Financial Services Management

CECL and Capital Requirements

Cite

FDIC, FRB, OCC; Notice of Proposed Rulemaking (NPR); Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations

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Impact Assessment

- CECL integration with capital requirements will reduce regulatory capitalization, leading to near-term capital increases and/or asset reductions and realignment.
- Although a transition period is proposed, banks will need quickly to revise capital planning and asset allocations to anticipate higher capital requirements.
- CECL recognition in regulatory capital creates an incentive for shorter-term, secured, or guaranteed lending.
- CECL in the capital framework creates additional procyclicality incentives unless corrected by CCAR.

Overview

Reflecting new U.S. accounting standards transforming loan-loss reserving from an incurred- to expected-loss approach, the federal banking agencies have proposed to transition the capital impact of the new accounting rule but not to separate capital calculations from this new accounting methodology. They also plan to leave the treatment of the newly-structured reserves the same as that now applied to loan-loss reserves for purposes of determining capital adequacy, although they will reconsider this after seeing how CECL in fact affects regulatory capital and bank lending activities. Stress-test standards would not reflect CECL until the 2020 cycle, at which point some banks could experience significant shortfalls unless the stress-test methodology is revised to reflect the new approach to reserves and resulting resilience.

Impact

The new FASB requirement are generally known as current expected credit loss (CECL) standards. Instead of adding reserves as loss is taken, the CECL standards require institutions to set reserves based on anticipated lifetime financial losses on assets at amortized cost, backing these up with robust forecasts of potential losses that take both the loan and future macroeconomic conditions into account. Past events and current conditions must also be considered and additional changes to recognition impairment and various thresholds also increase reserve requirements, as does the new way losses are charged to earnings. At the same time future losses must be recognized in current reserves, income on the loan may only be recognized when it is realized. As a result, the cost of making certain types of loans is first increased by the higher reserves mandated by the CECL method and then heightened by the need to raise still more capital in addition to the newly-larger loan-loss reserve, with these costs only offset over potentially lengthy time periods as a loan is repaid.

Because all of the agency capital rules are based on GAAP, the CECL methodology affects capital calculations and would, absent any changes to the underlying rules, generally require considerably larger loan-loss reserves that would then reduce regulatory-capital ratios. Since these basic capital calculations then run through stress-test scenarios, the change to CECL would also affect stress-test results, adding still more potential capital cost for the largest banking organizations. However, by virtue of both larger reserves and more capital, all banks would have larger loss-absorbency buffers and thus be less fragile than was clearly the result of the incurred-loss methodology.

CECL adds an additional loan-loss reserve cushion not contemplated in the current capital regime. Although current rules now allow limited recognition of allowances for loan and lease losses (ALLL) in Tier 2 capital,[1] reserves have historically not been seen as a substitute for capital because they were generally based on actual loss and thus could come too late for meaningful safety-and-soundness protection. This indeed proved the case during the financial crisis, leading the accounting regulators in the U.S. and internationally to adopt the CECL approach for all financial institutions, not just banks subject to regulatory-capital standards. Banking agencies also resisted offsetting capital for ALLL on grounds that regulatory capital is a bulwark against unexpected loss and reserves, even if under CECL, it only absorbs expected credit risk.

However, the boundaries between expected and unexpected loss in the regulatory capital framework have become blurred as current rules, especially in the advanced approach, adopt much of the CECL methodology for assigning probability of and loss given default. Further, the baseline scenario in stress-test requirements is based on expected losses under likely macroeconomic scenarios, with capital above and beyond this under the stress tests designed to absorb what would otherwise be unexpected loss through capital ratios still premised on the incurred-loss approach no longer applicable at any prior step in the capital framework.

Complicating the impact of this new approach, these changes come at a time also of significant change to the way the agencies are implementing CCAR and the enhanced supplementary leverage ratio (eSLR). The Fed's approach to CCAR[2] would redefine underlying capital rules into stress-capital and stress-leverage buffers, adding the GSIB surcharge atop these to calculate CCAR performance. This approach is likely to reduce CCAR impact for large regional banks in ways that CECL recognition could offset through underlying, higher capital requirements reflecting larger reserves absorbing the stress for which added capital is intended. The proposed eSLR[3] could significantly reduce this capital

1 See **CAPITAL199**, *Financial Services Management*, July 10, 2013.

2 See **STRESS29**, *Financial Services Management*, April 18, 2018.

3 See **LEVERAGE13**, *Financial Services Management*, April 16, 2018.

charge for custody-bank GSIBs less likely to be affected by CECL than GSIBs with large lending books. These non-custody GSIBs could see their eSLR unchanged or even rise based on how the surcharge intersects not only with the new approach to CCAR and the surcharge calculation, but also CECL.

Despite all these questions, the NPR does not change the way in which loan-loss reserves affect regulatory capital. Instead, the agencies intend to monitor the issue. They will look both at reserves and any possible effects on bank lending and, should revisions be warranted, issue a separate proposal. The delay between these accounting rules and their capital impact and any such reconsideration is likely to be lengthy and thus lead not only to near-term capital and earnings effects, but also to structural changes in the way banks do business that would take time to reverse were it even possible to do so. Historically, when banks exit a business and shed requisite infrastructure, it can take considerable time to rebuild that infrastructure and re-enter the business even if all of these new costs appear warranted by future profit prospects following a regulatory change.

