American Bankers Association
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Via email

Re: 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 *(Docket OCC-2018-0009; FRB Docket No. R-1605/RIN 7100-AF04; FDIC RIN 3064-AE74)*

To Whom It May Concern:

The American Bankers Association (ABA[1]) appreciates the opportunity to comment on the Notice of Proposed Rulemaking *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* (NPR). The NPR recognizes that the implementation of Accounting Standards Update 2016-13 ("CECL", which is effective in 2020, with early adoption available) can have significant implications for bank capital. As a result, the OCC, along with the Federal Reserve and the Federal Deposit Insurance Corporation, are proposing to amortize, on a straight-line basis, the incremental effect that CECL will have on a bank's regulatory capital level at the effective date over three years. ABA supports the agencies' efforts to address the effects CECL will have on regulatory capital. However, a transition based on the "day 1 difference" does not recognize that deterioration in economic conditions experienced soon after the effective date could make such a plan ineffective, if not futile. The transition would be of little benefit within a deteriorating environment.

More importantly, however, is that the proposal within the NPR ignores practical concerns that bankers and industry analysts all recognize: CECL will have an enormous impact on both the volatility and level of bank capital and could increase procyclicality in the industry. As a result,

[1] The American Bankers Association 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 more than $10 trillion in loans.

absent other regulatory guidance, the economics of the business will change, access to certain credit products may decline during economic downturns, and banks of all sizes will need to consider vast changes to product mix and pricing. Indeed, further public policy decisions are needed relating to longer-termed products, such as residential mortgages and student loans, to offerings to non-prime borrowers, and to the role of the community banking sector within an environment of higher operational costs and increased capital volatility.

With this in mind, while the transition terms proposed in the NPR will be addressed later in this letter, ABA first recommends that the banking agencies provide for an ongoing adjustment to Common Equity Tier 1 capital (CET1) that approximates the incremental regulatory capital impact of CECL credit loss allowance levels over levels currently recorded.[2] Until a long-term recalibration of the regulatory capital framework can be completed, incremental allowances required under CECL after the effective date can be estimated through use of streamlined proxy incurred loss methods to mitigate the operational challenges of estimating the differences on an ongoing basis. Such an adjustment will allow time for the agencies to determine how to integrate the higher loss absorbency aspect of CECL into the capital framework and will immediately provide a more level playing field internationally, as CECL allowances are also expected to be significantly higher than those reported under International Financial Reporting Standard (IFRS) No. 9. [3]

Further, we recommend a transparent, two-pronged quantitative impact study (QIS) be performed and shared with the industry that first addresses the impact of higher and more volatile allowances across the industry throughout various phases of an economic cycle. Such a study will assess the impacts to pricing and availability of specific products and the impacts to borrowers of varying credit risk characteristics.

Secondly, the QIS will address the costs and benefits of CECL implementation specifically on medium and smaller-sized banks. As they normally lack a critical mass of loans in their various portfolios, capital volatility will be amplified in these entities. Likewise, the ongoing costs of a reasonable implementation of CECL, including those for auditing, will be significant. At a minimum, this aspect of the QIS will clarify how these banks might compete and serve their communities in such an environment as well as to provide consistent expectations related to operations and auditing.

During the remainder of this letter, we will discuss in more detail the specific issues that will need to be addressed within the QIS and, because of their importance, why an adjustment to

[2] The net impact will also consider any deferred taxes and the availability to include deferred tax assets within the CET1 definition.

[3] ABA believes there may also be various ways to present the difference between incurred and lifetime loss estimates. Some ABA members, for example, believe that CECL estimates beyond losses that have been incurred are similar to market value adjustments on non-trading assets and, thus, should be presented within other comprehensive income. Such a component loss methodology would require engagement with FASB to change GAAP.

CET1 capital is required. Further, we will address several of the specific questions asked within the NPR.

<u>The QIS Should Focus on the Impact to Various Lending Products Over the Economic Cycle</u>

Preliminary estimates from ABA member banks of all sizes[4] indicate potentially significant increases to credit loss allowances are in store related to loan products with long tenors, such as residential mortgages and student loans, as well as to borrowers with non-prime credit quality. More importantly, however, is that these estimates, which are based on results over the period from 2005 through 2012, also show significantly greater capital volatility over the current accounting. For example, using assumptions that would likely have been applied during that period, banks are noting additional allowances that can be up to several times the levels recorded under the current accounting, with differences peaking amidst the bottom of the downturn. An expectation of significant volatility will effectively require an additional capital buffer to be maintained at all times, no matter the point in the economic cycle.

