Statement for the Record

On Behalf of the

AMERICAN **BANKERS** ASSOCIATION

Before the

Financial Institutions and Consumer Credit Subcommittee

of the

Committee on Financial Services

United States House of Representatives

Statement for the Record
On Behalf of the
American Bankers Association
Before the
Financial Institutions and Consumer Credit Subcommittee
Of the
Committee on Financial Services
United States House of Representatives
December 11, 2018

Chairman Luetkemeyer, Ranking Member Clay and members of the Subcommittee, the American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record on the issues surrounding pending changes to credit loss provisions. ABA is the voice of the nation's $17 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $13 trillion in deposits, and extend nearly $10 trillion in loans.

The upcoming implementation by banks of the Current Expected Credit Loss (CECL) accounting standard[1] for the measurement of credit losses represents a sea change to the banking industry. CECL requires, upon origination, recognition of credit losses using economic forecasts over the contractual lives of loans and held-to-maturity debt securities. Due to the inherent unreliability of long-term economic forecasting, implementation of CECL will increase the ***volatility*** of regulatory capital, necessitating ***increased capital*** at all times. While the forward-

[1] The CECL accounting standard is Accounting Standards Update 2016-13, issued by the Financial Accounting Standards Board. It is effective in 2020 for SEC registrants, and 2021/2022 for all other companies.

looking reserving requirement under CECL was intended to reduce procyclicality in the banking system by building and adjusting loss provisions earlier in the process, analyses by ABA members on their own portfolios indicate that in practice CECL will, in fact, cause ***more*** procyclicality (and capital volatility) during economic downturns than the current accounting.

Due to its effect on income and regulatory capital, CECL will change how banks are managed, may reduce the lending products provided and raise the cost of credit. Importantly, CECL will reduce the availability of credit when it is needed the most – during an economic downturn. Furthermore, as many banks will need to raise capital and incur significant costs to ensure CECL compliance at every stage of economic cycles, it will likely change the face of the banking industry, particularly smaller banks.

The banking agencies have proposed a three-year phase-in of the initial regulatory capital impact of CECL. While perhaps well-intentioned, this proposal ignores the fact that any deterioration in economic conditions soon after the effective date would make such a plan ineffective, if not futile, as capital volatility will be significantly increased under CECL.

More importantly, however, the proposal ignores practical concerns and does not take into account public policy implications that this change will likely have on longer-term lending products (such as 30-year residential mortgages and student loans), offerings to non-prime borrowers and the impact of higher operational costs and increased capital volatility on community banks.

Given these important and uninvestigated concerns, ABA strongly recommends that the effective date of the CECL accounting standard be delayed and a quantitative impact study be performed.

In the remainder of this statement, we will focus on our key concerns:

- CECL will increase procyclicality and exacerbate economic downturns.
- CECL will increase the cost and availability of credit to consumers, particularly on loans with longer terms.
- CECL will change the face of the community banking industry.

I. CECL will Increase Procyclicality and Exacerbate Economic Downturns

Regulatory capital levels directly affect the level of lending that a bank can offer: the more capital available, the more potential lending. Credit loss provisions reduce regulatory capital – therefore, the higher the provisions, the lower the capital and accompanying lending. Good public policy works to reduce capital volatility and procyclicality as an increase in either directly reduces the ability of banks to lend, particularly at critical periods.

As mentioned above, while CECL was intended to be forward-looking, the fact is that in practice, it would create more procyclicality and higher capital volatility. Provisions for loss under CECL will meld forward looking analysis of the robustness of credit quality with a qualitative overlay of cyclic economic forecasts. Long-term economic forecasting have often been inherently unreliable. Layering on an unreliable forecast to banks already extensive knowledge of the loans they make will add uncertainty and force higher levels of capital (relative to risk).

Relying on a theoretical “perfect foresight”—as a recent agency paper noted—can be problematic. Increased procyclicality appears to be caused by the general inability of forecasters to identify the timing and extent of turns in an economic cycle. During the last economic cycle, forecasters were not only late in

identifying both the economic peaks and troughs, but they also forecasted the downturn to be significantly longer than actually occurred. In fact, in 2008-10 the forecasts of loss experiences continually exceeded actual losses. If these macro forecasts drive allowances up in a downturn, income and capital will take a direct hit, and result in a negative (and pro-cyclical) impact on lending. Therefore, had CECL-based credit loss provisions been in place in 2008, it would have compounded the worse economic downturn since the Great Depression by increasing provisions for losses far beyond those that were otherwise established.

To try to minimize the volatility and to ensure that regulatory capital thresholds are not broken, banks will need to always keep more capital on hand, i.e., a capital cushion. Since credit loss provisions directly affect capital, increased potential volatility of credit loss provisions will reduce the amount of lending available.

As noted, ABA members have tested the impact of CECL using models designed for the new standard and have concluded that in practice volatility will increase. These results have also been supported by other studies over the past several months.

