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CECL Benchmarking for Portfolio Management

Using CECL benchmarking to influence multidisciplinary action

Profitable growth has always depended upon getting the right offers to the right customers at the right time. Two changes define a new era of competition. First, firms in a range of industries are using technology to reimagine traditional business models. Second, as their lives increasingly digitalize, consumers' expectations have permanently changed—the are empowered by access to information and demand innovation in exchange for their data. Bankers cannot sidestep this “Anticipation Economy”—to thrive they'll need to think more holistically about the customer lifecycle and the transformational potential that technology enables.

Savvy bankers will look to integrate back-office insights for insight-driven customer pursuit and use a consistent view of risk to direct expertise where it adds value across the customer lifecycle. Despite the customer-facing nature of this transformation, credit and accounting executives are well positioned to lead banks' strategic transformation. Following successful CECL implementations, these executives possess working relationships with multidisciplinary experts across the back-office, detailed knowledge of credit data and use cases, and deep experience developing controlled processes for delivering actionable insight.

The role of the reserve manager

Reserve managers have always had the unenviable task of estimating and defending the most abstract question in banking. CECL motivated bank investment in foundational credit loss measurement tools that enable process enhancements across the credit lifecycle. The complexity of the new estimate and scale of reserve change distracted stakeholders from the potential process transformation CECL's insights enable. Reengaging these stakeholders with an actionable credit narrative is a competitive imperative.

To lead this transformation, reserve managers must provide stakeholders with the means to interpret the new estimate and connect its granular, forward-looking insights to changes in management processes. Financial planning & analysis (FP&A), capital planning, underwriting and credit administration, customer strategies, and investor relations can all gain from insights provided by reserve managers. Thoughtful consideration of estimate inputs, quarterly reserve changes and comparison to peer results are key ingredients for engaging stakeholders in CECL's nuances the transformational potential deeper credit insights enable.

Why are benchmarks important?

Benchmarking is a key tool available to reserve managers to disseminate insight and drive action throughout the organization. Benchmarks can go beyond defense of the reserve estimate--providing actionable insights to help management:

- » Set clear business goals
- » Understand what is happening in the portfolio and market
- » Focus on the right customer opportunities
- » Direct expertise where it adds value

Each of these objectives go beyond defense of the reserve estimate. Knowledge is powerful—transformational potential expands when what you know changes what you do. To create an action plan that best suits your organization, the following questions are useful to consider:

- » How do reserve outputs impact your company's key business activities?
- » How can CECL tools be adapted, or their insights applied, as an empirical anchor for expert judgement beyond reserves?
- » What external references would enhance management's understanding of the portfolio and credit insights CECL can provide?

What's driving today's reserve number?

CECL's forward-looking, granular view of credit is well aligned with several processes across the credit lifecycle—a meaningful break from reserves under incurred loss. This alignment derives both from accounting standards' effort to prevent delay of credit loss recognition and consideration of a broader range of reasonable and supportable information than that used in incurred loss methodologies. To demystify CECL models for reserve stakeholders, it can be useful to present the alignment of model drivers within a broader credit and business context. A framework for this is presented in Figure 1.

Figure 1 CECL quantitative reserve drivers



Individual model characteristics may vary – for example, unit of account and length of reasonable and supportable period – but all changes in the quantitative portion of any CECL estimate can be attributed to the three categories shown above: forward-looking data, product mix, and portfolio credit quality. The more granular, volatile nature of CECL results challenge many reserve stakeholders to revisit the way they absorb and forecast reserve outputs. For example, FP&A budgeting for reserve levels on new loan volume, or future quarters' reserve impacts on profitability. Reporting CECL results and structuring these updated connections around the factors in Figure 1 is a key first step for creating an actionable transformation narrative. With a deeper understanding of how their process relates to reserve results, stakeholders can begin to prioritize investments to enhance profitability and performance.

These categories also align with portfolio activities owned by key reserve stakeholders. The CECL estimate drivers match criteria evaluated to extend credit – reserves are the result of how a portfolio is managed. If portfolio administrators can corroborate reserve estimates using evidence from their work, reserve managers are no longer left to defend loss estimates independently. Beyond portfolio administration, CECL's multi-scenario view of the portfolio central default tendency can be used to plan changes to underwriting, portfolio, asset liability management (ALM) or merger and acquisition (M&A) strategies.

What changed since yesterday's reserve estimate?