In light of this, with the increased capital requirements implemented through, among other things, Basel III and CCAR/DFAST stress testing requirements, the U.S. banking system is currently considered fundamentally sound by the banking agencies.[5] Therefore, if there is a need for CECL's increased loss absorbency (over incurred loss reserves) in order to help ensure safety and soundness, it appears that the related risks have already been mitigated, indicating a need to offset any incremental amounts back through CET1 capital.

As noted, without an ongoing adjustment to CET1 capital for the incremental difference, it is inevitable that banks will need significantly higher capital buffers and, so, eventually fit them into the pricing (and therefore, the availability) of products and to non-prime borrowers to anticipate times of economic stress. As a result, the QIS must evaluate whether the anticipated impact conforms to the agencies' objectives toward safety and soundness and an adequately liquid lending market throughout an economic cycle. If they do, banks need to know now in order to integrate the changes to the cost of capital in their strategic planning.

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[4] Overall, the industry is still in the beginning stages of CECL implementation efforts, with many smaller banks having performed nominal reviews of requirements. Those that have performed these initial estimates have not finalized many key aspects of their processes, including assumptions that are considered key drivers to credit loss. Each bank, based on their own portfolio credit risk characteristics, assumptions and individual processes, can arrive at estimates that are significantly different from other banks and even from their own previous results. Individual impacts can also be highly influenced by the level of conservatism reflected in allowances recorded today. Therefore, the preliminary estimates should not be used to estimate the impact of any one specific bank or group of banks at the time of the effective date or thereafter.

[5] See excerpt from the OCC Annual Report: https://www.occ.gov/annual-report/condition-of-the-federal-banking-system/index-condition-of-the-federal-banking-system.html that notes of "Robust capital levels."

The QIS Should Consider the Impact of an Increase in Overall Procyclicality

While CECL's forward-looking reserving requirement is designed to reduce procyclicality in the banking system[6], practical application of CECL could prove to be more procyclical than the current accounting. Certain estimates have been performed using "perfect foresight" to simulate how CECL can be expected to perform during an economic downturn (for example, during the financial crisis). These simulations will naturally show earlier credit loss recognition compared to the current accounting.[7] In the real world, however, neither bankers nor professional forecasters have perfect foresight. In fact, accurately forecasting a downturn in the economy has proven to be elusive, even for the most highly respected forecasting organizations. As a result, had CECL been in effect prior to the financial crisis, significant increased credit loss provisioning based on the contemporary professional macroeconomic forecasts available at the time would not have occurred appreciably earlier.[8] Once an economic downturn was recognized, however, the forecasts indicated a deeper and longer recession than was actually experienced. Therefore, at the bottom of the financial crisis, CECL-based credit loss provisions would have compounded the downturn worse than was actually experienced and longer than was actually experienced.

To illustrate this, credit managers generally believe unemployment trends are a significant indicator of credit risk and many banks are expecting to apply forecasts of unemployment within their CECL estimates.[9] The following chart shows how forecasted unemployment[10] from 2006 to 2014, compared to the actual rates (in continuous blue). As can be seen, the unemployment forecasts are relatively benign until 2009, and did not start drastically increasing until 2010. By 2010, however, forecasts "over shot" the actual unemployment rates, with forecasted improvement far less than actual.

