UNDERSTANDING LOAN CLASSIFICATIONS UNDER CECL

By **Vinayak Shetty**

CECL COUNTDOWN SERIES

marcus.cree@greenpointglobal.com | sanjay@greenpointglobal.com

International Corporate Center, 555 Theodore Fremd Avenue, Suite A102 Rye, NY 10580

CECL IS APPROACHING

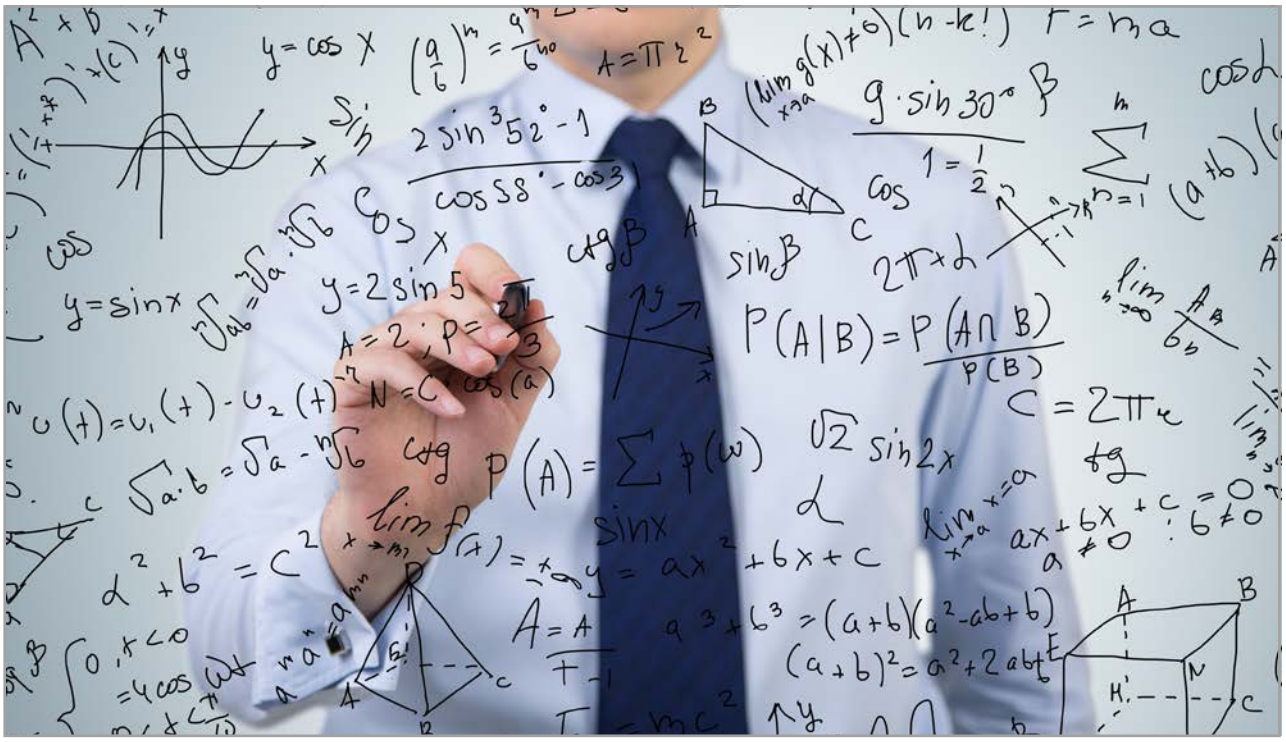
In June 2016, the Financial Accounting Standards Board (FASB) provided us with a new expected credit loss accounting standard. The current expected credit losses methodology (CECL) was introduced by this new accounting standard to estimate allowances for credit losses. The effective date of CECL was pushed back by the FASB to January 2023 from January 2021 for smaller reporting companies. For non-public companies, it has been moved from January 2022 to January 2023. The definition of smaller reporting companies is as per the rules laid out by the Securities and Exchange Commission (SEC).

The FASB, On November 15, 2019, issued the Accounting Standard Update (ASU) 2019-10. This update pushed back the effective date for the CECL standard, ASU 2016-13.

CECL preparation

There are some crucial points to consider when we compute CECL and implement it. Financial institutions are required to factor in the below-listed points during CECL calculations and not focus on historical loss calculations alone.

- Historical Loss rate
- Forecasted Economic Conditions that are reasonable
- Qualitative Factors (Q-factors)/Current Economic Conditions



Historical data and loan classifications

Procuring historical loan data is not always easy for banks, and that data is often limited. Banks usually use previous monthly board reports for loan and delinquency information. They can use this information to forecast loss rate calculations.

Historical loan delinquency data can also be an effective tool to create granular loan classifications, enabling banks to categorize loans into different pools. Classifications, in effect, provide the ability to differentiate between all loans and ensure that loans are correctly and conservatively accounted for.

As an example, let us consider how automobile

loans are classified within banks. The first classification pool would be where the loan is in good standing, and we term that pool as automobile or 'automobile pass'. This pool has a specific set of curves, probabilities, and Q-factors against it.

