Statement for the Record

On Behalf of the

AMERICAN BANKERS ASSOCIATION

Before the

Investor Protection, Entrepreneurship and Capital Markets Subcommittee

of the

Committee on Financial Services

United States House of Representatives

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Chairman Sherman, Ranking Member Huizenga and members of the Subcommittee, the American Bankers Association (ABA) appreciates the opportunity to submit a statement for the record on the issues surrounding the recent changes to credit loss provisions proposed by the Financial Accounting Standards Board (FASB). ABA is the voice of the nation's $18 trillion banking industry, which is composed of small, regional and large banks that together employ more than 2 million people, safeguard $14 trillion in deposits, and extend more than $10 trillion in loans.

The January 1, 2020, implementation by larger 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 potential 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

[1] The CECL accounting standard is Accounting Standards Update 2016-13, issued by the Financial Accounting Standards Board. It is effective in 2020 for larger SEC registrants, and 20232023 for all other companies.

increase the ***volatility*** of regulatory capital, generally necessitating ***increased capital*** at all times. While the forward-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 do current accounting practices.

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-particularly in uneven ways. 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 all stages of an economic cycle, it will likely change the face of the banking industry, particularly for smaller banks.

The banking agencies have provided a three-year phase-in of the initial regulatory capital impact of CECL. While perhaps well-intentioned, this plan 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. Such volatility is also not favored by bank analysts and investors, as most believe CECL will make their job harder. This puts into question the quality of the due process that FASB undertook in issuing the standard.

More importantly, however, the phase-in 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 (such as many small businesses, credit card holders, as well as auto and other consumer borrowers), and the impact of higher operational costs and increased capital volatility on community banks.

Given these important and uninvestigated concerns, ABA has advocated that a broad, full-cycle quantitative impact study be performed. While FASB recently deferred the effective date for smaller institutions until 2023, the systemic risk of procyclicality, its accompanying impact on lending, and the lack of confidence by the investing public in assessing bank results remain.

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.
- The process to issue CECL excluded key analyses that would have put support for the standard into question.

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 cyclical economic forecasts. Long-term economic forecasts have often been inherently unreliable. Layering on an unreliable forecast to banks' knowledge of the loans they make will add uncertainty and force higher levels of capital (relative to risk), introducing for bank managers an added uncertainty risk.

Certain studies indicate the CECL may reduce procyclicality. However, each of them rely on various levels of a theoretical "perfect foresight", which is unrealistic.[2] 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 (and beyond what turned out to be actual economic performance).

It has been suggested by some that, to minimize the volatility, banks should disregard the professional forecasts. Such a practice, however, puts them at risk of

[2] An analysis of each of the various CECL studies can be found in the ABA discussion paper "The Need for a CECL Quantitative Impact Study". See https://www.aba.com/advocacy/policy-analysis/need-cecl-quantitative-impact-studySee https://www.aba.com/advocacy/policy-analysis/need-cecl-quantitative-impact-study

accusation of managing earnings, especially in light of new, enhanced auditing standards over accounting estimates specifically targeting such bias in reporting.[3] Therefore, to ensure that regulatory capital thresholds are not broken, banks will need to always keep more capital on hand, i.e., an added 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. While there are specific CECL modeling methods that can mitigate a portion of the reserving spike during an economic downturn, they have concluded that, in practice, capital volatility will increase.

Given these results, ABA recommends that a detailed quantitative impact study – one in which actual bank estimates are used – be performed to better gauge this expected procyclicality and to assess whether it conflicts with the agencies' objectives of safe and sound lending and an adequately liquid credit market throughout an economic cycle. The study should assess 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.

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[3] Public Company Accounting Oversight Board standard AS 2501: *Auditing Accounting Estimates, Including Fair Value Measurements*, is effective for audits of fiscal years ending on or after December 15, 2020. See https://pcaobus.org/Standards/Implementation-PCAOB-Standards-rules/Pages/auditing-accounting-estimates-fair-value-measurements.aspx

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*.[4] 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, CECL would result in a bank digging a bigger hole in its capital position as a loss provision is immediately recorded, though the anticipated interest income is deferred into the future.[5]

It is also likely that the impact of CECL will not be uniform. Many ABA members are estimating that, for certain 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 generally decrease compared to the current accounting.[6] 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.

