



Two Fixes for CECL's Problematic Capital Impact

By David Wagner

FASB's new current expected credit loss (CECL) accounting standard for loan losses, which will fundamentally change the way banks account for loans, is scheduled to become effective in January 2020. As BPI [has documented](#), CECL could significantly increase the procyclicality of lending and exacerbate economic downturns. Additionally, the U.S. banking agencies have acknowledged that implementation of CECL in 2020 will require a downward adjustment to bank regulatory capital levels.¹ While the banking agencies have provided a three-year transition rule for regulatory capital purposes for the “day one” impact of CECL implementation, the phase-in does not address the ongoing procyclical nature of CECL or the volatility it introduces into capital planning for banks, particularly under stress economic conditions. Banking regulators must act now to address the issue of procyclicality and ensure that CECL is neutral with regard to regulatory capital under all economic conditions (non-stressed and stressed), rather than waiting to act until the next downturn in the business cycle develops.

PROBLEMS WITH CECL

CECL requires a bank to reserve for expected loan losses over the life of the loan at the time the loan is made. After the loan is originated, banks adjust their loan loss reserve as the probability of default increases or decreases. Since CECL does not allow recording of future expected interest income over the life of the loan, only expected losses, each incremental loan originated requires an upfront charge to earnings and is immediately dilutive to regulatory capital. All of the analysis of CECL that was considered in the design of the standard assumed that macroeconomic models and macroeconomic forecasters have perfect ability to forecast the onset of a recession and the subsequent recovery in advance of its occurrence and adjust their provisioning accordingly. Unfortunately, models and forecasters are unable to predict turning points in the business cycle well in advance, which leads to volatility in the projections of expected loan losses over the life of the loan. As mentioned, prior BPI research, without relying on the flawed assumption of perfect foresight, found that CECL would have been highly procyclical (i.e., banks would have significantly added to their loan loss allowances) had CECL been in effect during the 2007-2009 financial crisis. Banks would have been forced to deleverage and reduce their lending capacity in view of these higher de facto capital requirements, particularly for longer-tenor products like mortgages, student loans, unsecured term and non-prime lending, at a time of economic stress when access to credit was most needed. Specifically, BPI's research estimated a nine percentage point reduction in lending during 2009 due to CECL, in addition to the ten percent decline in loans observed that same year.

POTENTIAL SOLUTIONS

BPI has proposed two solutions to ameliorate these perverse consequences. An interim solution is to calculate a proxy for the additional loan loss allowances required by CECL and then allow banks to exclude that portion of reserves from common equity Tier 1 capital. This simpler approach of excluding the additional reserves from capital has been used in other regulatory capital contexts (e.g., cite to goodwill), and would allow the regulators the time needed to properly recalibrate capital requirements and avoid exposing the economy to the risk of a more severe recession during the next economic downturn.

A permanent solution would require the regulatory agencies to undertake a comprehensive recalibration of the regulatory capital framework once they accumulate more experience with CECL. The recalibration is necessary because existing Basel III regulatory capital requirements were designed and calibrated under the current accounting standard for loan losses, which is premised on losses that are probable and reasonably estimable in a year. Thus, regulatory capital requirements were designed to absorb losses beyond the one-year horizon that are not currently recognized in a bank's allowance for loan losses. Under CECL, loan loss reserves will include expected losses that go

¹ See, e.g., Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration and Office of the Comptroller of the Currency, Frequently Asked Questions on the New Accounting Standards on Financial Instruments — Financial Instruments – Credit Losses (Dec. 19, 2016) at 15, question 18, available at <https://www.federalreserve.gov/bankinfo/srletters/sr1619a1.pdf>.

well beyond one year, creating overlap between the losses intended to be addressed with reserves and losses intended to be addressed with capital under the current regulatory regime. A recalibration of regulatory capital requirements for all banks [would avoid double-counting](#) capital requirements for credit risk so that banks would not be required to hold capital effectively covering the same losses twice, driven purely by accounting changes without any change in the underlying credit risk. This recalibration could entail, among other things, revising minimum capital and buffer requirements, introducing or revising adjustments to common equity Tier 1 capital, adjusting risk weights and exposure measurements, and more generally, changing the regulatory capital treatment of credit loss allowances. Importantly, the recalibration would include adjustments to capital requirements or regulatory capital levels designed to reverse the procyclicality introduced by CECL. And, as noted earlier, the three-year transition rule adopted by the regulators is inadequate to address these concerns because it does not address the double-counting and does not eliminate the ongoing volatility in CECL-based allowances after the day one impact, especially under stressed economic conditions.

ADDITIONAL ISSUES FOR CCAR

For banks subject to CCAR, in addition to the recalibration described above, the Fed needs to carefully consider the impact of CECL on its stress tests (DFAST, CCAR). Each year, the Fed's stress tests presume a sudden economic downturn worse than the 2007-2009 financial crisis. If banks were required to exercise "perfect foresight" at the beginning of the stress tests and immediately recognize lifetime credit losses based on the prescribed stress scenario, banks would face severe losses at the start of the stress horizon. The frontloading of loan losses due to the assumption of perfect foresight would increase the peak-to-trough decline in regulatory capital ratios under stress and thereby raise banks' capital requirements. This would occur despite no change in total losses over the course of the nine-quarter stress horizon (only the timing of the recognition of those losses would change). While the Fed helpfully decided that CECL will not be incorporated into CCAR until the 2021 stress test cycle in order to allow them time to study the potential consequences of the intersection of CECL and stress testing[cite], banks subject to the stress tests in 2019 were still required to include the impact of CECL for four quarters of 2020 and the first quarter of 2021 (since the stress tests cover a nine-quarter planning horizon) in their recently completed 2019 company-run (DFAST) stress test and will need to do so for nine quarters in their 2020 company-run stress tests, which may impact their capital allocation decisions. In this way, CECL immediately introduced greater volatility and unpredictability into bank regulatory capital requirements.

Rather than maintaining a "wait and see" approach until the next economic downturn, the banking agencies need to act promptly so that the operation of a new accounting rule doesn't cause a reduction in bank lending during a time of economic stress.

Disclaimer: The views expressed in this post are those of the author(s) and do not necessarily reflect the position of the Bank Policy Institute or its membership, and are not intended to be, and should not be construed as, legal advice of any kind.