February 9, 2016

Weekly Post **Preparing for Current Expected Credit Loss (CECL) Reporting**

Dear Clients-

The final CECL standard is expected to be released Q2 this year. CECL standard may increase your bank capital requirement, increase volatility to your balance sheet, and will have multiple implications on your reporting operations. Indeed, 'CECL Implementation Challenges: the Life of Loan Concept' American Bankers' Association April 2015 listed <u>twelve</u> areas of concerns.

Key concepts of CECL are:

- Loss Allowance is determined by the expected lossed for the life of a loan
- A consistent model for credit risk, interest rate risk and liquidity risk

While CECL is not expected to be effective within 2 years, the broad implications of CECL on Tier 1 capital and loan production processes can be significant. For these reason, you need to prepare for the challenges now by adjusting the balance sheet and manage performance taking a holistic approach.

Challenges

- How much will CECL impact capital requirements that may require you to increase capital now?
- How much volatility will be added to the balance sheet resulting in adjusting your loan origination processes?
- How to implement Enterprise Risk Management, managing all risks and earnings in a holistic approach?

Solution

THC Risk Officer ™ was designed in 2006 with OTS to take the holistic approach. For this reason, extending your ALM analysis to incorporate CECL should relatively seamless. For example, ABA article mentions: vintage of loans has to be used (where the information is already in THC PATH); ALM system has to be adapted (CECL incorporated in Risk Officer); credit quality disclosures and credit metrics are presented in THC reports; loan pool approach may be changed to individual loan approach (THC model is always based on account level information). THC always uses discount cashflow model under uncertain interest rate risk, which is required under CECL. In sum, your ALM model covers all twelve areas of ABA concerns.

Consider the loan pool below for illustration. The pool consists of ARM 7-1. ABA article mentions the complexity of modeling loan prepayment and credit risk combined. THC model was built to analyze interest rate risk and credit risk combined. The model is explained in FHFA Mortgage Analytics Platform. The model is cashflow based, identifying CECL of each individual loan.

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Base Information									Cashflow Analysis				
									short term		long term		
Face Value	Int.Rate(%)	Type	Index Rate	Margin(%)	Servicing(BP)	WAM	FICO	LTV(%)	CPR(%)	CDR(%)	CPR(%)	CDR(%)	Default $
2,940,800	2.990	0	0	3.25	25	239	717	80	14.30	0.43	17.06	4.28	35,043
102,800	2.990	HYB7YR	1Y TSY	3.25	25	239	680	80	10.44	0.64	14.48	5.53	1,932
200,000	2.990	HYB7YR	1Y TSY	3.25	25	239	715	80	14.36	0.47	16.48	4.53	2,597
400,000	2.990	HYB7YR	1Y TSY	3.25	25	239	685	80	14.51	0.36	18.03	3.75	3,822

Numerical Example

Referring to the Table above, conditional prepayment rate (CPR) measures the % of prepayment to the outstanding amount. Conditional Default Rate (CDR) measures the % charge off before recoveries to the outstanding amount. The results show that the conditional prepayment rates are 14.30% and 17.06% for the coming 12 months and for the loan portfolio life. The conditional default rate is 0.43% and 4.28% for the first 12 month and for the life. The present value of the charge-offs net of recoveries is $35,043 (Default $) on $2,940,800 face value. Hence CECL is $35,043.

For reporting purpose, THC provides the cash flow reports projecting the outstanding amount, prepayment, amortization, interest income, servicing fees, charge off, recoveries monthly for the life of each loan. Risks of these cash flows can also be simulated, under different rate shocks, showing high prepayment must necessarily lower CECL and visa versa.

CECL can be integrated to your Contingency Funding Plan report, showing how moderate, severe and crisis scenarios affect your capital and liquidity, when there is a significant rise in default, run on the bank, and other market risks.

Conclusions

I believe CECL is a sound approach for asset-liability management: a holistic method, tying management dashboard to regulatory reporting, and forward looking. The concerns remain on implementation. As explained, Risk Officer can assist you in the implementation.

I recommend that you follow our PATH file instructions to provide credit information to THC, including your internal rating and recovery ratios. Our reports can then allow you to evaluate the impact of CECL on your balance sheet. You can use the results to adjust your strategies.

If you would like to learn more about the THC approach to evaluate your strategies, please do not hesitate to contact my colleagues or me.

Regards,

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