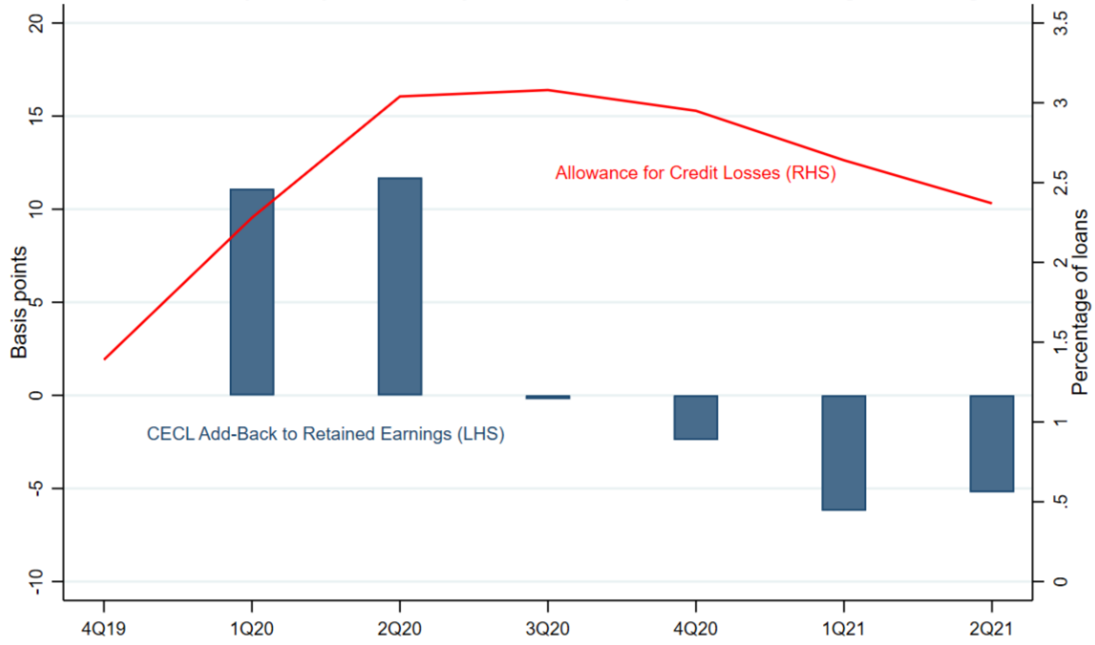
The CECL Adjustment is Even More Countercyclical for Consumer Banks

Francisco Covas & Gonzalo Dionis | July 26, 2021

In a blog post published last week, we presented data showing the countercyclical effect of the adjustment used by the federal banking agencies to mitigate the otherwise procyclical effects of the current expected credit loss (CECL) accounting standard at this point in the cycle. In sum, whereas the CECL adjustment in 2020 served to reduce the regulatory capital impact of CECL by limiting how much regulatory capital decreased as banks built their allowance for credit losses, the adjustment is currently reducing regulatory capital by limiting how much capital increases as banks release their allowance for credit losses. The post was written at a time when only the largest banks had reported earnings.

At this point, large and regional banks have all reported their second quarter 2021 earnings. We were able to confirm that the magnitude of the CECL adjustment reported in the prior post is similar between the global systemically important banks (excluding the broker-dealer and custodian banks) and regional banks (shown in Exhibit 1).