Given these results, ABA recommends that a study be performed to better gauge this expected procyclicality and to assess whether it goes against the agencies' objectives of safe and sound lending and an adequately liquid credit market throughout an economic cycle. This should also include assessing how regulatory guidance, changes to stress testing protocols, or changes to the CECL standard itself can reduce the risk of increased procyclicality.

II. CECL will Increase the Cost and Availability of Credit

Besides the concern of increased procyclicality, there is little disagreement that significant increases to credit loss provisions are in store for loan products

with long tenors, such as residential mortgages and student loans, as well as to borrowers with non-prime credit quality.

Higher credit loss provisions during benign times are understood, and this cost to capital is generally expected to result in higher interest rates charged to borrowers. However, during an economic downturn, such provisions can be up to *several times the levels recorded under the current accounting*. Due to CECL's requirement to record credit loss provisions at the time of origination without recognizing the expected interest income to be earned, it is easy to see how CECL could cause significant reductions in lending during a recession. With each loan made in a down economy, a bank digs a bigger hole in its capital position as a loss provision is immediately recorded, though the anticipated interest income is deferred.[2]

It is also likely that the impact of CECL will not be uniform. Many ABA members are estimating that, for commercial lending products and for loan portfolios with shorter terms, while the period-to-period volatility in provisioning will be higher under CECL, credit loss provisions could actually decrease compared to the current accounting.[3] The differences in credit loss provisioning between consumer loans and commercial loans, as well as between long-term loan and loans with shorter terms, will naturally change the pricing of each of these products.

[2] This phenomenon especially can be seen under current stress testing protocols, as assumed losses occurring up to nine quarters in the future are recognized immediately, though the interest income to be earned in the meantime may not be likewise included.

[3] This is largely due to current practices which assess the likelihood of renewals that commonly occur within commercial loan arrangements. Under CECL, unless a renewal is considered a "troubled debt restructuring", consideration of renewal is not allowed.

A quantitative impact study will help regulators assess the impacts of the shifts in pricing and availability of credit to both consumers and commercial borrowers.

III. CECL will Change the Face of the Community Banking Industry

The CECL accounting standard will affect the business of lending for banks of all sizes. However, the impact of CECL will be heavier on community banks. Compared to larger banks, community banks' lending is a larger part of their businesses and their portfolios are typically more concentrated in 30-year residential mortgages.

For example, 757 banks in the U.S. (with under $1 billion in assets) maintain greater than 50% of their loan portfolios in residential mortgage products. Another 1,192 of similarly-sized institutions hold residential mortgages that make up between 30-50% of their portfolios. Clearly, the impact of CECL will have a significant effect on the lending by these institutions and the capital they must hold. A study by StoneCastle Partners estimates that approximately 650 community banks should consider raising capital merely to maintain compliance with regulatory capital requirements at the CECL effective date.[4]

Preliminary research being conducted by ABA suggests a similar conclusion. This is why the quantitative impact study must address not only the banking industry as a whole, but also how smaller institutions will be able to compete and serve their individual communities. Due to the challenges in raising capital for many community banks, the study will allow regulators to assess

---

[4] See https://stonecastle.com/wp-content/uploads/2018/01/2017-12-18-CECL-and-Tier-2-Final.pdf

whether the requirements could accelerate unintended consolidation in the industry.

Therefore, an impact study must also address the significant implementation costs of CECL, particularly for community banks. The banking agencies are now beginning to understand that a reasonable implementation of CECL will require significant changes to technology and processes for all but the tiniest of banks. While implementation efforts among smaller banks are in very early stages, most are considering hiring 3rd party companies to manage the significant increases in data and analysis that will be necessary. These costs—and those related to auditing—will be significant to the many smaller banks that already have been stretched by one-sized-fits-all regulatory costs.

Conclusion

Implementation of the CECL accounting standard will have a significant impact on how banks manage regulatory capital and, thus, on the credit products, availability and terms offered. ABA believes that CECL will raise the cost and reduce the availability of credit in most cases, shift the emphasis from consumer lending to commercial lending, and favor shorter term loans over longer term ones like residential mortgages and student loans. Given the inherent procyclicality built into CECL, the next economic downturn is likely to be made more severe with banks less able to make the loans so critical to restarting a stalled economy.

Community banks will face significant challenges with CECL implementation, not only due to the significant 3rd party costs they will have to bear, but more importantly the implications for the types of loans they make to

support their communities. Added costs, higher capital, and greater volatility can be the tipping point that drives further consolidation in the industry.

Bankers need to understand how to conduct business going forward. For each of the concerns raised, there may be solutions—for example through adjustments to regulatory capital requirements, changes to stress testing protocols, industry guidance, or changes to the CECL standard itself—that may help mitigate the negative impacts. This is why a quantitative impact study—conducted by the banking agencies with close assistance and engagement of the banking industry—is needed to better understand these issues and to appropriately respond. Due to the impact this could have on company efforts in designing their CECL systems and in their overall long-term strategies, ABA recommends that the effective date of the CECL standard be delayed until the study, including recommendations, is complete.