Banks factor in the externally available FICO Score or the consumer credit risk score to make reliable credit risk decisions while lending money. FICO scores are helpful to CECL as they capture information about the borrower to which the bank may not have access. FICO collects data from multiple sources. If a borrower is stacking debt outside of the bank, even though they are paying down the loan on time each month, the risk should still be reflected if we want a near precise CECL estimate.

If a customer's historical delinquency data and FICO score do not show any cause for concern, banks need not provide any extra and treat this pool normally. This depends on FICO and other factors, if everything is fine with the loan and it is in good standing,

If there are loans that are 30 or 60 days over and the FICO score has gone down to 100, the loans are classified as automobile special mention. This pool has a slightly higher probability of default. Likewise, if the FICO score goes down to around 600 or you are 60 to 90 days late, then at that point, you are down to sub-standard and heading towards default.

Delinquent loans are those that have not been paid past their due date. Delinquency is a range, and the longer a customer does not pay, the likelihood of defaulting increases. If we go even lower to around a FICO 650 and delinquency of 90 to 120 days late, banks put it down as a loss and write the entire notional off, and the whole amount is considered as a provision while estimating CECL.

Significance of Loan classification under CECL

Every CECL calculation pulls in the previous rate, macroeconomics, and Q-factors. Thus, when Q-factors are higher, banks add more provision to impacted pools.

In summary, FICO scores of customers fall when they approach multiple banks for loans. This increases their loan-to-earnings ratio, thereby decreasing their capacity to pay back the loan and decreasing the free cash flow. This also increases the probability of default. The problem with this is that banks do not refresh their FICO score often. Without an updated FICO score, banks rely on information such as delinquencies, which can lead to inaccurate CECL results. Therefore, the calculation of CECL should be a function of the delinquency data available at the bank level and the credit score, which is dependent on activities outside the bank.

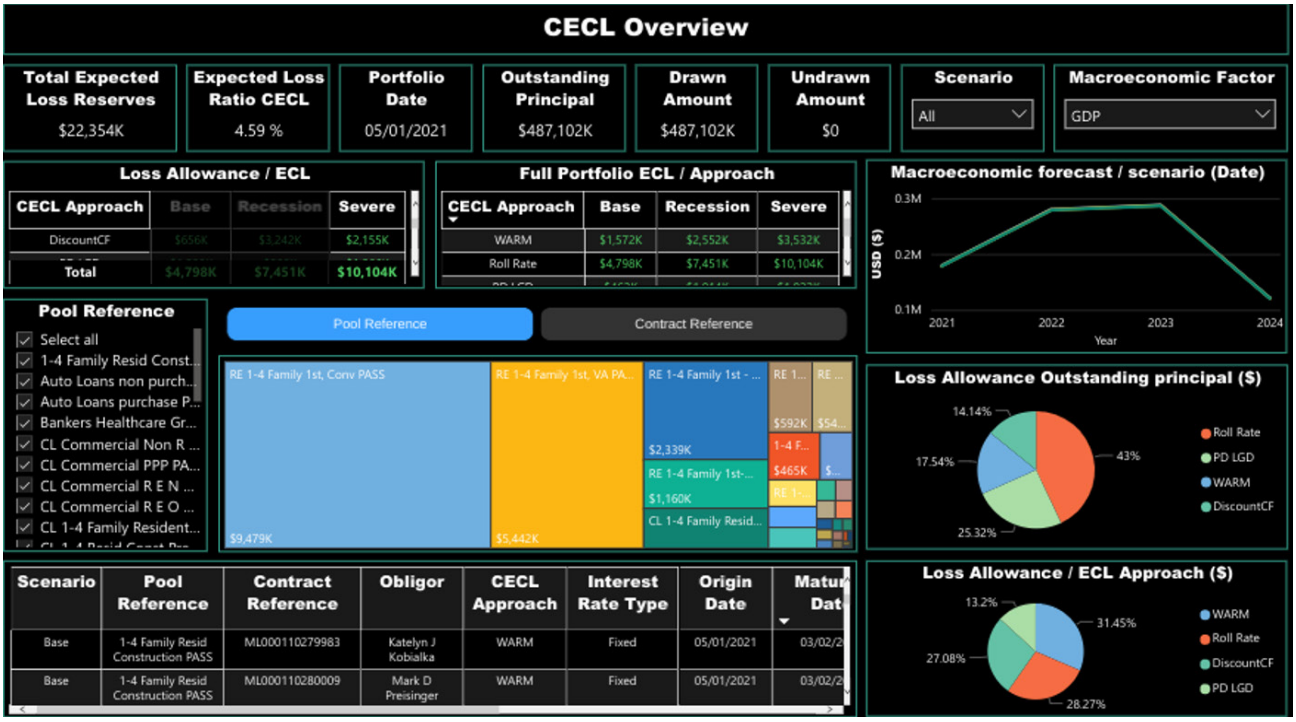
CECL Express can help...

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 studying 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.