July 13, 2018

Via Electronic Mail

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219
Attention: Legislative and Regulatory Activities Division

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, D.C. 20551
Attention: Ann E. Misback, Secretary

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20249
Attention: Robert E. Feldman, Executive Secretary

Re: Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations (Docket ID OCC–2018–0009 and RIN1557–AE32; FRB Docket No. R–1605 and RIN 7100 AF–04; FDIC RIN 3064–AE74)

Ladies and Gentlemen:

The Bank Policy Institute[1] appreciates the opportunity to comment on the Agencies' proposal[2] to implement the current expected credit loss methodology ("CECL")[3] into their capital and Dodd-Frank Act Stress Testing ("DFAST") rules. Beginning in January 2020, CECL will replace the existing incurred-loss methodology for establishing credit loss allowances under U.S. GAAP.

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1 The Bank Policy Institute (BPI) is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, they employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

2 83 Fed. Reg. 22312 (May 14, 2018).

3 FASB, *Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments (Topic 326) ASU No. 2016-13* (June 2016) ("ASU 2016-13"), *available at* https://asc.fasb.org/imageRoot/39/84156639.pdf.

The establishment of CECL is widely recognized as a major change in accounting standards that will have a significant impact on the banking industry.[4] It is expected to result in generally higher and more volatile credit loss allowances and, upon initial adoption, it will require banks to recognize adjustments to retained earnings and CET1 capital. Accordingly, we urge the Agencies to implement a capital neutral approach for CECL for purposes of *all* capital requirements (including stress capital requirements). We also therefore strongly support the Agencies' proposal of a transitional arrangement by which the "day one" impact of the adoption of CECL would be phased in over a period of years. However, we are concerned that because the transitional arrangement would only address the "day one" impact, but not its broader, ongoing impact thereafter, it is insufficient to fully address the anticipated effects of CECL on banks and the broader economy, which is why it is imperative that the Agencies' approach for CECL be capital neutral. We also offer a range of suggestions regarding the proposed transitional arrangement and a quantitative impact study on the anticipated effects of CECL that we urge the Agencies to conduct. Our recommendations are intended to further both our and the Agencies' objectives of developing a capital framework that promotes the safety and soundness of banks, as well as their ability to provide credit and support economic growth.

We note that the Federal Reserve has recently proposed to integrate its capital planning, stress testing and capital rules by proposing a new stress capital buffer framework.[5] The stress capital buffer proposal would effectively codify the role of CCAR stress tests in determining banks' binding capital constraints and, without complementary changes to the Federal Reserve's stress testing framework, introduce significant – indeed excessive – volatility in ongoing (i.e., point-in-time) capital requirements. It is therefore critical that the Federal Reserve consider the *collective* impact of the implementation of CECL, the incorporation of CECL into CCAR, the stress capital buffer proposal and the overall transparency of the Federal Reserve's capital planning and stress testing framework, all of which increase or would increase the volatility and unpredictability of bank capital requirements, when choosing how to incorporate CECL into all capital requirements (including stress capital requirements).

I. Executive Summary.

- The Agencies should revise their regulatory capital framework so that the implementation of CECL will be capital neutral as to all capital requirements (including stress capital requirements) both upon initial adoption and on an ongoing basis. A capital neutral approach would appropriately reflect the ways in which CECL will fundamentally change the relationship between regulatory capital and credit loss allowances.

  - Additional credit loss allowances under CECL will have greater loss-absorbing characteristics such that a capital neutral approach is appropriate.

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[4] *See*, *e.g.*, Deniz Tudor, Moody's Analytics, *White Paper: Challenges and Costs of CECL* (March 2018), at 4 ("CECL is one of the most significant changes in lending industry since the Federal Reserve's stress-testing exercises that started in the aftermath of the 2007 financial crisis. CECL will impact net worth of lending institutions in a way no accounting or other change has done in a long time."); Deloitte, *US Current Expected Credit Losses (CECL) implementation insights: Knowledge, dates and potential implications* ("For the banking industry, the FASB's new current expected credit losses (CECL) accounting standard is the most impactful accounting change in over a decade . . . CECL promises to be one of the most significant accounting projects of the next five years."), *available at* https://www2.deloitte.com/us/en/pages/financial-services/articles/us-current-expected-credit-losses-cecl.html.

[5] Federal Reserve, *Amendments to the Regulatory Capital, Capital Plan and Stress Test Rules*, 83 Fed. Reg. 18160 (Apr. 25, 2018); *see also* The Clearing House et al., *Letter re: Proposed Amendments to the Regulatory Capital, Capital Plan and Stress Testing Rules* (June 25, 2018) (the "Stress Buffer Comment Letter"), at 5-6, *available at* http://bpi.com/wp-content/uploads/2018/07/f751f6eaf79445b3ae744b6e02816d3d.pdf.

- Unless the Agencies implement a capital neutral approach, CECL will represent a new and additional capital buffer requirement that will affect how banks do businesses and have ramifications for the broader economy.

- Empirical analysis reflecting the inability of macroeconomic models and forecasters to accurately predict turning points in the business cycle shows that CECL will be more procyclical than the incurred-loss methodology and that credit loss allowances under CECL will be highly volatile and sensitive to small movements in economic variables.

- Adjustments to Tier 2 capital are insufficient to address the anticipated effects of CECL on bank capital.

- A permanent, capital neutral approach is more appropriate to address the anticipated effects of CECL than a transitional arrangement.

➢ The Federal Reserve should consider the collective effects of CECL, CCAR and the proposed stress buffer requirements when developing the framework for the implementation of CECL in CCAR. Delaying the initial incorporation of CECL into CCAR until the 2021 stress testing cycle would be consistent with the Federal Reserve's historical approach for reflecting changes in accounting standards in CCAR and provide additional time for the Federal Reserve to consider those effects and incorporate CECL into CCAR and supervisory DFAST in a realistic, simple, consistent and transparent manner.

➢ We support the Agencies' efforts to address the effects of the implementation of CECL on bank capital. A five-year transition period that phases in the ongoing – as opposed to "day one" – effects of the adoption of CECL would improve the Agencies' proposed transitional arrangement and should be reflected in any final rule if the Agencies do not implement a capital neutral approach.

➢ The Agencies should conduct a quantitative impact study in order to assess the impact of CECL on bank capital in varying historical economic conditions and over time. If the Agencies do not at this time implement our recommendation (in Section II) that CECL be capital neutral both upon initial adoption and on an ongoing basis, the effects of CECL on bank capital should be fully offset so that CECL is capital neutral pending completion of the quantitative impact study.

II. The Agencies should revise their regulatory capital framework so that the implementation of CECL will be capital neutral as to all capital requirements (including stress capital requirements) both upon initial adoption and on an ongoing basis. A capital neutral approach would appropriately reflect the ways in which CECL will fundamentally change the relationship between regulatory capital and credit loss allowances.

