DATA AND ISSUES AROUND CREATING A SMOOTH, AUDITABLE PROCESS IN THE FUTURE

Perspective of CECL

CECL FOUNDATION

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DAYS HOURS MINUTES SECONDS

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CECL COUNTDOWN SERIES

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AUDITING CECL RESERVE CALCULATIONS

The Financial Accounting Standards Board's (FASB) new standard, the Current Expected Credit Loss (CECL) continues to be a challenge for independent auditors, financial statement preparers, and users. The metrics that companies traditionally used to estimate their future credit losses have undergone a paradigm shift with CECL. The previous method of loan loss estimation, using historical credit performance, has been replaced by CECL, which directs organizations to recognize an estimated loss provision during the loan's lifetime, from the day of its origination.

The 2008 financial crisis highlighted the difficulty of financial institutions in estimating their actual expected credit loss provisions. This made investors lose confidence in the adequacy of Allowance for Loan and Lease Losses (ALLL) reserve balances reflected in the financial statements of those financial institutions.

Many lending products' profitability will be negatively affected by CECL calculations. Significant challenges are also anticipated in auditing post-CECL reserve calculations, including getting assurance that overly subjective measures are not being used by management to manipulate earnings. The CECL standard does not explicitly direct institutions on how to factor in forward-looking information while determining their lifetime credit loss estimates. This allows diversity in how institutions choose to estimate credit losses.

A thorough CECL audit framework ensures that management at financial institutions is prepared to justify the data, assumptions, models, and adjustments used, as well as enforce requisite governance and controls.

Source: BKD CPAs & Advisord

Changes to CECL audit practices

Auditors can anticipate seeing a wide array of practices across institutions since CECL is a principles-based accounting standard. It is critical for auditors to interact frequently with organizations that are still adopting CECL. This will provide them with plenty of time to learn about management's post-implementation processes and procedures. While implementation operations are ongoing, this approach can also ensure that the management has time to make necessary adjustments.

Economic conditions from the past are frequently poor predictors of future economic downturns. Forward-looking estimates are flawed and can be too late in reflecting signs of economic downturns, necessitating the management's judgment-based modifications in ECL estimation processes. As a result, auditors will have the difficult task of determining whether the management's depiction of financial statements is materially true. Since the management will be required to calibrate their models, they will need the liberty to make changes to their post-implementation ECL estimation models and techniques.

CECL is a complex requirement that needs a much broader set of assumptions and data that leads to more controls and documentation. All this preparation and anticipation will equip management at financial institutions to squarely tackle the audit and regulatory challenges. There are five principal areas that financial statement preparers need to focus on to defend their estimates while undergoing an audit. These areas are explained below.

Five main areas of focus for audit scrutiny:

- **Data**
  Data preparers for a CECL audit must be accountable for all data used in the estimate and must create and implement an internal control mechanism to ensure that the data is comprehensive and accurate. Data that supports upstream processes must be well sourced and evaluated. To support an adequate assessment of the impact that each data factor has on the estimate, it is necessary to create an inventory of data elements. When employing external data, preparers are supposed to analyze to verify the data's relevance and dependability.

- **The usage of models**
  The management must focus on conceptual soundness, data and assumptions, calculations, and outcome analysis, just as auditors do. To ensure optimal model use, more advanced models necessitate proportionate managerial skills. Model validation is an important governance control for both initial adoption and ongoing model use. To use models efficiently, managers must understand and analyze historical model accuracy as well as model behaviors or patterns.

- **Qualitative adjustments**
  The goal of qualitative adjustments is to resolve the quantitative approach's flaws and limitations, as well as to assure that the CECL estimate as a whole meets the accounting and regulatory guidance standards. Assessing the qualitative adjustment requires sound logic and analysis of relevant facts. Management should create a risk inventory to assess whether a qualitative adjustment is required. A framework that is well-documented should establish a systematic and transparent approach for determining qualitative modifications.