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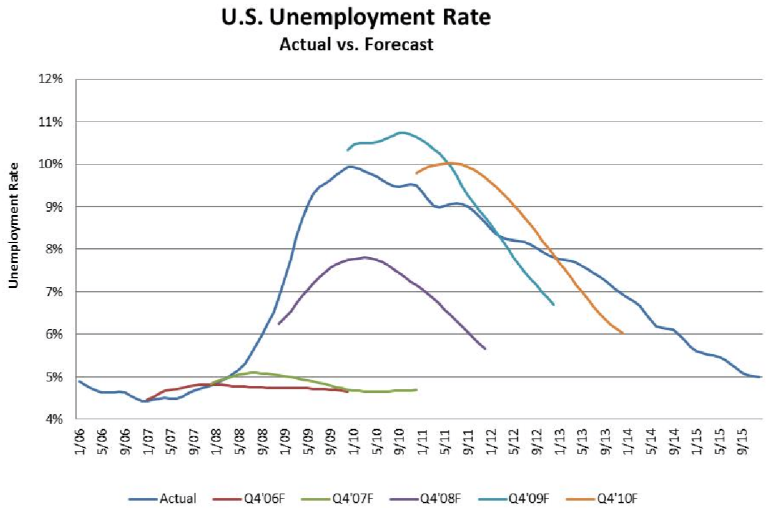
[6] Procyclicality is understood that, during times of economic stress, banks increase credit loss allowances, which reduces capital and the accompanying ability to lend to borrowers who need liquidity, thereby exacerbating the economic stress. Spurred on by the additional economic stress, credit loss allowances will further increase, prolonging the cycle. Earlier loss recognition is desired because it theoretically would decrease capital (and lending) before the economy heats up too much, thereby becoming a counter-cyclical force.

[7] See "The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves," published by The Federal Reserve Board https://www.federalreserve.gov/econres/feds/files/2018020pap.pdf.

[8] Per preliminary analyses performed by various ABA members using economic forecasts available during that time, lifetime credit loss allowances prior to the financial crisis would have indeed been higher than those actually recorded under incurred loss accounting. However, the differences were relatively insignificant.

[9] Due to concerns related to management bias within their estimates, many banks are considering using third party forecasts within their CECL estimates.

[10] Source: The Federal Reserve Bank of St. Louis and Moody's Analytics.



This real life example indicates that, in practice, CECL-based credit loss estimates, which heavily depend on forecasts of macroeconomic factors, will add to the procyclicality of the banking industry and not reduce it. Within the QIS, the agencies must, among other things, weigh the costs of extra capital to the industry against any perceived benefits of expected counter-cyclicality, which now appear to be ill conceived. If the amount of lending in an economy is dependent on levels of deployable capital, CECL will likely further shrink lending during a downturn and keep it lower for a longer period of time, preventing economic recovery. This further supports the need for an ongoing CET1 capital adjustment of the incremental difference in allowance levels.

The QIS Should Consider the Impact of CECL on Community Banks

Preliminary lifetime credit loss estimates indicate that allowances under CECL could require significantly more capital upon implementation for many community banks. For example, a recent study by StoneCastle Partners estimates that hundreds of community banks may need to raise capital merely in order to maintain compliance with regulatory capital requirements at the CECL effective date.[11] On an ongoing basis, the impact of CECL on individual community banks will naturally be significant because the lack of critical mass within community bank portfolios naturally multiplies the levels of capital volatility.[12] This is why the QIS must address not only the banking industry as a whole, but also on how smaller institutions will be able to compete and serve their individual communities.

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

[12] In addition to the lack of critical mass, further capital volatility will likely occur from the modelling risk that would be higher than the related risks assumed by larger banks, as agency personnel are encouraging "non-complex modelling" of CECL credit loss estimates. All other things being equal, non-complex modelling would be expected to result in less precise estimates. Further, preliminary estimates by ABA members indicate substantially lower and less volatile estimates when using more granularity in their models.

As credit loss estimates on loans with longer tenors, such as residential mortgages, are expected to be the most impacted by the change to a life of loan loss measurement, the Agencies should be mindful that over 800 banks in the U.S. with under $1 billion in assets maintain greater than 50% of their loan portfolios in residential mortgage products. Another 1,250 of similarly-sized institutions hold mortgages that make up between 30-50% of their portfolios. Based on preliminary estimates made by various ABA members, serious consideration to raising capital is in store for these entities, and many other smaller institutions due to CECL implementation. As the Agencies know, most of these banks do not have easy access to additional capital. CECL, therefore, will potentially change the face of the community institution.

The QIS must also address how the significant costs of CECL implementation will affect community banks. While agency personnel initially represented that smaller banks could incur little additional cost, agencies are now beginning to understand that a reasonable implementation of CECL will require significant changes to technology and ongoing processes for all but the tiniest of banks. For example, in a February 2018 Federal Reserve/FDIC webinar, agency personnel, for the first time, referred to the need to consider obtaining data warehouse capabilities and acquiring third-party credit loss data. Indeed, such changes in messaging may be due to continuing confusion among FASB and banking regulators on how CECL can be implemented. Held almost two years after the initial issuance of CECL, the February webinar emphasized a CECL calculation method that had been previously publicly discredited by FASB members themselves.