Under the incurred-loss methodology (current U.S. GAAP), banks recognize credit losses only when the losses have been incurred or it is probable that they have been incurred, and the amounts of the losses can be reasonably estimated.[6] In applying the incurred-loss methodology, banks "generally only consider[] past events and

[6] ASC 310-10-35-4.a ("[T]he concept in GAAP is that impairment of receivables shall be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements."); ASC 450-20-25-2 ("An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met: a. Information available before the financial statements are issued or are available to be issued . . . indicates that it is probable that an asset had been impaired or a liability had

current conditions in measuring the incurred loss."[7] U.S. GAAP provides that a loss is "probable" if it is "likely to occur,"[8] and the incurred-loss methodology restricts banks from recording credit losses that may be expected but that do not satisfy the "probable" threshold for loss recognition.[9] In practice, credit loss allowances under the incurred-loss methodology typically reflect losses that are expected to be realized in the near future,[10] based on evidence or a triggering event indicating that it is "probable that one or more future events will occur confirming the fact of the loss."[11] Experiences during the financial crisis, however, led some accounting standard-setters, regulators, and other stakeholders to conclude that the incurred-loss methodology posed problems and should be replaced by forward-looking methodologies because the incurred-loss methodology delayed the recognition of credit losses until they were reasonably estimable and the "probable" threshold had been satisfied,[12] "result[ing] in loan loss allowances that were 'too little, too late.'"[13]

CECL was intended to address concerns with the incurred-loss methodology by removing the "probable" threshold for loss recognition and expanding the information banks use to measure credit losses so that credit losses will be recognized earlier.[14] Under CECL, banks will be required to recognize the full amount of expected credit

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been incurred at the date of the financial statements. . . . It is implicit in this condition that it must be probable that one or more future events will occur confirming the fact of the loss. b. The amount of the loss can be reasonably estimated.").

7 ASU 2016-13, at 3.

8 *See* ASC 310-10-35-18.a ("The term *probable* is used consistent with its use in Subtopic 450-20, which defines probable as an area within a range of the likelihood that a future event or events will occur confirming the fact of the loss. The range is from probable to remote, as follows: a. Probable. The future event or events are likely to occur.") (emphasis supplied); ASC 310-10-35-19 ("Probable is a higher level of likelihood than more likely than not."); *see also* ASC 450-20-25-2 and -3 (applicable to unimpaired loans).

9 ASC 310-10-35-4.b ("Losses shall not be recognized before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future."); ASC 450-20-2 ("[I]t must be probable that one or more future events will occur confirming the fact of the loss . . . [E]ven losses that are reasonably estimable shall not be accrued if it is not probable that an asset has been impaired or a liability has been incurred at the date of an entity's financial statements because those losses relate to a future period rather than the current or a prior period."); *see also* Federal Reserve, FDIC, NCUA and OCC, *Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses* (Dec. 19, 2016 and Sept. 6, 2017) (the "Interagency CECL FAQs"), at 2, *available at* https://www.federalreserve.gov/supervisionreg/srletters/sr1708a1.pdf.

10 *See*, *e.g.*, Federal Reserve, *Dodd-Frank Act Stress Test 2018: Supervisory Stress Test Methodology and Results* (June 2018) ("2018 DFAST Results"), at 69 ("The appropriate level of ALLL [the credit loss allowance] at the end of a given quarter is generally assumed to be the amount needed to cover projected loan losses over the next four quarters."), *available at* https://www.federalreserve.gov/publications/files/2018-dfast-methodology-results-20180621.pdf.

11 ASC 450-20-25-2.a.

12 *See*, *e.g.*, ASU 2016-13, at 1; Interagency CECL FAQs, at 2.

13 *See*, *e.g.*, Interagency CECL FAQSs, at 2.

14 *See* ASU 2016-13, at 3 ("The amendments in this Update are an improvement because they eliminate the probable initial recognition threshold in current GAAP and, instead, reflect an entity's current estimate of all expected credit losses. . . . The amendments in this Update broaden the information that an entity must consider in developing its expected credit loss estimate . . .") and 242 (noting that FASB expects CECL to "[r]esult in an earlier recognition of credit losses."); 83 Fed. Reg. 22313-14 ("Taken together, estimated expected credit losses over the life of an asset

losses for the remaining lives of many financial assets, including loans, loan commitments and certain financial assets that are not currently subject to credit loss allowances under the incurred-loss methodology (e.g., held-to-maturity debt securities). These lifetime expected credit losses must be recognized when the financial assets are first acquired (for example, when a residential mortgage loan is originated) and updated each quarter.[15] Determinations under CECL will be based on historical experience, current conditions and, in contrast to the incurred-loss methodology, reasonable and supportable forecasts.[16]

Credit loss allowances under CECL will have greater loss-absorbing characteristics – and are also expected to be generally higher and more volatile – than under the incurred-loss methodology because CECL:

- requires banks to maintain credit loss allowances to cover future credit losses that do not satisfy the recognition criteria under the incurred-loss methodology, including those that are not currently recognized because they do not meet the "probable" threshold;
- requires banks to recognize the full amount of expected credit losses for the remaining lives of many financial assets, taking into account reasonable and supportable forecasts and without regard to evidence of incurred loss; and
- applies to additional types of financial assets, including held-to-maturity debt securities, as well as financial guarantees, reverse repos and securities borrowing agreements accounted for at amortized cost.

In the sections below, we discuss the implications of the greater loss-absorbing characteristics of credit loss allowances under CECL, as well as the implications of higher and more volatile credit loss allowances. In light of those implications, as well as the fact that the current bank capital framework was designed and calibrated based on experience with the incurred-loss methodology, prior to FASB's 2016 release of CECL, we urge the Agencies to adopt a capital neutral approach for the implementation of CECL before January 1, 2020 and to conduct a quantitative impact study, as discussed in Section V. We welcome the opportunity to work with the Agencies to develop a capital neutral approach to the implementation of CECL.

As an initial approach, the Agencies could revise their capital rules to include additional CECL-based allowances – a measure of credit loss allowances that would be recognized under CECL but not the incurred-loss methodology – in CET1 capital. This approach would entail the development by the Agencies of a mechanism for banks to calculate a proxy for credit loss allowances under the incurred-loss methodology.[17] Following the adoption of CECL, any credit loss allowances greater than the proxy would be included in CET1 capital. The development of

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under CECL, including consideration of reasonable and supportable forecasts but without applying the probable threshold that exists under the incurred loss methodology, results in earlier recognition of credit losses."); *see also* Interagency CECL FAQSs, at 2.

15 *See* ASC 326-20-30 (Initial Measurement) and 326-20-35 (Subsequent Measurement); *see also* Interagency CECL FAQs, at 3.

16 *See, e.g.*, ASU 2016-13, at 2. For periods beyond those reflected in a bank's forecasts, the bank may revert to historical loss information to determine its expected credit losses. *Id*., at 3.

17 There are various potential proxies that the Agencies could consider implementing. Potential options include, but are not limited to, providing a common horizon to estimate credit losses (e.g., one year) and treating credit loss allowances in excess of that estimate as the additional CECL allowances, or using historical relationships between credit loss provisions and charge-offs to estimate additional CECL allowances.

the proxy is intended to obviate the need for banks to determine credit loss allowances under both the incurred-loss methodology and CECL following a bank's adoption of CECL, as it would be unduly burdensome for banks to calculate credit loss allowances under both methodologies following adoption of CECL. The proxy for credit loss allowances under the incurred-loss methodology would allow for the efficient implementation – before January 1, 2020 – of a capital neutral approach, by limiting the adjustment to the capital framework to the inclusion of a measure of additional CECL-based allowances in CET1 capital.

Due to the significant implications of CECL on the relationship between regulatory capital and credit loss allowances, as well as the absence of any empirical analysis of the effects of CECL when the Basel III-based bank capital framework was proposed and finalized in 2012 and 2013, a comprehensive recalibration of the bank capital framework so that the implementation of CECL is capital neutral with respect to all capital requirements (including stress capital requirements) is warranted. Such a recalibration could entail, among other things, revising minimum capital and buffer requirements, introducing or revising adjustments to CET1 capital, adjusting risk weights and exposure measurements and, more generally, changing the regulatory capital treatment of credit loss allowances. We recognize that such a recalibration would be a significant undertaking that would likely not be feasible to complete before January 2020. We therefore recommend that the Agencies adopt the proxy-based approach at this time and, after finalizing the proxy-based approach, pursue a comprehensive recalibration of the bank capital framework.