The next step for stakeholders is to understand which variables are affecting changes in reserves period to period and the reasonableness of reserve movements. This understanding will depend on their portfolio understanding and beliefs about the status of the economic and credit cycles. These concerns are always relevant, but CECL's response to stress most clearly exemplifies the need for this capability, as economic stress corresponds with the greatest period-to-period reserve change. Targeting loss mitigation activities, scaling originations or risk appetite, and business planning activities could all benefit from CECL insight. CECL models are not a crystal ball. However, anchoring judgements that contribute to the forecast, mix or credit quality to quarterly changes in reserve estimates can help to interpret the portfolio's progression although a stressed cycle.

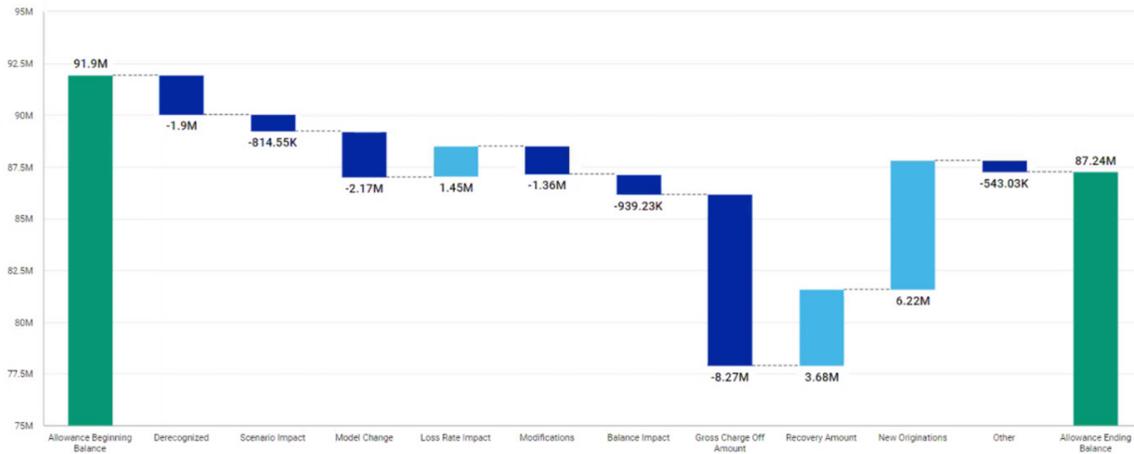
The initial adoption of CECL at the start of 2020 coincided with the outbreak of Covid-19 and a subsequent recession. This provided useful examples of reserve behavior and the ways detailed analysis can anchor management's expert judgement. National Bureau of Economic Research (NBER) estimates¹ provide February 2020 and April 2020 as the bounds of the recession. Despite this, significant uncertainty about the extent of economic damage caused by the pandemic lingered far beyond the recession's end – the NBER waited until July 2021 to announce the recession's end date. Recalling this environment and mindset is essential to understanding how reserve attribution can provide an important benchmark for expert judgement in stressed conditions.

In the first quarter of 2020, macroeconomic forecasts declined significantly in response to the COVID-19 pandemic. Reserves responded quickly to this decline, which deteriorated further in the second quarter, when seasonally adjusted, US unemployment peaked at 14.7%.² The recession was unusual in that lockdowns were its proximate cause, but coincident actions by Congress, the Federal Reserve, state and local governments prevented the credit migration and loss emergence that was anticipated by CECL models' response to the forecast deterioration. Ordinarily, migration and loss emergence would be key benchmarks for management navigating a credit portfolio through a recession and its aftermath (assuming the government interventions that accompanied the pandemic do not recur in future recessions). The combination of a recovery in the economic forecast, credit migration and charge-off would help management see that issues were working their way through the portfolio, but better days lay ahead. In turn, this would influence action by reserve managers, portfolio managers and loan origination appetite. An example of this breakdown of reserves is provided in Figure 2.

1 National Bureau of Economic Research. (2021, July 19). Business Cycle Dating Committee Announcement. Retrieved February 15, 2022 from <https://www.nber.org/news/business-cycle-dating-committee-announcement-july-19-2021>.

2 U.S. Bureau of Labor Statistics, Unemployment Rate [UNRATE], retrieved from FRED, Federal Reserve Bank of St. Louis; <https://fred.stlouisfed.org/series/UNRATE>, February 15, 2022.

