CECL and Capital Relief: A Choice Between Doing the Right Thing for the Right Reason or the Wrong Thing Based on a Misunderstanding

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When the pandemic hit in March 2020, everyone witnessed the procyclicality of the new current expected credit loss (CECL) accounting standard. Just as the economy came to a stop, banks were required to make massive additions to their reserves (the allowance for credit losses), thereby reducing their capital and as a result their capacity to lend. Less noticed but equally interesting is what is happening now, which is procyclicality in another form: banks releasing those same reserves into net income amidst robust economic growth, thereby boosting their capital and increasing their capacity to lend.

Recognizing this second side of the CECL procyclicality coin is extraordinarily important. At the outset of the COVID-19 crisis, the federal banking agencies limited how much a change in the allowance could affect banks' regulatory capital ratios.[1] As banks increased their loan reserves (by charging net income), regulators allowed banks to add back to capital a quarter of the increase in the allowance. This change reduced the decrease in bank capital and gave banks more capacity to lend at the outset of the pandemic.

Currently, though, the adjustment is having the *opposite* effect. As banks release reserves (with a corresponding increase in net income), they are not receiving the full capital benefit of those actions – that is, their capital is not rising to the full extent that it would in the absence of the adjustment adopted by the agencies. As Chairman Powell noted last week, now is the time in the economic cycle when bad loans tend to get made. The CECL adjustment made by the banking agencies is currently suppressing the trend that worries the Chairman.[2]

Thus, the banking agencies' CECL adjustment makes just as much countercyclical sense in recovery as it does in stress. So, who would oppose making it permanent? Unfortunately, the regulatory change made by the banking agencies in March of 2020 was characterized at the time as capital "relief," even though it was actually a neutral change over a longer time horizon. And in the increasingly politicized world of bank regulation, a mistaken impression carries a lot of weight.

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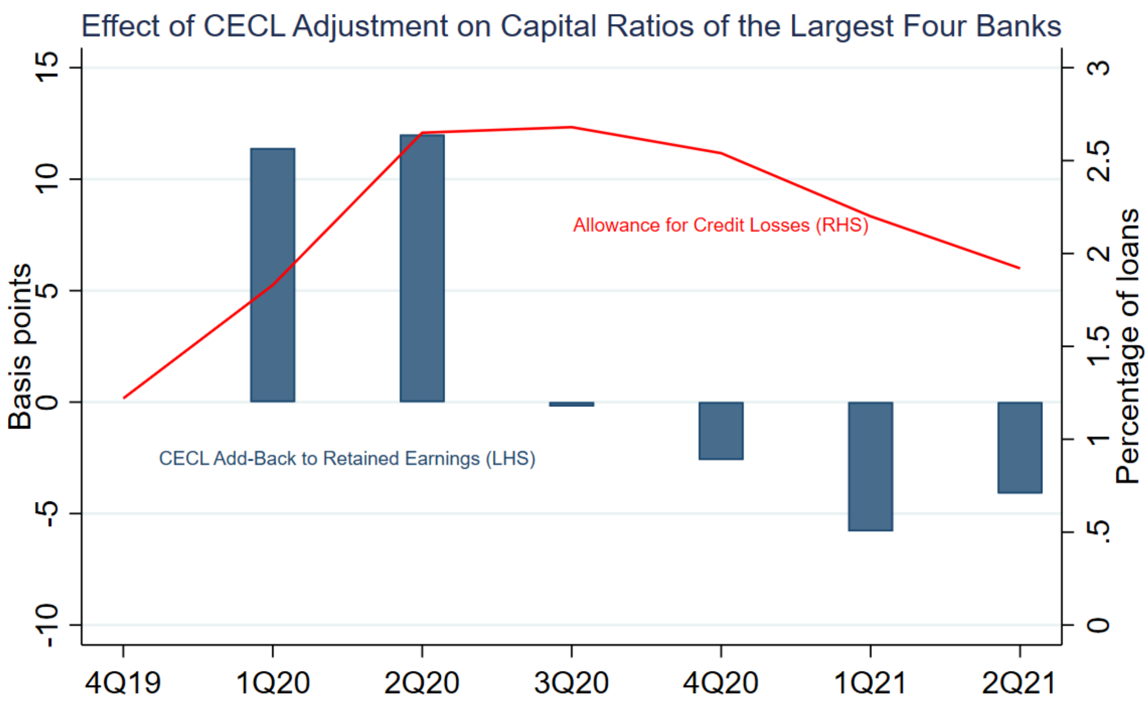
[1] The banking agencies delayed the effect of the initial impact of CECL on regulatory capital for the first two years, followed by a three-year phase-in period. Furthermore, banks were also allowed to delay a portion of the ongoing increase in the allowance for credit losses for the first two years, also followed by a three-year phase-in. If banks elected to make this adjustment, and almost all did, they must follow the transition provision until 2025.

[2] Testimony to U.S. Senate Committee on Banking, Housing and Urban Affairs (2021). *The Semiannual Monetary Policy Report to the Congress*, 02:07:05. https://www.banking.senate.gov/hearings/07/07/2021/the-semiannual-monetary-policy-report-to-the-congress ("This is the time when risk takers can begin to forget that there's a bad state of the economy out there waiting for them at some future date and take too much risk. And so, from a supervisory and regulatory perspective, we're very mindful that it's … a time when we need to keep people focused on risk management."

BACKGROUND

For years leading up to the finalization of CECL, critics (including us) expressed concern that it would be procyclical: that is, its effect would be to build reserves (and therefore raise the cost of credit) when the economy experienced trouble and to release reserves (and therefore lower the cost of credit) when the economy boomed. This concern was based on an assumption that economic forecasts that drive the size of the allowance for credit losses were not based on perfect foresight, as CECL assumed – that is, that those forecasts would not be downgraded months or years ahead of economic trouble but rather just as it arrived, and that those forecasts would then not be upgraded at the first hint of recovery but rather only once it was well underway.

Having seen the former phenomenon play out in March 2020 (see here and here), we are now seeing the latter play out in July 2021. As banks announce second-quarter earnings, a constant feature has been large reserve releases. For instance, last week, the four largest banks (who are traditionally the first to report earnings) announced a $9 billion release in their allowance for credit losses at the end of the second quarter because of the ongoing improvement in the economic outlook. The reduction in reserves caused bank profits to rise and bank capital to increase. Without the CECL capital adjustment, their capital would have increased approximately $7 billion (the after-tax amount of $9 billion). However, because of the CECL capital adjustment, bank capital of those banks increased only $4.9 billion. The same phenomenon is certain to play out as other banks announce their earnings, with the aggregate dollar amounts of reserve releases growing significantly larger. Thus, the regulatory change is dampening the increase in banks' regulatory capital ratios as economic conditions improve.



Source: Federal Reserve Board, FR Y-9C and Earnings Calls for 2Q21 (BAC, C, JPM, and WFC).

Note: The height of the blue bar represents 25 percent of the change in the allowance for credit losses in that quarter scaled by risk-weighted assets.

The countercyclicality of the regulatory change is illustrated by the chart above. When the allowance for credit losses increased during the early stages of the pandemic, the CECL adjustment increased the capital ratios of the four largest banks about 23 basis points (represented by the sum of the two bars in 1Q20 and 2Q20). Conversely, when banks started to release reserves in the fourth quarter of last year, banks' capital ratios have declined about 15 basis points.

CONCLUSION

The case for maintaining the CECL capital adjustment appears unassailable. Over time, it is neutral with respect to banks' capital levels, and thus their ability to meet regulatory capital requirements. At all times, it is countercyclical. A mistaken impression should not prevent the agencies from making it permanent.