A. Additional credit loss allowances under CECL will have greater loss-absorbing characteristics such that a capital neutral approach is appropriate.

For many financial assets, credit loss allowances under CECL will have greater loss-absorbing characteristics than the allowances established under the incurred-loss methodology. Under the incurred-loss methodology, credit loss allowances are available to absorb losses that have already been or are probable to have been incurred. In contrast to incurred-loss allowances, CECL-based allowances will be available to absorb losses that have not yet occurred and that do not satisfy the "probable" threshold for recognition under current U.S. GAAP if and when those credit losses materialize. Therefore, credit loss allowances under CECL are available to absorb more losses than under the incurred-loss methodology. Indeed, CECL-based allowances may cover credit losses that are expected to occur well beyond the horizons that factor into regulatory capital requirements, such as the one-year horizon used to determine credit risk capital requirements under the advanced approaches.[18] In this regard, additional credit loss allowances under CECL – those allowances that would not be recognized under the incurred-loss methodology – will have similar going-concern loss-absorbing characteristics to CET1 capital with respect to financial assets subject to CECL: CECL-based allowances will be fully available to absorb credit losses that have not yet occurred and that do not satisfy the "probable" threshold in the incurred-loss methodology on a going-concern basis if and when such losses are realized. The Agencies should be guided by these fundamental differences between credit loss allowances under the incurred-loss methodology and CECL when considering and addressing the implications of CECL on CET1 capital. These differences justify the Agencies' taking a capital neutral approach to the incorporation of CECL into the regulatory capital framework.

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[18] *See* OCC, Federal Reserve, FDIC and OTS, *Risk-Based Capital Standards: Advanced Capital Adequacy Framework—Basel II*, 72. Fed. Reg. 69288, 69292 (Dec. 7, 2007) ("[T]he IRB approach for assessing credit risk capital requirements is based on a 99.9 percent nominal confidence level, *a one-year horizon,* and a supervisory model of credit losses embodying particular assumptions about the underlying drivers of portfolio credit risk, including loss correlations among different asset types.") (emphasis added).

B. Unless the Agencies implement a capital neutral approach, CECL will represent a new and additional capital buffer requirement that will affect how banks do businesses and have ramifications for the broader economy.

CECL will effectively increase capital buffer requirements in two ways. First, CECL is expected to result in generally higher credit loss allowances, which, correspondingly, will reduce retained earnings and CET1 capital. Indeed, due to recent tax law changes and the treatment of deferred tax assets under the Agencies' regulatory capital rules,[19] the impact of CECL on bank capital could be considerably more severe than the after-tax effects on retained earnings. Second, CECL is also expected to result in more volatile credit loss allowances and, therefore, changes in retained earnings and CET1 capital. CECL will accordingly result in banks' holding additional capital to offset the impact of generally higher credit loss allowances and to manage the greater volatility in credit loss allowances. Indeed, banks will face capital management challenges as a result of CECL that are analogous to those CCAR banks face as a result of the year-to-year variability of the Federal Reserve's supervisory scenarios and lack of transparency regarding its supervisory models.[20]

Many also expect CECL to have a number of negative effects on banks and the broader economy, including:

- exacerbating the volatility in capital requirements that are anticipated in light of the Federal Reserve's stress capital buffer proposal and the current design and application of the Federal Reserve's stress testing framework;[21]
- reductions in banks' ability to lend, in particular during economic downturns, as discussed in Section II.C and Annex A;
- changes in the pricing, terms and even availability of many products, in particular longer-dated products, such as residential mortgage loans and student loans,[22] and loans to non-prime customers and small businesses;[23] and

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19 *See* Federal Reserve, FDIC and OCC, *Interagency Statement on Accounting and Reporting Implications of the New Tax Law* (Jan. 18, 2018), at 3-4, *available at* https://www.federalreserve.gov/supervisionreg/srletters/sr1802a1.pdf.

20 *See* Francisco Covas, Bill Nelson and Robert Lindgren, The Clearing House, *An Assessment of DFAST 2018 results through the lenses of the SCB and eSLR proposals* (June 22, 2018) (noting that banks' stress capital buffers under the stress capital buffer proposal would have increased from an average of 3.0 percent based on the 2017 DFAST results to an average of 3.9 percent based on 2018 DFAST results. For GSIBs, the stress capital buffers would have increased from an average of 3.2 percent to an average of 4.3 percent (these percentages exclude the addition of each GSIB's surcharge)), *available at* http://bpi.com/an-assessment-of-dfast-2018-results-through-the-lenses-of-the-scb-and-eslr-proposals/; *see also* Stress Buffer Comment Letter, at 5.

21 *See* Stress Buffer Comment Letter, at 5-6.

22 *See*, *e.g.*, Deniz Tudor and Timothy Daigle, Moody's Analytics, *White Paper: How Much Will CECL Impact Reserves for First Mortgages* (December 2017), at 1, 2 and 10 (presenting an analysis showing that credit loss allowances for first mortgage portfolios may increase by as much as 100% under a consensus economic scenario as a result of CECL, noting that the impact of CECL on credit loss allowances depends on, among other factors, portfolio quality, loan tenor, age and expected remaining life of loans in a portfolio).

23 *See*, *e.g.*, Francisco Covas and William Nelson, Bank Policy Institute, *Staff Working Paper 2018-1 – Current Expected Credit Loss: Lessons from 2007-2009* (July 2018) ("BPI CECL Working Paper"), at 6 8 (noting that CECL would

- incentives for banks to make loans with shorter maturities,[24] which would result in lower durability of funding and increased credit spread and refinancing risk for banks' clients – this would also have the perverse effect of increasing liquidity risk in the real economy.

In addition, the quality and amount of bank capital has increased significantly since the financial crisis and the banking sector is generally considered to be appropriately capitalized by the Agencies.[25] Accordingly, the recognition of CECL-based credit loss allowances in regulatory capital is not necessary to achieve an appropriate capitalization of the banking sector. Indeed, as described in the June 2017 report of the U.S. Department of the Treasury, continual increases in capital requirements are "not a costless means of making the banking system safer"[26] and they can decrease the availability of credit and have other adverse economic effects.[27] In light of the

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incentivize banks to reduce lending to riskier, generally bank-dependent borrowers, and that, in the Bank Policy Institute's analysis, CECL-based allowances increase to a greater degree in adverse economic conditions than under the incurred-loss methodology, with the increase especially acute for loans with longer maturities (e.g., residential mortgage loans) and for riskier loans, including loans to small businesses), *available at* http://bpi.com/wp-content/uploads/2018/07/CECL-Lessons-2007-2009-WP-July-12-2018.pdf.

24 *See*, *e.g.*, Deniz Tudor, Moody's Analytics, *Challenges and Costs of CECL* (March 2018) at 4 ("There could also be economy-wide costs and consequences of CECL, as increased reserves will mean less credit supply. If institutions shift from longer-term loans to shorter-term loans to optimize profitability, for instance from first mortgage loans to C&I loans, this could hurt markets such as housing from which the credit supply is shifted and can create micro bubbles in others such as C&I to which the focus shifts.").