While community banks have recently received relief from complying with the many onerous regulations required through the Dodd-Frank Act, CECL implementation stands to be a continuing cost of business that is likely to be significant. Therefore, the QIS should not only address the one-time and ongoing costs of analyses and governance of CECL, but also the related costs of auditing and reporting.[13] The changes in agency messaging are understandably delaying the implementation efforts of many community banks and the results of the QIS will not only provide an indication of costs and benefits to the community banking sector, but also will provide a basis for consistent and high quality CECL implementation and audit expectations.

[13] ABA points out that it is also likely that many community banks that can otherwise qualify for alternative call reporting requirements may be disqualified under CECL because of leverage ratio requirements. See (Capital Simplification for Qualifying Community Banks) of the Economic Growth, Regulatory Relief and Consumer Protection Act (also known as "**EGRRCPA**").

Additional Comments

The Impact of CECL to Stress Testing Processes Must be Considered

CECL will increase capital volatility within the CCAR and DFAST stress testing processes and the increased volatility must be factored into any decisions related to the recent Federal Reserve proposal "Amendments to the Regulatory Capital, Capital Plan, and Stress Test Rules".[14] The biggest change that CECL presents to the stress testing process, however, is that changes to future economic conditions are immediately factored into current credit loss estimates. For example, if the unemployment rate is slated to be 10% during quarter 9 of the planning horizon, the related credit losses are recognized in the current quarter. In most situations, however, consideration of dramatic changes in assumed economic factors applying to periods so far in the future would be discounted and/or weighed against other assumptions within the governance process. Fully applying such a specific – and dramatically higher – quarter 9 assumption within quarter 1 credit loss measurements would not be realistic. With that in mind, ABA recommends that the stress test processes recognize that, in real life, forecasts of future macroeconomic conditions develop over time, with greater weight given to forecasted conditions as time passes and current conditions change. In other words, perfect foresight should not be assumed. The Federal Reserve must integrate more realistic foresight assumptions into the CCAR process while ensuring simplicity, consistency, and transparency. This can be a challenge. However, ABA members are eager to assist in analyzing the various ways to accomplish this.

Further, consistent with standard practice today, we recommend that the CCAR and DFAST stress testing requirements not be required to be on a CECL basis until the 2021 stress testing cycle. This would allow the 2020 effective date of CECL for GAAP purposes to become the basis for the initial stress tests and would provide additional time for the agencies to address realistic CECL assumptions in CCAR.

A Transition Period Should be No Shorter than Five Years and Should be Flexible

The NPR has proposed a three-year amortization of the incremental CECL allowance at the effective date over the ending incurred loss allowance, using a straight-line method. In the event the agencies are unable to implement a CET1 capital adjustment of the ongoing incremental capital impact of CECL, ABA urges the agencies to use a period no shorter than five years for transition. This is based on the following factors:

- Estimating credit losses over the life of a portfolio is fundamentally different from the current incurred loss estimation processes. Based on discussions with banking agency personnel, auditors, and other regulators, specific CECL practice is expected to evolve over several years. Therefore, the incremental difference of allowances may often be subject to

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[14] See ABA's comment letter at https://www.aba.com/Advocacy/commentletters/Documents/cl-RegulatoryCapital20180625.pdf

significant change throughout the transition period even if economic conditions remain constant.

- Banks will be in the midst of adjusting to the additional capital requirements of recording the value of operating leases on their balance sheets. This is not expected to have significant impact to earnings. However, risk weighting of the resulting right of use assets will require many banks to rethink their strategies on information technology acquisition and branch operations. Juggling these demands with those of CECL requires more transition time.

A five-year transition period will effectively allow a bank to transition through the vast majority of the expected life of its loan portfolio. As the timing and volatility of CECL allowances will change the economics of certain loan products, a longer period length will also assist in mitigating the potential disruption to the market.

While the agencies should allow for straight-line amortization, the agencies should also permit dynamic amortization, whereby differences in allowances from an incurred loss estimate after the effective date can be amortized over the remaining transition period. A dynamic amortization method appears to be the best way to address volatility in the CECL allowance that would result from a subsequent downturn in economic forecasts. In this case, the difference between incurred loss accounting and CECL accounting would be calculated both at the effective date and afterward, with the differences amortized over the remaining life. The same proxies for an incurred loss estimate that are noted for the ongoing CET1 adjustment can be used within this context in order to minimize operational complexity.