Reflecting these issues, the Basel Committee initially proposed not only the transition period to capital recognition now also proposed by the U.S. agencies,[4] but also permanent action to disconnect global capital standards from accounting loss calculations. It ultimately decided not to do so and the U.S. has thus similarly proposed to retain its current approach after various transition periods have ended.

The NPR is premised on a three-year transition period because the agencies believe that banks have had ample time since CECL was finalized in 2016 and, should they use the transition, the additional three years gives them time to develop the capability of establishing likely losses over an asset's lifetime and to handle any short-term increases in capital requirements resulting from adverse macroeconomic circumstances not now factored into ALLL holdings. However, banks are likely to fear significant capital shortfalls given that CECL is in fact coming into effect at a time not only of other regulatory changes with capital costs, but also when the business cycle may well turn and ALLL allocations put aside in benign circumstances will not stand up under more pessimistic, forward-looking projections. The agencies appear to recognize this risk and believe it necessary for banks to absorb it to move CECL to full recognition for capital purposes, but comment on this is invited and surely will be received.

Comments are sure also to press the agencies to distinguish CECL reserving from the capital requirements by, for example, increasing the amount of the loan-loss reserve that counts as regulatory capital. Although the NPR mentions this only in a footnote, it is possible that the regulators read the law as requiring conformity between GAAP's new CECL treatment and the capital rules. This is because a provision in law requires that the accounting principles used for agency filings must be consistent with GAAP. As a result, call reports and similar filings would need to reflect CECL and doing so while at the same time varying the capital standards to reflect non-GAAP considerations would be complex, if not actually prohibited.

What's Next

The FRB released this NPR on April 13 and the FDIC approved it unanimously on April 17. Comments will be due sixty days after publication in the *Federal Register*. CECL implementation deadlines vary by the size of the affected banking organization and the transition periods in this rule thus also vary based on when ALLL methodology must change,

4 See **ALLL2**, *Financial Services Management*, October 18, 2016.

with implementation possible as early as the first quarter of 2019. Overall transition of the capital rules to CECL would take place over three years, although the FDIC notes in the NPR that it considered a five-year transition but rejected this on grounds that it could prove procyclical.

The Board also proposes to defer CECL implementation in its CCAR test until the 2020 round.

Analysis

A. Capital Standards

A new term – allowance for credit losses (ACL) – would be added to the capital rules covering financial assets measured at amortized cost except for certain purchased assets. ACL would then be included in the capital rules in the same manner and to the same extent now provided for ALLL (see above). The regulatory definition of "carrying value" would also be changed so it does not reflect the ACL for assets other than those available for sale (AFS) and certain purchased assets.

Banking organizations are now required under the CECL standard to determine whether a decline in fair value below an AFS debt security's amortized cost resulted from a credit loss, and to record any such credit impairment through earnings with a corresponding allowance. Similar to the current regulatory treatment of credit-related losses for other-than-temporary impairment, all credit losses recognized on AFS debt securities would flow through to CET1 capital and reduce the carrying value of the AFS debt security under the NPR. The agencies are proposing to maintain the requirement that valuation allowances be charged against earnings to be eligible for Tier 2 capital and clarifying that valuation allowances that are charged to retained earnings in accordance with GAAP are eligible for inclusion in Tier 2 capital. The agencies considered allowing banks to bifurcate allowances for purchased credit-impaired assets to include only post-acquisition allowances, but are concerned that doing so could create undue complexity and burden when determining the amount of credit loss allowances for these assets that are eligible for tier 2 capital. Doing so also reduces regulatory capital.

The definition of eligible credit reserves applicable to advanced-approach banks would be revised to conform to this proposal when the bank adopts CECL. Total leverage exposure for advanced-approach banks would continue to include the balance-sheet carrying value (now redefined) of on balance-sheet assets minus deductions from Tier 1 capital. Total leverage exposures would be increased in a phased-in manner consistent with the transition discussed below. However, advanced-approach banks would face additional limits on how CECL amounts may be included in retained earnings, with two options for doing so provided in the NPR for comment.

B. Transition

As noted, the NPR includes an implementation transition option over three years after CECL is required under GAAP. Banks using this transition would need to determine that CECL would reduce its regulatory capital and need to notify its regulators and, for accounting purposes, implement CECL. Banks that do not use this option immediately could not do so later and would need to recognize CECL for regulatory-capital purposes when CECL applies for public reporting. The Board would allow DIHCs and each of their subsidiary insured depositories to make different CECL implementation decisions (a change for these non-bank parents reflecting the different way capital is calculated for them than for BHCs). The NPR details the mechanics for calculating capital amounts when banks elect to use the transition option.

The regulators would use the capital results of the transition for prompt corrective action and other determinations.

C. Disclosures and Reporting

The NPR details how numerous disclosures and reports would have to be updated to reflect CECL.

D. Request for Comment

In addition to general questions on the changes described above, the agencies seek views on:

- other ways to phase in CECL accounting for regulatory-capital purposes and whether to extend the transition period;
- how business combinations should be treated in the transition;
  whether the 2019 CCAR round should reflect CECL;
- the need to change CCAR more generally to reflect CECL;
- the burden of new disclosure requirements; and
- the impact of CECL on the financial system.

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