25 Indeed, Agency principals have recently noted the robust capitalization of the banking sector. *See* Comptroller of the Currency Joseph M. Otting, *Testimony before the Committee on Financial Services of the U.S. House of Representatives* (June 13, 2018), at 8 ("Capital and liquidity are near historic highs. Bankers understand the risks facing their banks better than at any point in my 35-year banking career."), *available at* https://www.occ.treas.gov/news-issuances/congressional-testimony/2018/pub-test-2018-60-written.pdf; Vice Chairman for Supervision Randal K. Quarles, *Statement before the Committee on Financial Services of the U.S. House of Representatives* (Apr. 17, 2018), at 2 ("The largest U.S. banking organizations – those the failure of which would pose the greatest risk to the financial system and that are subject to the Federal Reserve's stress testing framework – have increased the dollar amount of their loss-absorbing common equity capital by more than $700 billion since 2009, more than doubling their common equity capital ratios from approximately 5 percent to more than 12 percent."), *available at* https://www.federalreserve.gov/newsevents/testimony/files/quarles20180417a.pdf; Vice Chairman for Supervision Randal K. Quarles, *Early Observations on Improving the Effectiveness of Post-Crisis Regulation* (Jan. 19, 2018), at 1 ("Core aspects of [the post-financial crisis regulatory reform] project have resulted in critical gains to our financial system: higher and better quality capital, an innovative stress testing regime, new liquidity regulation, and improvements in the resolvability of large firms."), *available at* https://www.federalreserve.gov/newsevents/speech/files/quarles20180119a.pdf; Governor Lael Brainard, An Update on the Federal Reserve's Financial Stability Agenda (Apr. 3, 2018), at 6 ("The core of the framework is the requirement of a substantial stack of common equity to build resilience against shocks and to provide an incentive for prudent risk management. Regulatory capital ratios for the largest banking firms at the core of the system have about doubled since 2007 and are currently at their highest levels in the post-crisis era."), *available at* https://www.federalreserve.gov/newsevents/speech/files/brainard20180403a.pdf.

26 *See* U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities, Banks and Credit Unions*, Report to President Donald J. Trump, Executive Order 13772 on Core Principles for Regulating the United States Financial System (June 2017), at 49, *available at* https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

27 *See id.*, at 37 ("an excess of capital and liquidity in the banking system will detract from the flow of consumer and commercial credit and can inhibit economic growth").

current condition of the banking sector and the macroeconomic implications of higher capital requirements, raising bank capital requirements through the implementation of CECL is not appropriate – but adopting a capital neutral approach is.

C. Empirical analysis reflecting the inability of macroeconomic models and forecasters to accurately predict turning points in the business cycle shows that CECL will be more procyclical than the incurred-loss methodology and that credit loss allowances under CECL will be highly volatile and sensitive to small movements in economic variables.

In addition to addressing the issue of "too little, too late," certain stakeholders supported changes to accounting standards to address procyclicality under the incurred-loss methodology:[28] banks recognize higher credit losses as economic conditions deteriorate and lower credit losses as economic conditions improve. Procyclicality was observed during the financial crisis and remains evident in capital stress testing today. For example, in the Federal Reserve's supervisory stress tests, "the projected ALLL [credit loss allowance] increases during the early quarters of the planning horizon, given the increased economic stress in the severely adverse scenario, and then declines as the economic stress abates."[29]

Application of CECL is, however, expected to increase – rather than reduce – procyclicality during economic downturns because of the inability of macroeconomic models and forecasters to accurately predict turning points in a business cycle. If banks had perfect foresight into the paths of macroeconomic indicators, determinations under CECL could result in less procyclicality. But under real-world conditions – where there is uncertainty about those paths and an inability to anticipate turning points in business cycles – the determinations would have the opposite effects.

As described in greater detail in Annex A, the Bank Policy Institute has estimated expected credit losses under CECL during the 2007-2009 financial crisis to evaluate whether CECL would add or reduce procyclicality in accounting and capital frameworks.[30] The analysis reflects that macroeconomic models and forecasters are generally unable to accurately predict economic turning points. In contrast to studies that suggested that CECL may be less procyclical than the incurred-loss methodology, which were based on assumptions that banks would accurately predict future changes in macroeconomic conditions,[31] the Bank Policy Institute's analysis replaces those assumptions with more realistic assumptions, which are based on projections of the macroeconomic variables

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28 *See* ASU 2016-13, at 248 ("Generally, U.S. preparers and auditors supported the development of an impairment model that would address the "too little, too late" concern. The procyclicality of reserving also was an overriding concern of those stakeholders.")

29 2018 DFAST Results, at 26.

30 *See* BPI CECL Working Paper.

31 *See, e.g.*, Benjamin Cohen and Gerald Edwards, BIS Quarterly Review, *The New Era of Expected Credit Loss Provisioning* (March 2017), at 53 ("Both of these, of course, assume an unusually strong capacity for foresight among banks, almost all of which were caught unaware by the size of loan losses during the crisis. . . . If [CECL] is performed appropriately and with the full range of future risks in mind, [it] should reduce the procyclicality of the financial system."), *available at* https://www.bis.org/publ/qtrpdf/r_qt1703f.pdf; Sarah Chae, Robert Sarama, Cindy Vojtech and James Wang, Federal Reserve, *The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves* (Mar. 6, 2018), at 8 ("One forecast that we investigate is a perfect foresight model where we use the actual path of home prices to show that CECL, with perfect foresight, leads to more forward-looking and less pro-cyclical provisioning than the incurred loss standard."), *available at* https://www.federalreserve.gov/econres/feds/files/2018020pap.pdf.

needed to forecast CECL-based allowances in real-time during the 2007-2009 financial crisis. The analysis shows that CECL would have been highly procyclical had it been in place during the 2007-2009 financial crisis, with the greatest impact on bank capital and, therefore, banks' ability to supply credit to the economy when continued credit availability would have been most important – during the trough of the great recession. Credit loss allowances under CECL would also have been highly volatile and sensitive to small movements in macroeconomic variables during the financial crisis. It is critical that the Agencies' approach to the implementation of CECL reflect and mitigate the potential severe macroeconomic implications of CECL during a recession, which only a permanent capital neutral approach could do.

Beyond macroeconomic implications, CECL's procyclicality will frustrate longstanding policy goals and the statutory mandate that the Agencies implement countercyclical capital requirements. The Dodd-Frank Act requires that the Agencies make their capital requirements countercyclical so that the amount of capital that banks are required to maintain increases in times of economic expansion and decreases in times of economic contraction.[32] Consistent with this statutory mandate, numerous aspects of the post-crisis regulatory framework were designed to promote countercyclicality.[33] Unless the Agencies revise their capital rules to address the impact of CECL on a permanent – and not merely transitional – basis, CECL will have the exact opposite effects on bank capital requirements as those mandated by the Dodd-Frank Act and contemplated by the policy goal of greater countercyclicality: CECL will reduce banks' regulatory capital in times of economic contraction and have the opposite effect during an economic expansion, which is likely to exacerbate the decrease in bank lending during a recession.

D. Adjustments to Tier 2 capital are insufficient to address the anticipated effects of CECL on bank capital.

Under the Agencies' regulatory capital rules, credit loss allowances are included in a bank's Tier 2 capital up to 1.25 percent of its standardized credit risk-weighted assets ("RWAs") for purposes of standardized approach capital calculations.[34] The proposal would not adjust the limit on the credit loss allowances that may be included in Tier 2 capital. Rather, the proposal provides that the Agencies "intend to monitor the effects of this limit on regulatory capital and bank lending practices" and that "ongoing monitoring . . . will assist the [A]gencies in determining whether further change to the capital rules' treatment of [credit loss allowances] might be warranted."[35] Although we support the Agencies' ongoing evaluation of the effects of their capital rules on banks and the broader economy, we do not believe the Agencies should wait for CECL to be implemented to address the anticipated effects of CECL. The stakes are too great for banks and the broader economy.

