BANK POLICY INSTITUTE

October 17, 2018

Via Electronic Mail

The Hon. Steven T. Mnuchin
Chairman, Financial Stability Oversight Council
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Request for FSOC Review of the Systemic & Economic Risks Posed by the Implementation of CECL

Dear Chairman Mnuchin:

The Bank Policy Institute[1] is writing to express its members' concerns regarding implementation of the Current Expected Credit Loss (CECL) accounting framework. We believe that the implementation of CECL could undermine financial stability in a future recession or financial crisis, as its requirements establish disincentives for banks to extend credit during stressed economic conditions. Further, these same requirements are likely to adversely affect the availability, structure and price of credit at all times, with a disproportionate impact on longer-term and higher-risk loans, including residential mortgage, small business, student, and unsecured term and non-prime lending. We therefore request that the FSOC work to evaluate the systemic and economic risks posed by CECL and engage with the Financial Accounting Standards Board (FASB) and regulatory agencies to seek a delay in CECL's implementation. Such a delay will provide time for the completion of a comprehensive quantitative impact study of CECL's effect on bank lending and consideration of changes to CECL to better reflect a financial institution's exposure to credit risk.

For the banking industry, CECL represents the most significant rewrite of U.S. GAAP in the past 40 years. As a methodology for accounting for credit reserves for loans and other forms of credit, CECL represents a sea change from the traditional U.S. GAAP approach, which has required banks to establish a reserve when a loan loss is probable and reasonably estimable. In contrast, CECL requires a day-one recognition of credit losses expected over the life of the loan; it does not, however, allow a lender to recognize any of the corresponding future income generated from the loan. That future income is based on an interest rate that compensates for the credit risk undertaken in the loan. As a result, CECL creates a significant disincentive to lend during an economic downturn, as each incremental loan originated will require an upfront charge to earnings and therefore be immediately dilutive to

[1] The Bank Policy Institute 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.

capital, without any accounting recognition of the interest income that compensates for this heightened risk. This disincentive is especially pronounced for longer-term lending, such as a thirty-year residential mortgage loan, as expected losses increase commensurately with the term of the loan, and for other higher risk lending products such as small business and unsecured term and non-prime lending.

These outcomes are exactly contrary to the goals of CECL. One of the FASB's primary objectives in revising its credit loss accounting methodology was to resolve concerns that existing accounting requirements resulted in credit loss recognition that was "too little, too late." Unfortunately, the life-of-loan loss recognition requirement actually magnifies the losses that must be recognized at the outset of an economic downturn, as projected losses over the life of a loan may increase rapidly as macroeconomic forecasts deteriorate. Thus, for both existing and new loans, the required reserve may rise quickly and appreciably as the economy worsens -- reducing earnings, driving capital levels down and triggering capital contingency plans that typically result in decreased lending activity. Conversely, a projected upturn in a bank's economic forecast during good economic times may increase the availability of credit at a time when it is least needed. Thus, CECL is likely to prove highly procyclical.

These impacts of CECL are particularly problematic for banks because they are subject to regulatory capital requirements, which were recently substantially revised as part of the Basel III process in response to the 2007-2009 financial crisis. Importantly, these requirements were developed when loan losses were recognized when they *probable.* The regulatory capital requirements were designed so that capital would then serve to absorb any unidentified losses that were not recognized in the financial institution's allowance for loan losses. However, under CECL, depending on the macroeconomic outlook, loan loss reserves will include much more than probable losses because the calculation required for determining loan loss reserves under CECL is fundamentally different; in other words, if capital requirements are not recalibrated, banks may be required to hold excess amounts of capital, effectively covering the same losses twice.[2] Yet, to date, not enough work has been performed to consider the implications for regulatory capital of the adoption of CECL. Absent appropriate measures, CECL may result in a de facto increase in capital requirements driven purely by accounting changes, and not by any actual change in credit risk. This impact to bank capital may be large, particularly during an economic downturn; for example, BPI staff conducted an empirical analysis of the 2007-2009 financial crisis which revealed that credit loss allowances would have significantly increased under CECL at the beginning of 2007, resulting in a sharp decline in bank regulatory capital ratios during the peak of that crisis in 2008, and an additional nine percentage point reduction in lending during 2009.[3] This nine percent is in addition to the ten percent of lending reduction actually observed during this timeframe.

CECL's impact could be magnified even further for banks subject to the Federal Reserve's supervisory stress test. Each year, that test has presumed a sudden economic downturn of historic magnitude. If the Federal Reserve were to presume that banks would have to take immediate CECL charges upon the onset of such a scenario due to the procyclical nature of CECL, massive loan loss reserves would be required. Given that a bank must carry sufficient capital at all times to allow it to remain adequately capitalized under the supervisory stress scenario, a bank subject to supervisory stress tests would, whenever making a new loan, have to establish an additional reserve, in the form of increased capital for losses that would only potentially materialize in the event of a global depression – an outcome clearly at odds with the intent of CECL. The impact of this could be especially large during economically stressed periods of time when lending is most vital to economic recovery. Therefore, more work should be done to understand the potential consequences from the interaction of CECL and the Federal Reserve's supervisory stress test. The intersection of CECL, supervisory testing and the Federal Reserve's proposed Stress Capital Buffer may also have significant unintended consequences for credit availability.

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2 *See* Bank Policy Institute Letter re: Implementation and Transition of the CECL Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations (July 13, 2018), *available at* https://bpi.com/wp-content/uploads/2018/07/BPI-CECL-Comment-Letter-Final.pdf.

3 *See* Francisco Covas and William Nelson, *Current Expected Credit Loss: Lessons from 2007-2009*, BPI Staff Working Paper 2018-1 (July 2018), *available at* https://bpi.com/wp-content/uploads/2018/07/CECL_WP-2.pdf.

As CECL is not yet effective, there is sufficient time to delay implementation to further study its shortcomings and mitigate its unintended consequences. For example, the accounting methodology and regulatory capital rules could exclude a specific portion of CECL reserves from being charged against income and common equity tier one capital. We believe that the involvement of the FSOC is vitally important given CECL's potentially detrimental impact to financial stability as outlined in this letter, and the need to coordinate action across a variety of decisionmakers. Thus, we urge the FSOC to seek a delay in the implementation of CECL and conduct a quantitative impact study that fully quantifies its potential impact on bank lending and regulatory capital, and facilitate appropriate adjustments to the accounting and capital framework that appropriately resolve CECL's flaws and adverse systemic and economic effects.

Respectfully submitted,

Greg Baer
President & CEO
Bank Policy Institute

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cc: Russell G. Golden
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