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[4]The "ABA Snapshot of Banks' CECL Estimates" lists credit loss rates by product line in both benign and stressed economic environments." See https://www.aba.com/news-research/research-analysis/aba-snapshot-of-banks-cecl-estimates.

[5] This phenomenon is the primary reason two FASB members opposed the issuance of CECL and 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.

[6] 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. Such a study should consider whether, and to what extent of this lending would be assumed by non-regulated lenders, which are not bound by minimum capital requirements.[7]

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 tend to have more longer-term loans, such as commercial real estate loans and 15-year and 30-year residential mortgages.

For example, 687 banks in the U.S. (with under $1 billion in assets) maintain greater than 50% of their loan portfolios in residential mortgage products. Another 1,144 of similarly-sized institutions hold residential mortgages that make up between 30-50% of their portfolios. Further, portfolios of much of the remainder of the community banking sector are similarly concentrated in commercial real estate, a line that exhibits similar capital volatility to residential mortgages in stressed economic environments. Clearly, the impact of CECL will have a significant effect on the lending by these institutions and the capital they must hold. This is why the quantitative impact study must address not only the banking industry as a

[7] The combination of low interest rates and high regulatory compliance costs is believed to be the main reason why leveraged loans are predominately held by nonbank entities. Certain investors have expressed a similar expectation to ABA of the consumer loan market because of the increased costs of CECL. Such a migration of credit risk to nonbank entities can present liquidity and loan servicing concerns during a time of economic stress over and above any such risk if those loans were held and serviced by regulated entities.

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 should allow regulators to assess 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 nearly all. While implementation efforts among smaller banks are in very early stages, most are considering hiring third 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 additional regulatory costs.

IV. The Process to Issue CECL Excluded Analyses that Would Have Put Support for the Standard into Question.

Analysis to Inform Banking Regulators

Prior to issuing the CECL accounting standard, FASB underwent a several year process that included outreach to banks, investors, and regulators, and FASB has documented these efforts. In doing so, FASB acknowledges that, while a cost/benefit analysis is part of its process, a detailed quantitative impact study is not part of that framework. An appropriate quantitative impact study would be a detailed study that contemplates the impacts of CECL on bank lending (related to both consumer and commercial borrowers) and bank competition (large banks vs. community banks vs. nonbank financial sector participants).

As noted above, preliminary CECL estimates by individual banks indicate that, instead of providing sufficient early recognition of credit losses that would reduce procyclicality in the industry, CECL—if applied to the recent recession—would have likely made the financial crisis more acute and endure for a longer period of time. In other words, these and other reports strongly suggest that CECL will likely *increase* procyclicality. This result contradicts the very reason that banking regulators worldwide requested a review of impairment accounting in reaction to the financial crisis.[8] In other words, had banking regulators, which are important constituents of FASB and key users of bank financial statements, known that CECL would *add to* procyclicality, they would not likely have supported CECL in its current form.

Therefore, while FASB believes its process was extensive, the process was in fact structurally limited, blind to important review as to whether it was achieving the intended countercyclical mission. Banking regulators have been blindsided by that limitation in FASB's review. The feedback received from banking regulators was based on an inaccurate assumption of how CECL would (or could) operate in actual practice. FASB maintains that economic impact is not part of its due process and is the responsibility of industry regulators. However, a quantitative impact study addressing the economic impact would have ensured that the quality of regulator feedback was sufficiently grounded in a review of the most

[8] The CECL project was initially based on the objective of implementing an accounting standard that decreases the level of procyclicality in the banking system. This objective was provided by the Financial Stability Board (FSB, formerly the Financial Stability Forum), an organization of worldwide regulating bodies. See "Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System," April 2, 2009. https://www.fsb.org/wp-content/uploads/r_0904a.pdf.

significant question: does CECL provide countercyclicality, or does it, instead, reinforce procyclicality.