Figure 2 Reserve change attribution analysis



How do we compare to peers?

Portfolio and reserve change insights provide one meaningful benchmark. Understanding how reserves compare with market or peer reserve trends can also provide meaningful support for management's judgements.

Q1 2020 disclosures were the first chance for most issuers to see their peers' reserve levels under CECL. As the pandemic unfolded throughout the year, there was great interest in reserve levels and the allocation of reserves to individual asset classes. These were used to support judgements about the likely level of loss and where it would originate. As Figure 3 and Figure 4 illustrate, direct comparison to peers' reserve levels and changes in reserves provide a first order indicator of differences in expectation across institutions – but this is only a starting point.

Figure 3 Reserve level by segment benchmark

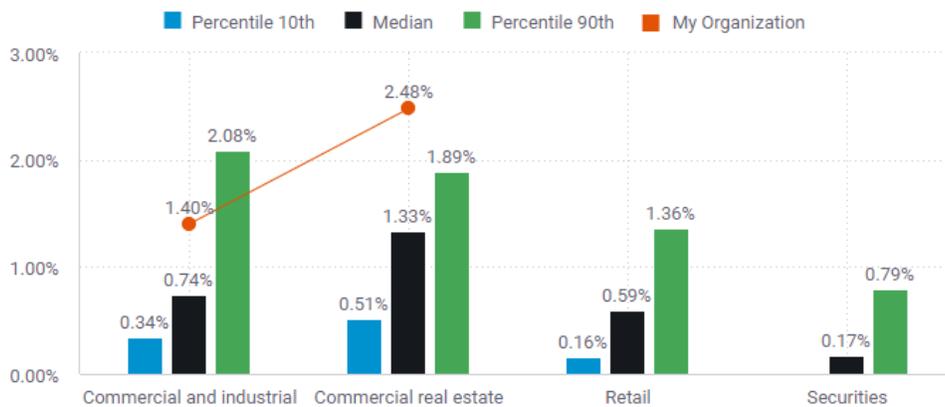
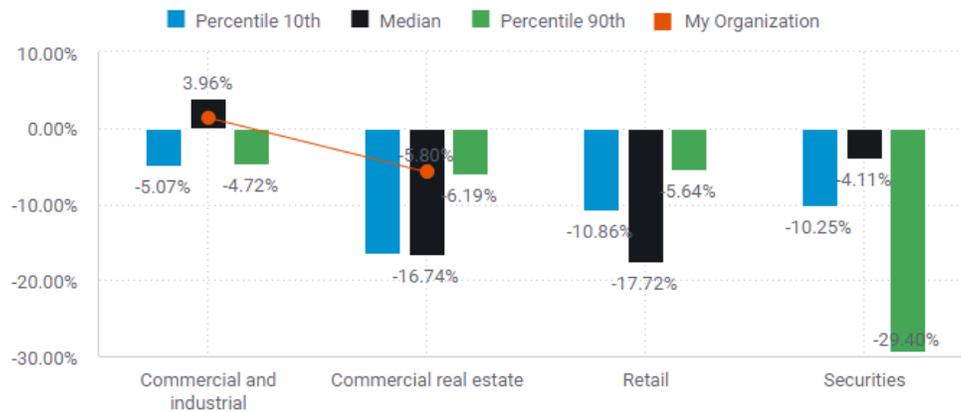


Figure 4 Quarterly reserve change by segment benchmark



Publicly available call report or SEC filing data allow reserve stakeholders to aggregate benchmarks like these, but do not provide deeper insight into reserve drivers. Without this, it is difficult to attribute differences in reserve levels.

Segment and credit quality disclosures provide some insight into mix and credit migration. However, there are still meaningful questions about differences in expected lives, forecast assumptions or expected default and recoveries represented in peer reserves. These all limit the explanatory value of reserve level comparison. Within each segment shown in the charts above, the range of estimates could reflect differences in many areas, including economic forecasts used, variances in expected lives, and differences in credit quality. In addition, public data often does not segregate the quantitative and qualitative components of reserve estimates. Your model results may match those of peers, but if they're applying different qualitative adjustments, there's no way to know.

Is there value in benchmarking beyond final reserve balances?

While economic scenarios captured significant attention ahead of CECL adoption, prepayment assumptions can significantly affect the expected life reflected in reserve results. This impact can be understood through weighted average life (WAL) and weighted average maturity (WAM) benchmarks, illustrated in Figure 5.