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32 *See* Sections 616(a), (b), and (c) of the Dodd-Frank Act, codified at 12 U.S.C. §§ 1844(b), 1464a(g)(1), and 3907(a)(1).

33 For example, in December 2017, the Federal Reserve proposed to amend its Policy Statement on the Scenario Design Framework in a manner that was intended to enhance its countercyclicality. *See* Federal Reserve, *Policy Statement on the Scenario Design Framework for Stress Testing*, 82 Fed. Reg. 59533 (Dec. 15, 2017). *See also* The Clearing House, *Comment Letter re: Stress Testing Transparency Proposals* (Jan. 22, 2018), *available at* http://bpi.com/wp-content/uploads/2018/07/20180122_tch_comment_letter_re_stress_testing_transparency.pdf.

34 In addition, for a bank that calculates credit RWAs under the advanced approaches, to the extent the bank has excess eligible credit reserves, credit loss allowances up to 0.6 percent of its credit RWAs may be included in Tier 2 capital for purposes of advanced approaches capital calculations. *See* Sections 10(c)(3) and 20(d)(3) of the Agencies' capital rules, 12 C.F.R. Parts 3 (OCC), 217 (Federal Reserve) and 324 (FDIC); *see also* 83 Fed. Reg. at 22315.

35 83 Fed. Reg. at 22316.

In any case, adjusting the amount of credit loss allowances that may be included in Tier 2 capital is insufficient. CECL will affect banks' retained earnings and, therefore, CET1 capital. Changes in CET1 capital affect all capital ratios because CET1 capital is a component of every capital metric, including Tier 1 and Total capital. Further, since the introduction of the CET1 capital metric, regulators, investors, creditors and other stakeholders have increasingly focused on CET1 capital. Increasing the amount of credit loss allowances eligible for inclusion in Tier 2 capital would not appropriately reflect the greater loss-absorbing characteristics of additional CECL-based allowances. In addition, it would also not address the anticipated effects of CECL on banks and the broader economy described in Section II.C above because those effects would persist so long as CECL has an impact on CET1 capital.

E. A permanent, capital neutral approach is more appropriate to address the anticipated effects of CECL than a transitional arrangement.

Although we support the Agencies' efforts to address the impact of CECL on bank capital, a transitional adjustment is insufficient to reflect the loss-absorbing characteristics of CECL-based allowances and to address the anticipated effects of CECL on bank capital and the broader economy. A transitional arrangement is, by its nature, temporary and would only phase in the initial regulatory capital impact of CECL as currently proposed. CECL's anticipated effects on the relationship between credit loss allowances and regulatory capital, as well as on banks and the broader economy, can be addressed only through permanent changes to the Agencies' capital rules that reflect the greater loss-absorbing characteristics of CECL-based allowances and offset the higher magnitude, volatility and procyclicality in credit loss allowances under CECL.

III. The Federal Reserve should consider the collective effects of CECL, CCAR and the proposed stress buffer requirements when developing the framework for the implementation of CECL in CCAR. Delaying the initial incorporation of CECL into CCAR until the 2021 stress testing cycle would be consistent with the Federal Reserve's historical approach for reflecting changes in accounting standards in CCAR and provide additional time for the Federal Reserve to consider those effects and incorporate CECL into CCAR and supervisory DFAST in a realistic, simple, consistent and transparent manner.

Capital stress testing has become an integral part of the bank capital framework, and the Federal Reserve recently proposed to integrate its capital planning, stress testing and capital rules by proposing stress buffer requirements. As noted in our comment letter on the stress capital buffer proposal, there is the potential for significant – indeed excessive – volatility in stress buffer requirements resulting from volatility in the Federal Reserve's macroeconomic stress test scenarios.[36] The incorporation of CECL into CCAR heightens the urgency of addressing volatility in CCAR stress test results and, as contemplated by the stress capital buffer proposal, stress buffer requirements. It is therefore critically important that the Federal Reserve consider the collective impact of the implementation of CECL, the incorporation of CECL into CCAR, the stress capital buffer proposal and the overall transparency of the Federal Reserve's capital planning and stress testing framework when determining both the regulatory capital treatment of CECL and the approach for incorporating CECL into CCAR.

In particular, the Federal Reserve should consider the implications of CECL's requirements that banks recognize the full amount of expected credit losses for the remaining lives of many financial assets based on forecasts in a stress test where the paths of macroeconomic indicators are prescribed and reflect significant stress over a multi-year period. If banks were required to exercise "perfect foresight" of the planning horizon at the beginning of the stress test – and immediately recognize lifetime credit losses based on the prescribed stress

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[36] Stress Buffer Comment Letter, at 5-6.

scenario paths – banks would face severe losses and capital depletion upfront. This immediate recognition of credit losses under CECL would accelerate and deepen start-to-trough losses in CCAR and, under the Federal Reserve's stress capital buffer proposal, would result in higher and more volatile stress buffer requirements.

In this way, "perfect foresight" would operate as a new and additional shock applicable to all banks subject to CCAR. While this is conceptually attractive to some, perfect foresight would not, however, accurately reflect how credit losses would be recognized in an actual stress scenario. Credit losses would be recognized over time – and not immediately – as banks update their forecasts in deteriorating economic conditions. As noted in Section II.C and Annex A, macroeconomic models and forecasters would not have perfect foresight in an actual stress scenario because of their inability to accurately predict turning points in business cycles. This is a foundational aspect of how CECL would work in an actual stress scenario that cannot be overemphasized in order to properly assess the impact of CECL. We therefore urge the Federal Reserve to incorporate CECL into CCAR through a realistic methodology.[37]

We recognize that the incorporation of CECL into capital stress testing presents complex issues and we therefore recommend that the Federal Reserve and other Agencies revise the proposal so that CECL would not initially be reflected in capital stress tests – whether for purposes of CCAR or DFAST – until the 2021 stress testing cycle. This change would be consistent with the Federal Reserve's historical approach to reflecting changes in accounting standards in CCAR and DFAST: new accounting standards are reflected in stress testing projections only if they are reflected in a bank's financial statements as of and for the period ending immediately before the start of the planning horizon, for example December 31, 2017 for the 2018 stress testing cycle.[38] Banks that are SEC reporting companies will first be required to reflect CECL in their financial statements for fiscal years beginning after December 15, 2019.[39] Accordingly, when those banks make their CCAR and DFAST submissions for the 2020 stress testing cycle, they will not have reflected CECL in their financial statements as of and for the period ending December 31, 2019.[40] Our recommendation would promote the consistency of CCAR stress test projections, as the

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37 A capital neutral approach involving the full inclusion of additional CECL allowances in CET1 capital generally would also address our concerns regarding perfect foresight: the shock of accelerated recognition of credit losses to regulatory capital would be mitigated by the inclusion of CECL allowances in CET1 capital. In light of recent tax law changes and the treatment of deferred tax assets under the regulatory capital rules (*see* footnote 19), however, a capital neutral approach may not fully address the impact of perfect foresight, depending on how tax effects are treated in that approach and in CCAR.

38 *See, e.g.*, Federal Reserve, *Comprehensive Capital Analysis and Review 2018 Summary Instructions* (Feb. 2018), at 3 ("As was the case last year, for CCAR 2018 a firm should not reflect the adoption of new accounting standards in its projections unless the firm has already adopted the accounting standard for financial reporting purposes. If a firm was required to adopt or had voluntarily adopted a standard or a particular provision of a standard as of December 31, 2017, that adoption should be reflected in the FR Y-14A report with December 31, 2017, as-of dates, and in the subsequent projected quarters."), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180201a2.pdf.