Exhibit 1: Countercyclicality of CECL Adjustment on Capital Ratios of 16 Largest Lending Banks

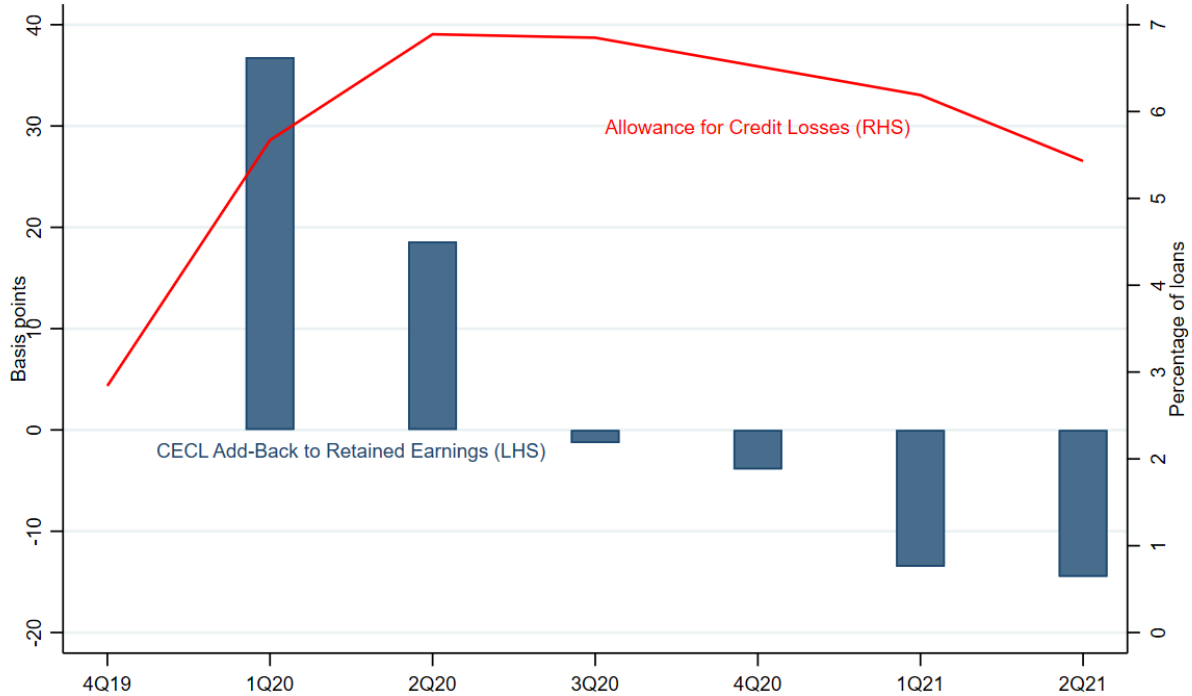


Source: Federal Reserve Board, FR Y-9C and Earnings Calls for 16 Large Banks in 2Q21.

Note: The height of the blue bar represents 25 percent of the change in the allowance for credit losses (ACL) in that quarter scaled by risk-weighted assets. The day 1 effect on the ACL is excluded from 1Q20.

In addition, the countercyclicality of the CECL adjustment is most pronounced with respect to large consumer lenders as shown in Exhibit 2. In fact, the increase in the allowance for credit losses that resulted from the sudden deterioration of the economic outlook at the early stages of the pandemic led to a 55 basis points increase in the capital ratios for the top 5 consumer banks (ALLY, AXT, COF, DFS and SYF) on average. The increase in the capital ratios of the largest lenders was about 50 percent less. In a symmetrical effect, the reduction in the allowance for credit losses we have seen in the most recent quarters is mainly due to the improvement in economic conditions caused the capital ratios of consumer banks to decline 33 basis points (the sum of the last four bars in the chart). The effect was again approximately 50 percent less for large lending banks. Thus, the adjustment adopted by the banking agencies continues to have a countercyclical effect, reducing the benefit to bank capital for banks releasing reserves in good times. This effect is approximately twice as large for consumer banks.

Exhibit 2: Countercyclicality of CECL Adjustment on Capital Ratios of Five Largest Consumer Banks



Source: Federal Reserve Board, FR Y-9C and Earnings Calls for 5 Consumer Banks in 2Q21 (ALLY, AXT, COF, DFS, SYF).

Note: The height of the blue bar represents 25 percent of the change in the allowance for credit losses (ACL) in that quarter scaled by risk-weighted assets. The day 1 effect on the ACL is excluded from 1Q20.

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