DISCOVER

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July 12, 2018

Via Electronic Submission

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219
Attention: Legislative and Regulatory Activities Division

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, NW
Washington, D.C. 20551
Attention: Ann E. Misback, Esq., Secretary

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20249
Attention: Robert E. Feldman, Executive Secretary

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 ID OCC–2018–0009 and RIN1557–AE32; FRB Docket No. R–1605 and RIN 7100 AF–04; FDIC RIN 3064–AE74]

To Whom It May Concern,

Discover Financial Services ("Discover") appreciates the opportunity to provide comments to the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (the "Agencies") in connection with the notice of proposed rulemaking addressing banking organizations' implementation of the current expected credit losses ("CECL") accounting standard.[1] As described in the proposal, the Agencies are inviting public input on proposed changes to regulatory capital and stress testing regulations that would, among other things, provide banking organizations the option to phase in the day-one adverse effects on regulatory capital that may result from the adoption of the CECL methodology. For the reasons described below, we believe a more permanent solution is required to ensure regulatory

[1] "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," 83 Fed. Reg. 22312 (May 14, 2018).

capital requirements reflect fundamental changes made by CECL to the standard for calculating credit loss reserves.

Discover is one of the leading direct banks in the United States, offering a broad array of retail banking services to consumers, including deposit products, credit cards, student loans, personal loans, and home equity loans. We have a lend-centric business model with more than 80% of our consolidated assets comprised of loans to individuals. As a result, like most banks of our size, credit risk is the predominant risk for Discover and a primary factor in evaluating the company's capital needs. Changes necessitated by CECL will accelerate the recognition of credit losses and increase allowances, thereby adversely impacting capital levels. The interaction of CECL and regulatory capital rules is therefore a topic of utmost importance to us. In this regard, we have actively engaged with the Financial Accounting Standards Board ("FASB"), the Agencies, and the Securities and Exchange Commission ("SEC") throughout the standard-setting process.

Once implemented at the beginning of 2020, the CECL standard will replace the long-standing "incurred loss" model for calculating credit reserves with a new model that will require banking organizations to hold allowances to cover expected losses over the *lifetime* of the loan. This change represents a major shift in the method for calculating allowances for credit losses and we believe it could have significant adverse impacts on lending practices, borrowers, and the broader economy if action is not taken to address the issue. Requiring banks to recognize all expected credit losses up front, while related revenues are recognized gradually over the life of the loan, fundamentally alters the economics of lending. For instance, the new standard will incentivize short-term lending over longer term products (e.g., 20-yr student loans and 30-yr mortgages) and may necessitate some banks to change their pricing practices.

There is also well founded concern that CECL will have adverse macro-economic impacts on credit markets during recessionary periods. Given the inherent difficulty in forecasting macro-economic conditions, many banks may not foresee the need to build credit reserves until economic conditions have already begun to deteriorate, which would have procyclical effects. The up-front negative impact on earnings when booking new loans under CECL will also create a strong disincentive to grow loans during a stressed environment as banks seek to conserve capital. This would further constrain credit availability during a downturn in the economy. Although there has been much discussion about these issues, it does not appear policy-makers have performed the type of robust quantitative impact study that is necessary to fully understand the consequences of the impending changes.

One thing that seems reasonably certain is CECL will increase aggregate credit reserves across the banking industry, to varying degrees for individual institutions. Depending on an institution's portfolio composition, CECL will require some banks to hold significantly larger reserves against their loan portfolios without any change in the underlying credit characteristics of the loans. Therefore, because reserves generally do not count as capital, CECL will in effect substantially increase the total loss absorbency requirements for many banks in the United States. This impact will only be felt by U.S. banks and their holding companies, which could create competitive imbalance versus nonbank and international lenders. The changes will have been imposed in

effect by the FASB without opportunity for notice or comment from the banking Agencies until now.

The recommendations we describe below include ways in which the Agencies can adjust the proposed changes to regulatory capital requirements to address some of the unintended consequences of CECL while accommodating the FASB's accounting goals in issuing the new standard. In that regard, we recommend the Agencies: (I) recalibrate the regulatory capital framework to neutralize the long-term impact of CECL on banking organizations' capital requirements; and (II) extend the proposed transition period from 3 to 5 years to further study the impact of CECL on lending and the economy.

