Q-FACTORS – THE SECRET SAUCE FOR EVERY US INSTITUTION

Perspective of CECL

CECL FOUNDATION

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Q FACTORS UNDER CECL

Most financial institutions in the U.S. were left wondering about the fate of their qualitative factors, also known as Q factors, under the Current Expected Credit Losses (CECL) standard when it was issued by the Financial Accounting Standards Board (FASB) in 2016.

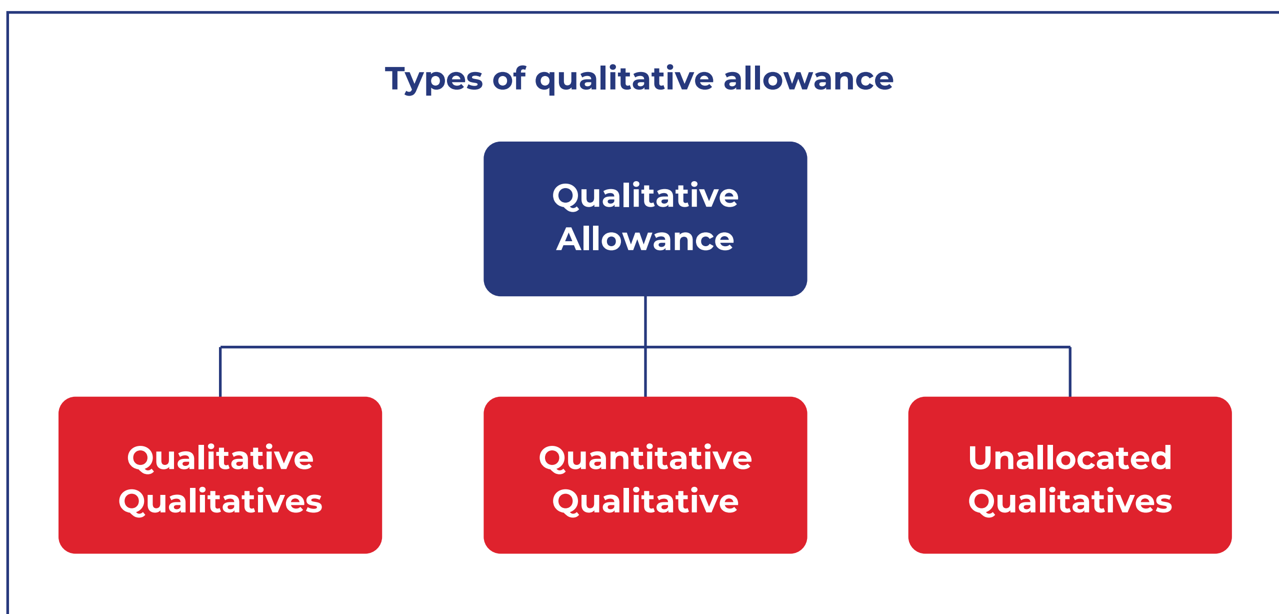
Bankers, faced with a 2023 CECL implementation date, wonder how best they will implement their existing Q factors to keep their allowance for credit losses figures at manageable levels. Banks and credit unions are also struggling to understand the percentage of quantitative to qualitative factors needed for their CECL calculations. The economic uncertainty caused by COVID-19 has further pushed qualitative aspects of the allowance process to the forefront of allowance estimates. A framework is now required for integrating both qualitative and quantitative dimensions into the standard Q-factors.

To meet the mandates of auditors, regulators, senior management, and investors, all qualitative allowance considerations must follow a complete, methodical, well-documented, and consistently applied approach. Most allowance models need to be supplemented with a qualitative allowance component if they are to be accurate. When compared to incurred loss models, the qualitative allowance for most institutions is likely to increase under CECL.

Qualitative allowance and its types

There are three types of qualitative allowances based on how the important data is compiled and consumed. They are:

- Qualitative qualitatives
- Unallocated qualitatives
- Quantitative qualitatives



1. The qualitative qualitatives are that part of the qualitative allowance, which is made up of data that are subjective in nature. Given its subjective nature, auditors and regulators require a well-defined, supportable, transparent, and consistent approach.

2. The quantitative qualitative allowance is that component of qualitative allowance made up of objective data pieces that can be gathered and tracked openly.

3. Additional management adjustments to the allowance that are not linked to certain segments or models and do not belong within the framework of quantitative or qualitative qualitatives are covered by unallocated qualitatives.

Qualitative allowance application and its tiers

In some areas of the portfolio, qualitative allowance may be used more liberally than in others. We can segregate these areas into three tiers.

