Testimony of William Nelson, Chief Economist, Bank Policy Institute

before the Financial Institutions and Consumer Credit Subcommittee of the

Committee on House Financial Services, U.S. House of Representatives

December 11, 2018

Chairman Luetkemeyer, Ranking Member Clay and Members of the Committee, thank you for the opportunity to testify today. I am Bill Nelson, Chief Economist of the Bank Policy Institute (BPI), a bank trade group representing 48 of America's leading commercial banks. BPI is the successor organization to the advocacy and research work of The Clearing House Association, where I was also chief economist. Before joining The Clearing House three years ago, I was Deputy Director of the Division of Monetary Affairs at the Federal Reserve Board, where I worked for 23 years. At the Federal Reserve, I was extensively engaged in developing our emergency liquidity programs during the crisis and helping to strengthen the liquidity and other elements of our regulatory framework afterward. At BPI, I continue to concentrate on providing research and analysis of bank regulatory policy with the goal of ensuring that US bank regulation is well designed and rigorous.

Today I will discuss BPI's recent research that addresses upcoming changes to how banks will be required to account for loan losses. Our research demonstrates that these changes are procyclical; that is, they will amplify swings in the economy, leading to longer and deeper recessions as well as credit excesses during periods of economic growth. It will be helpful to start by describing how we got here.

During the financial crisis, banks were following accounting rules, which are still currently in place, that used the so-called "incurred loss" methodology for credit losses. Under this approach, a bank takes a provision –that is, recognizes credit losses which are subtracted from capital—when a loss is both probable and estimable. Through the crisis, domestic and international banking agencies were frustrated by how slowly banks were provisioning for losses on loans.

So, in the immediate aftermath of the financial crisis, in April 2009, the G-20 and the Financial Stability Board (FSB) recommended that the international accounting standard setters, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB), reconsider how banks account for losses. Their goal was to reduce procyclicality in the financial system. To achieve that reduction, in June 2016, FASB published a new standard that revised how banks in the United States will be required to provision for a loan loss, and this is scheduled to take effect in January 2020 for many institutions.

Under this new approach -- the "current expected credit loss" or "CECL" methodology -- banks must provision for **all** losses expected over the entire life of the loan when they first book the loan. As an illustrative example, if a bank projects the loss rate on five-year home equity loans to be 2 percent per year, it will book an immediate loss equal to 10 percent of the loan amount when it makes such a loan. For each subsequent period, the bank would take new provisions, positive or negative, as it updates its projections of remaining lifetime loan losses based on incoming information about the performance of the loan and changes in economic expectations. Importantly, under CECL, banks must mark only expected losses over the life of the loan to market, not the expected income earned over the life of the loan; as a result, loans that make economic sense, but not accounting sense, are disincentivized.

It is undisputed that lending standards deteriorated in the years preceding the crisis, and that loans made in those years subsequently performed poorly. Consequently, a requirement that banks take losses based on a more forward-looking perspective would appear to offer the prospect of increasing provisions during the go-go years as financial imbalances are building, thereby diminishing the enthusiasm for making bad loans and making banks better prepared for the subsequent fallout. Indeed, early studies of CECL concluded it **would** be countercyclical, as intended.

However, we have all learned a lot about projecting loan losses over the last decade, due in large part to annual stress testing. Among other things, we have learned that loan losses depend, importantly, on the state of the economy **in addition** to lending standards. As a result, understanding the cyclical properties of CECL requires determining how the economic projections banks will utilize evolve over the cycle. Unfortunately, early studies of the cyclical properties of CECL simply assumed that banks had perfect foresight – that is, that they knew the future with certainty. This proved to be a critical mistake.

By contrast, my colleague Francisco Covas and I used real-time projections of the economy to estimate what level of loan (and lease) loss allowances CECL would have called for in the years before, during, and after the financial crisis. We combined those projections with models of loan losses developed by the New York Fed to determine what allowances would have been called for under CECL.

Because economic projections almost never anticipate turning points in the business cycle, economists tend to revise their outlook down as the economy slows and up when the economy picks up. By our estimates, CECL-based loan and lease loss allowances as a percent of bank assets would have risen about ½ percentage point in 2005 and 2006 as lending standards deteriorated but 3½ percentage points in 2007 and 2008 as the economy collapsed.

Had CECL been in place during the 2007-2009 crisis, we estimate that banks' capital ratios would have been 1½ percentage points lower in the third quarter of 2008. Using estimates from a paper recently

published in the Journal of Finance, those lower capital ratios would have reduced bank credit supply in the crisis by an additional 9 percent, as banks worked to preserve capital, significantly worsening the recession. These results support our conclusion that CECL is indeed procyclical.

CECL loan loss accounting will not only be procyclical, it will also disproportionately affect longer-term borrowing, such as home mortgages and student lending, as well as lending to higher risk borrowers, such as small businesses and households with less-than-perfect credit histories. For example, for a $250 thousand mortgage loan, our results indicate a bank would be required to immediately book a loss of $1.5 thousand in good times for originating that loan, and nearly a $15 thousand loss in bad times for making the same loan, almost a tenfold increase. Such a requirement would undoubtedly reduce banks' willingness to make such loans in times of stress.

While FASB followed a rigorous process around the proposal, we believe that, given our findings, more economic analysis is required to understand better the downside risks of implementing this new standard and its incorporation into regulatory capital.

Thank you again for the opportunity to testify, and to present our research. This hearing to examine the impacts of this significant change in accounting is precisely what is needed, as well as more time to assess and address the concerns that we have raised. Thank you, and I look forward to answering your questions.