Analysis to Inform Investors

FASB has often noted that the investor is its primary constituent and that there is broad support for CECL among investors. This appears to be contradicted by results of a January 2019 survey conducted by Fig Partners (now Janney) of investors that concentrate on financial institutions—those that know banking and rely on bank financial statements the most. The survey found that 85% feel that the *current* accounting model and practice are sufficient, and 75% disagree or strongly disagree with the change presented by CECL.[9] ABA discussions with investors and analysts indicate that, had investors understood the complexities and impact that economic forecasting could have, their feedback would have been negative. Thus, while FASB's mission is to make an analyst's job easier, bank investors ultimately believe CECL makes their job more difficult. In fact, some analysts have already introduced alternative performance metrics that exclude the impact of CECL from their analyses.[10] FASB could have avoided this by coordinating a quantitative impact study and sharing any observations prior to CECL's issuance.

Analysis to Understand Operational Costs

By delaying the effective date of CECL for smaller entities to 2023, FASB is acknowledging that its estimate of the costs of a sound implementation was

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[9] See https://research.figpartners.com/wp-content/uploads/2019/01/FIG-Partners-1-11-19-Analyzing-Results-From-Our-Credit-CECL-Survey.pdf for the Janney (then named "Fig Partners") survey.

[10] An example is Stephens, Inc. "REAL EPS" (Reported Earnings Adjusted for the Allowance for Loan Loss Reserves) metric. The report can be accessed by clicking HERE.

understated. We believe this understatement to be significant and that it will naturally impact smaller banks the most. While some have said that CECL can be performed on a spreadsheet, most banks are currently considering implementing third party data warehouses, as well as hiring personnel merely to manage the extra data that will be collected and analyzed each reporting period.

In short, the vast operational implications of a change to lifetime credit loss estimates have been widely misunderstood.[11] The auditing industry is now just understanding the change. In light of a new PCAOB auditing standard that becomes effective in 2020 (related to auditing estimates such as CECL), the American Institute of CPAs (AICPA) published a 63-page CECL Technical Practice Aid, a mere three months before the effective date. While the delay provides more time to prepare, the ongoing additional costs will remain.

A quantitative impact study that includes smaller bank portfolios would assist banks, auditors, and regulators to agree on how community banks can comply with the standard in a meaningful way. If such a study was performed prior to the issuance of CECL, it is likely there would be changes made to the standard to simplify the requirements.

In summary, a quantitative impact study is not a part of the FASB due process. However, such a study would have highly influenced the feedback

[11] One example is a public FASB presentation stating that applying a historical annual loss rate to a weighted average life of a portfolio was a “CECL Misunderstanding” and “Not a CECL Application”. Such a method is currently being recommended to community banks by regulators, though it has been discredited by a credit modeling expert. See ABA analysis at https://www.aba.com/advocacy/policy-analysis/cecl-implementation-concerns-warm

provided banking regulators and investors and it also would have assisted FASB in assessing the practical costs of compliance.

ABA notes that there is still time to address this deficiency. Although CECL is now in effect for a significant portion of the industry, the delay FASB has provided for smaller institutions provides yet time for a detailed quantitative impact study and the implementation of reforms appropriate to address issues identified. We encourage such action to be initiated forthwith.[12]

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 commercial real estate, 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

[12] Per H.R. 1865: Current Expected Credit Loss.—The Committee is aware of concerns regarding the potential adverse effects on the U.S. economy from the Financial Accounting Standards Board's Current Expected Credit Loss [CECL] standard, especially during times of recession or economic crisis. The Committee directs the Department of the Treasury, in consultation with the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the National Credit Union Administration, to conduct a study on the need, if any, for changes to regulatory capital requirements necessitated by CECL, and to submit the study to the Committee within 270 days of the date of enactment of this act.

stalled economy, particularly lending in support of vulnerable communities hardest hit by recession conditions.

Community banks will face significant challenges with CECL implementation, not only due to the significant third 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 detailed 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.[13] While not a normal process of FASB, a quantitative impact study conducted prior to the issuance of CECL would have ensured that regulator and investor feedback was sound. A quantitative impact study performed now, perhaps by the Office of Financial Research, can help assess CECL's weaknesses and make changes before an economic downturn occurs and is exacerbated by its procyclicality. It also can help assess how CECL can be implemented in practical and cost-effective terms at smaller banks.

[13] A fuller description of the quantitative impact study is in the ABA discussion paper "The Need for a CECL Quantitative Impact Study". See https://www.aba.com/advocacy/policy-analysis/need-cecl-quantitative-impact-studySee https://www.aba.com/advocacy/policy-analysis/need-cecl-quantitative-impact-study