividends, and raising capital, the stakes can be high!

Michael Gullette American Bankers Association

#### Adapting to Adopt, April 2018 7

Lauran Ata Managaman Lauran Banda Ananang Bandara Banda

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Emphasizing Simplicity





## Deriving ECL Measures for Community Banks

### Reserves for credit losses impact profitability



ROA and Reserves/Loans (1991-2017)

# There is a greater need for operational efficiencies to improve profitability

Average Assets Per Employee (\$ Millions)



Source: FDIC

# One-third of community bank assets have maturities greater than five years...

Long-Term (> 5 Years) Assets to Total Assets 40% 35% 33% 30% 25% 20% 19% 15% 10% 5% 0% 201001 201002 201003 201004 201101 201102 201103 201104 201104 201201 201202 201203 2006Q2 2006Q3 2006Q4 2007Q2 2007Q3 2009Q2 2009Q3 2012Q4 2013Q1 2013Q2 2013Q3 2013Q4 2014Q1 2014Q2 2014Q3 2015Q3 2007Q1 2007Q4 2008Q2 2008Q3 2008Q4 2009Q1 2009Q4 2014Q4 2015Q1 2015Q2 2015Q4 2016Q2 2016Q3 2006Q1 2008Q1 2016Q1 2016Q4 2017Q1 2017Q2 2017Q4 2017Q3

Source: FDIC

# ...and you need hold reserves over the remaining contractual life of each loan/segment



How you get there can take a variety of paths, and it will likely vary by asset class/segment

## For most community banks, using a loss rate approach is the most sensible option



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# For many community banks, using a loss rate approach is the most sensible option



### Data requirements depend upon segmentation and ECL methodology; will vary by segment EXAMPLES

- » Segmentation criteria/identifier (e.g., borrower NAICS code, Call Report code)
- » Segment-level historical losses (own, peer, 3<sup>rd</sup> party)
- » Origination date and maturity
- » Exposure amount for each loan/segment (including paydowns and pre-payment assumptions)
- » Loan product type (e.g., RLOC for ABL facilities)
- » Collateral/asset type
- » Credit risk metrics (usually scorecard/risk rating factors)
- » Economic variables (segment-specific) and forecasts
- » Risk ratings (if and accurate and providing risk differentiation)

### A quick word on risk ratings...

#### Not Good Good % of loans **Risk Rating**

**Risk Rating Distribution (10-point scale)** 

### Thinking about dual risk ratings...?



... Then a PD/LGD approach might be right for you

### Illustration of a PD Scorecard

### **Risk Rating Scorecard**















### Spectrum of risk rating methodologies (for the ACL) General observations of commercial credit practices at US banks





### The Ultimate Test

## Can You Explain Your Results?

Questions CECL Solution Needs to Answer



## Banker's CECL Implementation Modus Operandi



**Improve already lean operations.** Adopt a holistic approach to implementation. Comply, communicate, compete



Identify and institutionalize factors that drive risk in your portfolio. CECL helps to manage and communicate credit risk inherent in the portfolio



Apply modern technology. Analyze the various aspects of lifetime credit risks within the current reporting timeframes

### How to Get Compliant Now...



### Get an estimate of "an Estimate" now



Wrap an estimate into ICFR framework



**Compare different approaches** 





Execute multiple period parallel runs

### Allowance Calculation as an Advantage

Banks that can demonstrate how certain borrowers present lower credit risk will record less ALLL at origination, increasing the relative amount of deployable capital.

Banks that are able to better monitor loss expectations by credit rating and term may be able to better price these factors into their products over time.

American Bankers Association Backgrounder: CECL June 2016

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## Globally and locally acknowledged for award-winning tools to measure and manage risk.

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