I. The Agencies should recalibrate the regulatory capital framework to neutralize the long-term impact of CECL on banking organizations' capital requirements.

As described in the notice, the proposed 3-year transition period is intended by the Agencies only to smooth out "day-one" impacts of CECL on regulatory capital. The proposal would not address any of the longer-term impacts described above. We believe more permanent adjustments to the regulatory capital framework are necessary to ensure the requirements are properly calibrated. CECL will significantly increase credit loss allowances for many institutions without any change in the institution's business model or risk profile. Credit reserves, like capital, are intended to absorb future losses and thus provide protection against risk.[2] However, under the Agencies' current rules, reserves generally cannot be counted toward a banking organization's capital ratio requirements. As a result, CECL will require banks to utilize earnings both to build reserves *and* to replenish retained earnings to continue to meet capital requirements on an ongoing basis. The change in accounting standards will act, in effect, as a new capital requirement by increasing the total loss absorbency requirements for many U.S. financial institutions.

In light of these fundamental changes brought about by CECL, the Agencies should revise existing regulatory capital rules to neutralize the long-term capital impacts. The FASB itself has clarified that CECL "is intended to reflect—not to drive—economic activity and behavior" and has acknowledged that "regulatory capital requirements and other public policy considerations are decisions appropriately left to regulatory and political bodies."[3] It should also be noted that there have been significant changes to the regulatory capital framework, particularly for large and mid-size firms, since the CECL standard was originally proposed in 2012. These developments have increased both the quality and quantity of capital that banking organizations are required to hold to buffer against losses.

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[2] We acknowledge that tier 1 capital has greater *overall* loss absorbency because it is available to cover losses other than credit loss; however, credit remains far and away the predominant risk for most lending institutions in the United States.

[3] *See* Letter from Russell G. Golden, FASB Chairman, to Representatives Scott R. Tipton and Patrick E. Murphy (February 22, 2016).

There are several ways the Agencies could adjust regulatory capital rules to reflect the impact of CECL, including making adjustments to risk weighted assets or an across the board reduction in minimum capital requirements. However, a preferred simple approach would be to provide credit towards common equity tier 1 (CET1) capital for CECL reserves that exceed a stipulated level such as expected losses over a fixed time horizon (e.g., 12-months). Using a fixed 12-month time horizon would be the most capital neutral, would ensure consistency among institutions, and would be relatively simple to operationalize and calculate. This approach would also be transparent to financial statement users through disclosure of the capital component representing expected credit losses beyond the defined horizon. The goal of any changes to the current rules should be to incorporate the increased loss absorbency of CECL reserves into regulatory capital calculations to permanently offset the capital impacts. We believe implementation of CECL should be capital-neutral.

II. The Agencies should extend the proposed transition period from 3 to 5 years to further study the impacts of CECL on lending and the economy.

If the Agencies are unable or unwilling to implement permanent changes to regulatory capital rules prior to the implementation date for CECL, the Agencies should extend the proposed phase in period from 3 to 5 years. A 5-year phase in would be consistent with the international standard adopted in Europe and elsewhere for transitioning to the comparable IFRS 9 accounting standard. A longer transition period would also provide the Agencies additional time to study the impact of CECL on bank capital levels and credit availability and to assess potential changes to the regulatory framework. We encourage the Agencies to work with the FASB and others to perform a rigorous quantitative impact study that considers the long-term implications of CECL before its effects are fully realized.

Discover appreciates the Agencies' attention to this critically important issue and we are grateful for the opportunity to comment on the proposed rulemaking. We respectfully request that you carefully consider the recommendations in this letter and would welcome further constructive dialogue to ensure the accounting changes are implemented in a manner that meets the FASB's goals while mitigating unintended consequences that could result from the interaction of CECL with regulatory capital requirements.

Sincerely,

R. Mark Graf
Executive Vice President, Chief Financial Officer