WAM represents the average time to receipt of all future principal cashflows for instruments in a portfolio, including prepayment and default. Higher values indicate a longer expected life. Since prepayments and default make expected lives shorter than contractual term, it can also be helpful to understand loan age differences. This is calculated using a balance-weighted average of years to contractual maturity for all instruments in a portfolio and is expressed by WAM. Higher values indicate a longer contractual life.

Figure 5 Weighted average life vs. maturity benchmarks



Benchmarks can provide additional consideration for differences in expected lives and credit quality. For example, low values for probability of default (PD) and WAL combine with high WAM to indicate a high degree of prepayment reflected in peer benchmark rates. Looking at these benchmarks over several quarters, as shown in Figure 6 and Figure 7, can provide further insight to support management judgements about the progression of a stress event through peer portfolios. For instance, are peers anticipating a near-term turnaround, or still building reserves in anticipation of further deterioration? Separating default (PD) and recovery (loss given default or LGD) risks in peer data enables separation of bad borrowers from good collateral, or good borrowers from declining property values.

Figure 6 Portfolio PD five-quarter trend

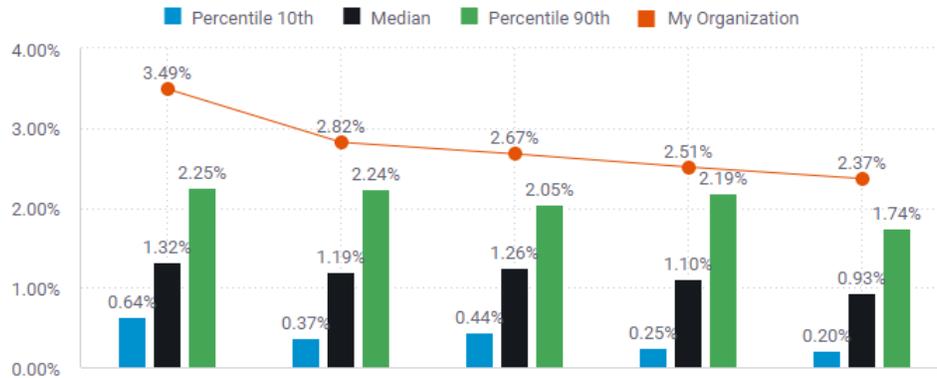
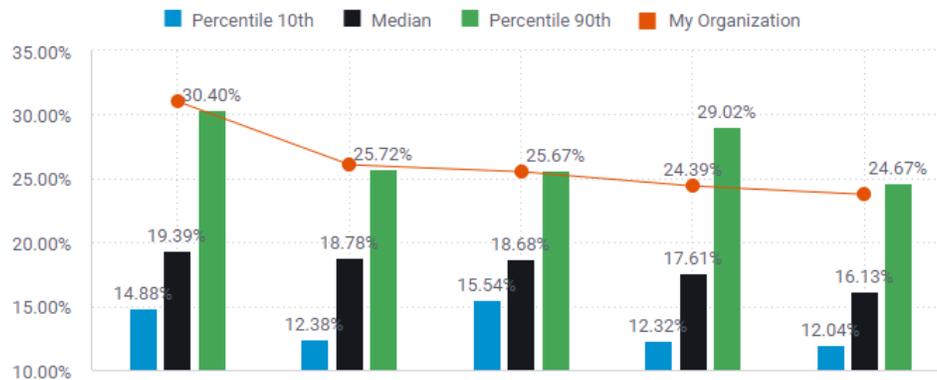


Figure 7 Portfolio LGD five-quarter trend



Reserve managers lead the way

In the Anticipation Economy, successful banks will invest to differentiate their customer experience and generate profitable growth. Savvy banks will leverage interdisciplinary insights from their back office, including risk, compliance, IT, finance, and capital planning, to reimagine and integrate activities across the customer lifecycle.

With their insight into data inputs, multidisciplinary use of forecasts and alignment with credit decisioning across the customer lifecycle, CECL reserve managers are uniquely positioned to lead this transformation.

Benchmarks are one of reserve managers' most important tools to encourage reserve stakeholder engagement. Benchmarks can help to tell a story that drives cross-business engagement by spurring stakeholder interpretation and buy-in – and so inspiring transformation. They are key to anchoring management judgement through the credit cycle and keeping your organization competitive in a changing landscape.

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