39 For SEC reporting companies, CECL is effective for fiscal years beginning after December 15, 2019, including interim periods within those years. Accordingly, for SEC reporting companies with December 31 fiscal year-ends, CECL will become effective beginning with the first quarter of 2020. For other companies, CECL will first become effective for the fiscal year beginning after December 15, 2020, with differences in when it becomes effective for interim reporting periods depending on whether the company is a public business entity. For public business entities that are not SEC reporting companies, CECL is effective for fiscal years beginning after December 15, 2020, including interim periods within those years. For non-public business entities, CECL is effective for fiscal years beginning after December 15, 2020 and for interim periods within fiscal years beginning after December 15, 2021.

40 Banks that are not SEC reporting companies will first be required to reflect CECL in their financial statements for fiscal years beginning after December 15, 2020. When those banks make their CCAR and DFAST submissions for the 2020

accounting standards used for the start of the stress test – the balance sheet as of December 31 of the year immediately preceding the stress testing cycle – would be the same as those reflected throughout the planning horizon. Changes in accounting standards would not affect banks' capital or capital ratios over the planning horizon because every quarter would be presented on a comparable basis to the starting point. This approach would also appropriately mitigate undue volatility in any stress buffer requirements resulting from "day one" adverse effects due to CECL adoption.

In addition, reflecting CECL in CCAR beginning with the 2021 stress testing cycle for banks that are SEC reporting companies would provide additional time for the Federal Reserve to develop an appropriate approach for the incorporation of CECL into CCAR and the treatment of CECL in supervisory stress tests. We believe that approach should reflect the following four principles, and we welcome the opportunity to work with the Federal Reserve on the incorporation of CECL into CCAR.

- Realism: The approach should be realistic, reflecting how banks would actually respond to a stress scenario, and promote the credibility of the stress tests.

- Simplicity: The approach should avoid unnecessarily complications in CECL forecasting while supporting the other principles, as an overly complex approach would present undue operational challenges and could potentially reduce the comparability and transparency of the results.

- Consistency: Although CECL allows for banks to implement a wide range of methodologies to develop their forecasts, methodologies in supervisory stress testing should be consistent and promote comparability.

- Transparency: The approach should be transparent to all stakeholders, including banks, market participants, academic experts and other members of the public.

IV. We support the Agencies' efforts to address the effects of the implementation of CECL on bank capital. A five-year transition period that phases in the ongoing – as opposed to "day one" – effects of the adoption of CECL would improve the Agencies' proposed transitional arrangement and should be reflected in any final rule if the Agencies do not implement a capital neutral approach.

Upon adopting CECL, a bank will record a one-time adjustment to its retained earnings as of the adoption date equal to the difference between its credit loss allowances under the incurred-loss methodology and those under CECL, net of tax effects. Retained earnings typically form a major component of banks' CET1 capital. Accordingly, the adoption of CECL is expected to have negative effects on banks' regulatory capital and capital ratios. The Agencies' proposal would allow banks to elect to phase-in the "day one" impact of adopting CECL on regulatory capital over a three-year transition period.

As discussed in Section II, we urge the Agencies to adopt a capital neutral approach for the implementation of CECL. But if the Agencies determine not to implement a capital neutral approach at this time, we recommend the Agencies make two changes to the proposed transitional arrangement in order to better achieve the Agencies' objective of addressing the capital planning challenges banks face in connection with CECL.[41]

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and 2021 stress testing cycles, they will not have reflected CECL in their financial statements as of and for the periods ending December 31, 2019 and 2020. Accordingly, for banks that are not SEC reporting companies, CECL should be reflected in CCAR beginning with the 2022 stress testing cycle.

41 *See* 83 Fed. Reg. at 22315-16.

First, the transition period should be lengthened to a minimum of five years. A longer transition period is appropriate because, though generally expected to result in higher credit loss allowances and lower capital, the extent of the impact of CECL on bank capital in the aggregate and for individual banks cannot be precisely estimated at this time. As the Agencies recognize, the impact of CECL may be material[42] and will depend on, among other things, current and projected future economic conditions, which will not be known or estimable until adoption.[43] In addition, although FASB released CECL in 2016, there have been and remain unresolved interpretive issues that could significantly affect the impact of CECL, which has limited banks' ability to estimate and prepare for the impact of adopting CECL. These unresolved interpretive issues have related to a variety of matters, including, for example, ways in which banks will estimate the life of loan for products such as credit cards and the methodologies used to generate the required full life economic forecasting. Further, a longer transition period would not weaken banks' capital. Indeed, as discussed in Section II.B above, the current capitalization of the banking sector provides strong support for a capital neutral approach.

Second, the transitional arrangement should phase in the ongoing – as opposed to only the "day one" – impact of CECL. For the reasons discussed in Section II.C above, if economic conditions were to deteriorate during the transition period, a transitional adjustment that appears appropriate on "day one" may quickly become wholly inadequate in an economic downturn that follows. The Agencies could phase in the ongoing impact of CECL by using the proxy-based approach described in Section II to determine the transitional adjustments.

V. The Agencies should conduct a quantitative impact study in order to assess the impact of CECL on bank capital in varying historical economic conditions and over time. If the Agencies do not at this time implement our recommendation (in Section II) that CECL be capital neutral both upon initial adoption and on an ongoing basis, the effects of CECL on bank capital should be fully offset so that CECL is capital neutral pending completion of the quantitative impact study.

Any rulemaking – and particularly one addressing an issue as important as the regulatory capital implications of CECL – should be based on empirical analyses. We therefore recommend that the Agencies conduct a quantitative impact study to evaluate the potential effects of CECL on bank capital, as well as on lending and economic activity. The quantitative impact study should commence before January 1, 2020 but only once banks have sufficiently progressed in their preparations for the implementation of CECL and are in position to provide meaningful estimates of the impact of CECL so that the study is robust and high quality. In addition, in light of the anticipated volatility and procyclicality of credit loss allowances under CECL, as well as the sensitivity of CECL allowances to small changes in macroeconomic indicators, the quantitative impact study should evaluate the effects of CECL in varying historical economic conditions and over time, taking into account that, in practice, the macroeconomic models and forecasts used in CECL will not have foresight into future changes in the macroeconomic environment. We expect that such a quantitative impact study will provide further strong support for the capital neutral approach we recommend in Section II. If the Agencies determine not to implement a permanent capital neutral approach at this time, however, the effects of CECL on bank capital should be fully offset so that

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42 *See, e.g.*, Memorandum from Doreen R. Eberley to the Board of Directors of the FDIC, *Regulatory Capital Rule: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rule and Conforming Amendments to Other Regulations* (Apr. 17, 2018), at 5 ("Some institutions have expressed concerns about the difficulty in capital planning due to the uncertainty about the economic environment at their CECL adoption date. It is possible that the initial adjustment to an institution's allowance for credit losses upon adoption of CECL will be material and that the amount of this potential adjustment may not be known until much closer to each institution's CECL adoption date."), *available at* https://www.fdic.gov/news/board/2018/2018-04-17-notice-dis-a-mem.pdf.

43 *See* 83 Fed. Reg., at 22316.

CECL is capital neutral until the Agencies have completed an empirical analysis of the effects of CECL and sought comment on the appropriate approaches to address those effects. Pending completion of the quantitative impact study and any related rulemakings, the Agencies could maintain capital neutrality by implementing the proxy-based approach described in Section II.