Any Transitional Adjustments to CET1 Capital Should Carry Over Within a Business Combination

The NPR proposes that, in the event of a business combination, transitional amounts of an acquiring bank will not include those of the target. Understanding that this is not an issue if CET1 capital is adjusted on an ongoing basis, ABA recommends that both of the transitional amounts be combined for regulatory capital purposes. As noted above, economic conditions will change, CECL practice will evolve, and, thus, banks will need the flexibility to adjust their capital planning strategies. Eliminating any transitional amounts of the target will only reduce such flexibility.

A Comprehensive Review of Regulatory Capital Requirements is Needed

As noted above, CECL credit loss allowances contain significantly increased loss absorbency capabilities relative to incurred loss allowances. Since the current capital requirements are based on incurred credit loss reserving methodologies, a comprehensive revision to the ongoing capital framework is needed. Regulatory responses to the financial crisis have resulted in more stringent requirements related to levels of regulatory capital, leverage, and liquidity. On top of that, new accounting standards expected to go into effect over the next two to three years, pertaining to not only credit losses, but also lease accounting, promise to put further strain on capital adequacy and may result in greater volatility in regulatory capital.[15] Unreasonably high capital requirements inevitably limit access to credit and a revision would also be necessary because of the accumulation of these other incremental efforts to increase capital requirements.

With this in mind, ABA urges the banking agencies to expedite efforts to address the long-term implications of the new accounting standards on both the standardized (risk-weighted) and the internal ratings-based capital approaches. Our 2017 comment letter, in response to the Basel Committee Discussion Paper *Regulatory Treatment of Accounting Provisions*[16], notes:

- The impact of the incremental CECL allowances, and the volatility of those allowances, requires a recalibration of CET1 capital requirements, as noted in this letter.
- The Tier 2 capital add-back of 1.25% of risk-weighted assets should be recalibrated. This point is mitigated by the adjustment we have proposed to CET1 capital.
- A level playing field internationally must be maintained. With CECL's lifetime loss notion, credit loss reserves in the U.S. will normally be significantly higher than those of foreign banks (who adhere to IFRS 9's 12-month probability of default notion for most loans). This difference must be mitigated to allow U.S. banks to compete, which makes the adjustment we have proposed to CET1 especially relevant in the short run.[17]

As noted in our 2017 comment letter, there are several ways to address this complex issue for the long run and our members are ready to work with the agencies to analyze the various options.

This is a critical and challenging issue, as the expected credit loss provisioning that is required under CECL is fundamentally different than current accounting standards. The ongoing impact to capital will be significant and banks may need to change their operating strategies. This is why a quantitative impact study on the impact of CECL is needed. In the meantime, an adjustment to CET1 capital can mitigate anticipated problems until a long-term solution can be implemented.

[15] Effective in 2019 for SEC registrants and other FASB-defined "Public Business Entities" and in 2020 for all other companies, the new lease accounting standard requires lessee/renters to record the value of all operating leases on the balance sheet, thus increasing risk-weighted assets.

[16] See https://www.aba.com/Advocacy/commentletters/Documents/Regulatory-Treatment-Accounting-Provisions-11317.pdf

[17] Some may believe that international implementation of IFRS 9 will increase credit loss allowances to levels exceeding the incurred loss practice in the U.S., thus leveling the playing field prior to CECL implementation. Per Deloitte, however, this is not necessarily the case: "To frame the current playing field, none of the U.S. IRB traditional commercial banks have a capital deduction from CET1 for an allowance for credit losses shortfall as calculated under the existing "incurred loss" model. Under CECL, this trapped capital increases. Conversely, many international banks do have a deduction for a shortfall even after adopting IFRS 9." See https://www2.deloitte.com/us/en/pages/financial-services/articles/us-current-expected-credit-losses-cecl.html?id=us:2em:3na:cecl7:awa:fsi:070918&sfid=0033000000YG0M9AAL

Thank you for your attention to these matters and for considering our views. Please feel free to contact me (mgullette@aba.com; 202-663-4986) if you would like to discuss our views.

Sincerely,

Michael L. Gullette