Tier 1:

- Off-balance sheet allowance
- New products
- Bank loans that were recently acquired, including purchased credit deteriorated that have a little history prior to acquisition
- Models that rely on data from the industry
- Portfolios that are extremely sensitive to model inputs

Tier 2:

- Loans that are originated and collectively reviewed
- Immaterial portfolios
- Portfolios that are seasoned and well-understood

Tier 3:

- Individually reviewed loans

Source: Wolters Kluwer

Integration of qualitative factors into CECL quantitative models

Several qualitative factors will figure more prominently under CECL. These Q factors are:

- Changes in nature of the portfolio
- Changes in lending policies and procedures
- Changes in the value of underlying collateral for loans that are collateral-dependent
- Changes in quality of assets
- Changes in regional, international, national, and local economic and business conditions

Other Q factors are likely to remain unaltered from the existing incurred loss model. This is because it is difficult to incorporate them into specific quantitative model assumptions on a consistent basis. Both qualitative and quantitative criteria can be utilized to determine the appropriate degree of supplemental qualitative allowance to be added or deducted from the allowance model output for most of the nine Q-factors.

Macroeconomic forecasts play a crucial role in CECL projection models over the expected lifetime of a portfolio. To cover management's evaluation of each of the qualitative components, appropriate documentation is required.

Management can use qualitative allowance to supplement allowance model outputs based on their best judgment of overall economic or credit conditions throughout the forecast horizon. It is an best practice to extract the quantitative parts of any Q-factor and utilize them as a starting point in establishing any qualitative rating. To convert Q-factor ratings to genuine qualitative allowances, a rating scale is required. Documentation remains the most relevant aspect of the qualitative process for regulators, management, and auditors.

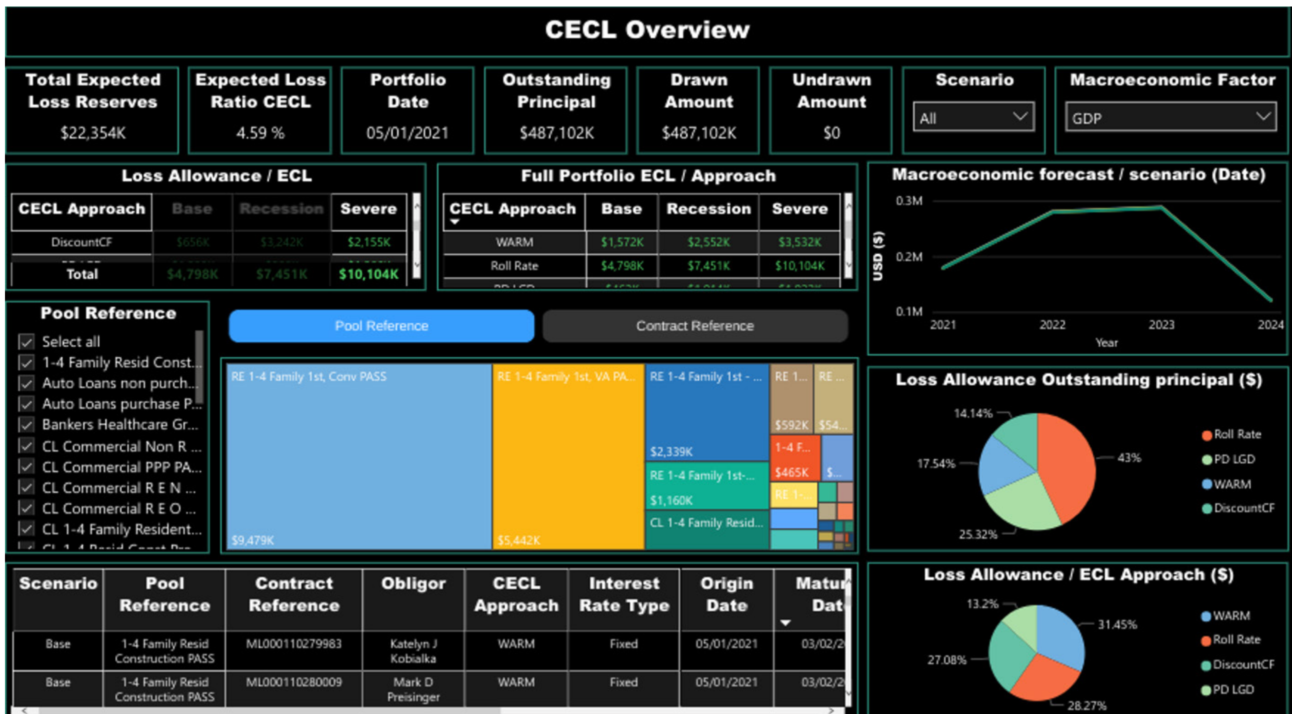
CECL Express can help...

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
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.