VI. Technical Matters.

Technical matters are addressed in Annex B of this letter.

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The Bank Policy Institute appreciates the opportunity to comment on the proposal. If you have any questions, please contact the undersigned by phone at (212) 613-9883 or by email at david.wagner@bpi.com.

Respectfully submitted,

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Annex A: The Bank Policy Institute's Empirical Analysis of CECL

The Bank Policy Institute has estimated expected credit losses under CECL to evaluate whether CECL would add or reduce procyclicality in accounting and capital frameworks.[1] The Bank Policy Institute's analysis uses a macroeconomic model of the economy, the historical relationship between loan losses and economic conditions by loan type, and information obtained from banks on the composition of loan portfolios and the remaining expected life of loan for each loan category. The analysis also reflects that macroeconomic models and forecasters are generally unable to accurately predict economic turning points. Most of the time, the models predict that economic conditions in the future will be similar to the present while gradually reverting to the mean. When times are good, they are generally expected to remain good. When times are bad, they are expected to remain bad, at least for a while. In contrast to studies that suggested that CECL may be less procyclical than the incurred-loss methodology, which were based on assumptions that banks would accurately predict future changes in macroeconomic conditions, the Bank Policy Institute's analysis replaces those assumptions with more realistic assumptions, based on real-time macroeconomic forecasts of the economy during the 2007-2009 financial crisis.[2]

The Bank Policy Institute's analysis shows that CECL would have been highly procyclical had it been in place during the 2007-2009 financial crisis. In particular, CECL-based allowances under the baseline scenario reflected in the analysis would not have increased significantly relative to credit loss allowances under the incurred-loss methodology until the beginning of 2007. Thereafter, over the period between the first quarter of 2007 and the third quarter of 2008, CECL allowances would have risen from 1.5 percent of loans to approximately 4¾ percent of loans. As a result, banks' regulatory capital ratios would have declined by an additional 160 basis points in the third quarter of 2008 relative to the reported regulatory capital ratios reflecting the incurred-loss methodology.

Under CECL, banks' aggregate Tier 1 common ratios would have declined to 5.3 percent as of the third quarter of 2008, and many banks would have had Tier 1 common ratios lower than 5 percent under CECL. Before the Agencies adopted their Basel III-based capital rules and introduced the CET1 capital metric, the Federal Reserve considered a 5 percent Tier 1 common ratio as the level of capital necessary for a bank to remain "a going concern throughout stressful conditions and on a post-stress basis."[3] Had CECL been in place during the 2007-2009 financial crisis, banks would have faced strong incentives to prevent such declines in their capital ratios in order to continue to be viewed as viable and solvent by regulators, investors and creditors. It is also possible that more banks would have failed during the financial crisis as a result of an inability to satisfy minimum capital requirements if CECL had been in effect and, as contemplated by the proposal, the bank capital framework had not been recalibrated to reflect the greater loss-absorbing characteristics of CECL allowances, as well as the generally higher and more volatile credit loss allowances under CECL, described in Sections II.A and II.B of this letter. To avoid large declines in their

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1 Francisco Covas and William Nelson, Bank Policy Institute, *Staff Working Paper 2018-1 – Current Expected Credit Loss: Lessons from 2007-2009* (July 2018), *available at* http://bpi.com/wp-content/uploads/2018/07/CECL-Lessons-2007-2009-WP-July-12-2018.pdf.

2 *See, e.g.*, Benjamin Cohen and Gerald Edwards, BIS Quarterly Review, *The New Era of Expected Credit Loss Provisioning* (March 2017), at 53 ("Both of these, of course, assume an unusually strong capacity for foresight among banks, almost all of which were caught unaware by the size of loan losses during the crisis. . . . If [CECL] is performed appropriately and with the full range of future risks in mind, [it] should reduce the procyclicality of the financial system."), *available at* https://www.bis.org/publ/qtrpdf/r_qt1703f.pdf; Sarah Chae, Robert Sarama, Cindy Vojtech and James Wang, Federal Reserve, *The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves* (Mar. 6, 2018), at 8 ("One forecast that we investigate is a perfect foresight model where we use the actual path of home prices to show that CECL, with perfect foresight, leads to more forward-looking and less pro-cyclical provisioning than the incurred loss standard."), *available at* https://www.federalreserve.gov/econres/feds/files/2018020pap.pdf.

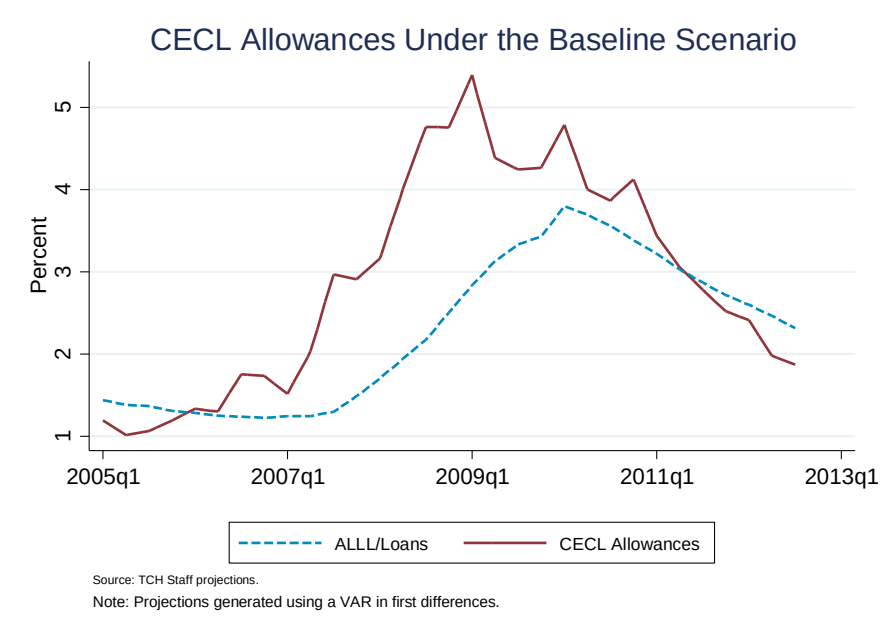
3 Federal Reserve, *Capital Plans*, 76 Fed. Reg. 74631, 74636 (Dec. 1, 2011).

capital ratios during the financial crisis on account of CECL, banks would have likely needed to aggressively reduce lending due to the difficulty and cost of raising extensive amounts of capital in such stressed conditions. Reduced lending would have amplified the decline in economic activity during the recession.

The chart below plots the results for CECL allowances under the baseline macroeconomic scenario in the Bank Policy Institute's analysis, illustrating how CECL will be more procyclical than the incurred-loss methodology. The chart also shows that credit loss allowances under CECL would have been highly volatile and sensitive to small changes in macroeconomic variables.

In the chart below, the level of CECL allowances is scaled by the sum of loans across all 15 loan categories used in the Bank Policy Institute's net charge-off rate projections. For comparison purposes, the chart also depicts credit loss allowances that were actually recognized under the incurred-loss methodology scaled by total loans (allowance for loan and lease losses, or "ALLL"). The chart thus shows two main results:

- When the economy is not in a recession, credit loss allowances under CECL are not that different from those under the incurred-loss methodology; and
- When the macroeconomic forecasts start to pick-up the deterioration in economic conditions, CECL is very procyclical and would have likely exacerbated the impact of the 2007-2009 financial crisis.