- **Assumptions**
  The management should also build an inventory of assumptions in order to recognize all assumptions. Auditors must be able to comprehend how management has determined the value of an assumption and why a particular one was chosen. Benchmarks should be assessed for relevance and consistency, as well as any discrepancies between benchmark numbers and internal data. Materiality is an important assumption in developing a CECL estimate, and the management's records should show how materiality was taken into account. As new risks emerge, changes to the process may become essential.

- **Controls/Governance**
  The control environment relies heavily on good documentation. Given the extra complexity and judgment required to produce a CECL assessment, a solid structure of governance is essential.

CECL is a more complicated requirement than prior standards, as it is based on a considerably broader range of data and assumptions, requiring more documentation and controls both during and after implementation. This article has outlined some of the major issues from the perspective of an auditor to assist preparers in better positioning themselves to substantiate their estimates when audited.

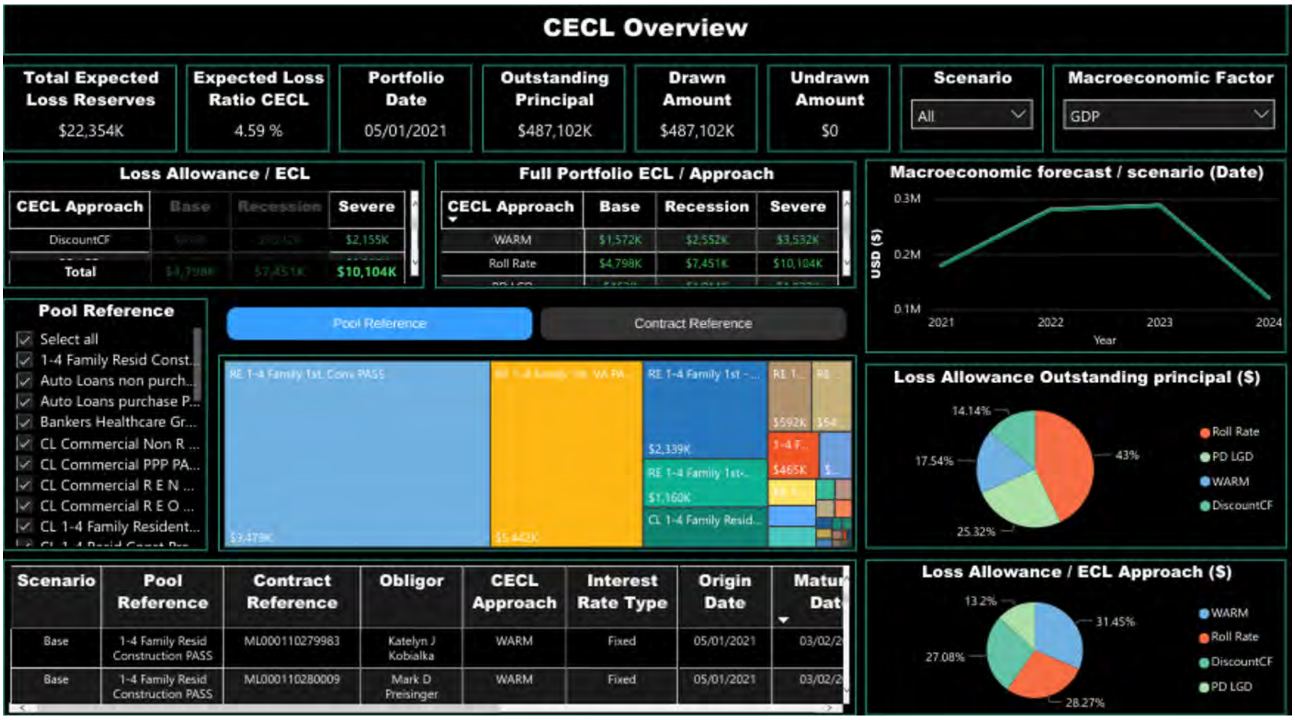
CECL Express can help...

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.

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.

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
CO-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 co-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.