As shown in the chart above, between the first quarter of 2005 (the first quarter in which the analysis estimates CECL allowances) and the first quarter of 2007, the ratio of CECL allowances to loans trends slightly upwards. In particular, in the first quarter of 2007 credit loss allowances under CECL were just 50 basis points above allowances under the incurred-loss methodology. The main reason why the path of CECL allowances is not so different from the path of ALLL is that until the end of 2006 almost all forecasts were projecting the house price index to continue to rise over the next 2 to 3 years. In early 2007, however, the house price index forecasts are reversed and between the first quarter of 2007 and the third quarter of 2008, CECL allowances increase rapidly from 1½ percent to 4¾ percent. The rapid change in credit loss allowances under CECL in this period is also supported by revisions to projections for the civilian unemployment rate, especially at the end of 2007 and early 2008.

In contrast, actual credit loss allowances that were recognized under the incurred-loss methodology rise approximately 1 percentage point between the first quarter of 2007 and the third quarter of 2008. This result illustrates CECL's procyclicality. As a bank's capital starts to be eroded by loan losses, CECL forces banks to recognize significantly greater credit losses allowances for losses over the remaining lives of its loans in a relatively short amount of time. The requirement to increase credit loss allowances is akin to an increase in capital requirements in a downturn – higher credit loss allowances reduce CET1 capital. On the other side, however, the chart also shows that when economic conditions recover, credit loss allowances under CECL decline at a much more rapid pace relative to the incurred-loss methodology. As a result, by the third quarter of 2011, credit loss allowances under CECL would be projected to be lower than those under the incurred-loss methodology.

As described above, during the financial crisis the impact of CECL would have been significant and very procyclical, with the greatest impact on bank capital and, therefore, banks' ability to supply credit to the economy when continued credit availability would have been most important – during the trough of the great recession. The Bank Policy Institute's analysis estimates a 1.6 percentage point decline in aggregate Tier 1 common ratios as a result of CECL, which would have functioned similarly to a 1.6 percentage point increase in capital requirements. Based on the literature cited in the Bank Policy Institute's analysis, such a decline in capital ratios (or increase in capital requirements) is estimated to lead to a 9 percentage point decline in lending beyond what occurred during the financial crisis, which, in turn, would have translated into a very sizable decline in real GDP during the crisis period according to the Federal Reserve's own Greenbook forecasts at the time.[4]

[4] Federal Reserve, *Greenbook* (Oct. 22, 2008), at I-13, *available at* https://www.federalreserve.gov/monetarypolicy/files/FOMC20081029gbpt120081022.pdf.

Annex B: Technical Matters

I. The OCC should amend its DFAST rules to address when national banks should reflect CECL in their capital stress testing projections in a manner consistent with the proposed amendments by the Federal Reserve and FDIC.

The Federal Reserve and FDIC proposed amendments to their DFAST rules to require banks not to reflect CECL in their DFAST projections until the later of the 2020 stress test cycle and the cycle that coincides with the year in which CECL is adopted, even if the stress test cycle covers periods during which CECL will be in effect (e.g., for the 2019 stress test cycle, more than half of the stress testing horizon will be after 2019 and, for SEC reporting companies, during periods in which CECL will be effective). The OCC did not, however, propose similar amendments to its DFAST rules. We recommend that the OCC make similar amendments to its DFAST rules to those proposed by the Federal Reserve and FDIC in order to promote clarity and consistency of the stress testing requirements among the Agencies.[1]

II. If the Agencies do not revise the proposal so that CECL is reflected in CCAR and DFAST projections for a bank only if the bank has reflected CECL in its financial statements as of and for the period ending immediately before the start of the planning horizon, the Agencies should clarify when CECL will first be required to be reflected in capital stress testing projections for non-public business entities that do not immediately adopt CECL for interim periods.

Beginning January 1, 2020, the Federal Reserve's and FDIC's proposed amendments to their DFAST rules would require DFAST projections (i) to reflect CECL provisions and allowances in projections for banks that have adopted CECL and (ii) not to reflect CECL provisions and allowances in projections for banks that have not then adopted CECL. Specifically, for banks that have not then adopted CECL, the proposed amendments provide that, with respect to a bank "that has not adopted the current expected credit losses methodology under GAAP," projections would reflect "the provision for loan and lease losses as would be reported on the [FR Y-9C or Call Report, as applicable] in the current stress test cycle."[2] For banks with December 31 fiscal year-ends that are SEC reporting companies or public business entities, each FR Y-9C or Call Report during the stress test cycle would reflect credit loss provisions and allowances under either the incurred-loss methodology or CECL. This is because such a bank would adopt CECL beginning as of the first quarter of the stress test cycle. For such a bank, the intended timing of reflecting CECL in stress testing projections is clear. As noted in Section III of this letter, however, we believe that CECL should not be reflected in stress testing projections unless the bank has reflected CECL in its financial statements as of and for the period ending immediately before the start of the planning horizon.

Non-public business entities are not required to adopt CECL for interim reporting periods in the initial year of adoption. Accordingly, in 2021, when a non-public business entity with a December 31 fiscal year-end adopts CECL, CECL will be reflected only in its FR Y-9C or Call Report (as applicable) for the period ended December 31, 2021. CECL will not be reflected in its regulatory reports for the first three quarterly fiscal periods of 2021, including the periods that coincide when the bank makes its DFAST submission to its regulator, which would be due by April 5,

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1 As discussed in Section III, the Agencies should defer the incorporation of CECL into CCAR and DFAST until the 2021 stress testing cycle for banks that are SEC reporting companies and the 2022 stress testing cycle for banks that are not SEC reporting companies. The OCC should likewise not require banks to reflect CECL in their DFAST stress tests unless the bank has reflected CECL in its financial statements as of and for the period ending immediately before the start of the planning horizon.

2 *See* proposed 12 C.F.R. §§ 252.12(m), 252.42(l), 252.52(m) and 325.2(g).

2021.[3] Similar issues also arise for banks that are non-public business entities and do not have December 31 fiscal year-ends.

In the proposal, Table 2 summarizes when the incurred-loss methodology and CECL would be required to be used in stress test projections based on the year of adoption of CECL.[4] The table notes that CECL will be used in the 2021 stress test cycle for a bank that adopts CECL in 2021. For a non-public business entity (whether or not it has a December 31 fiscal year-end), the summary would appear to contemplate that CECL must be reflected in its stress testing projections for the 2021 stress test cycle, even though the bank would not have adopted CECL or reflected CECL in its regulatory report or financial statements when it makes its DFAST submission.

Accordingly, if the Agencies do not implement our recommendations regarding the timing of initial applicability of CECL in capital stress testing, we recommend that the Agencies revise the proposed amendments to the DFAST rules to clarify that CECL will not and should not be reflected in stress test projections for non-public business entities before such banks report credit loss allowances using CECL in their applicable regulatory reports (FR Y-9C or Call Reports). We also recommend that, in the supplementary information accompanying any final rule, the Agencies clarify in a summary similar to Table 2 when CECL will be reflected in stress test cycles for non-public business entities, which will not be required to report credit loss allowances under CECL for interim reporting periods until the first quarter of 2020.

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3 Under the Agencies' current DFAST rules, banks with total consolidated assets of less than $50 billion are generally required to make their DFAST submissions by July 31 of each year, but such banks will no longer be required to make DFAST submissions as a result of the recently enacted the Economic Growth, Regulatory Relief and Consumer Protection Act. Pub. L. No. 115-174 (2018). *See also* Federal Reserve, FDIC and OCC, *Interagency Statement Regarding the Impact of the Economic Growth, Regulatory Relief, and Consumer Protection Act (EGRRCPA)* (July 6, 2018), at 1-2, *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180706a1.pdf.

4 *See* 83 Fed. Reg. at 22320.