AFR Americans for Financial Reform

Education Fund

July 13, 2018

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW
Washington, DC 20219

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429

Ms. Ann E. Misback
Secretary Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Docket ID OCC-2018-0009; Docket No. R–1605 and RIN 7100–AF04; and RIN 3064-AE74.

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.

To Whom It May Concern:

Americans for Financial Reform Education Fund (AFR) appreciates the opportunity to comment on the above referenced proposed rule (the proposed rule or the proposal) by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (together, the agencies).[1]

We generally support the manner in which this proposal provides for the implementation of the Current Expected Credit Losses (CECL) methodology. We particularly support the agencies decision to properly reflect the impact of CECL implementation on Tier 1 equity capital, without artificially reducing required equity capital in a manner that would reduce the effect of CECL implementation on the total resources banks set aside in advance to absorb losses.

[1] Americans for Financial Reform is an unprecedented coalition of more than 200 national, state and local groups who have come together to reform the financial industry. Members of our coalition include consumer, civil rights, investor, retiree, community, labor, faith-based and business groups. A list of coalition members is available at: http://ourfinancialsecurity.org/about/our-coalition/

The new CECL accounting standards will replace the current approach, commonly known as the "incurred loss" methodology, to shift the way banking organizations estimate and record their credit losses. Under CECL, upon recording a loan, banks will be required to recognize the expected credit losses over the entire lifetime of the loan, forecasting these losses using a combination of historical data and the impact of current and predicted future economic conditions. This is a change from the current method of recognizing credit losses that have actually been incurred or that have crossed a probability threshold for recognition.

With these methodological changes, the CECL framework will result in earlier recognition of credit losses. If effectively implemented, CECL should have a significantly countercyclical effect compared to the incurred loss accounting used over the past several decades. The negative effects of incurred loss accounting was clearly observed during the 2008 financial crisis, when loan loss allowances did not begin to build up until provisions were sharply increasing and the crisis-induced recession had already begun (and allowances did not peak until 2010).[2] These allowances thus provided no advance funding for loan losses and were useless in buffering the impact of the recession on financial intermediation.

The failure to do advance recognition of loan losses also contributed to the large scale collapse of confidence by investors in bank financial data, which contributed centrally to the failure of financial markets. As Stefan Ingves, the then-chair of the Bank of International Settlements, later explained:[3]

> "…under existing accounting standards, bank provisioning for credit losses on their loan books was backward-looking. The incurred loss model that underpinned IFRS and US GAAP prevented banks from making forward-looking assessments of likely losses. So provisions had not been adequately built up in good times, and there was considerable uncertainty about what additional provisioning might be needed. All of this meant that, when confidence in banks was most needed, the key regulatory metric of financial health - the regulatory capital ratio - was increasingly discounted because it potentially overstated a bank's true loss-absorbing capacity."

Indeed, the initial SCAP stress testing efforts were in part driven by the need to provide trustworthy information to the market about the potential "hole" in bank balance sheets that could be created by future loan losses.[4]

[2] See Figure 1 in Chae, Sarah, Robert F. Sarama, Cindy M. Vojtech, and James Wang (2018). "The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves," Finance and Economics Discussion Series 2018-020. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2018.020 .
[3] Ingves, Stefan, "Restoring Confidence in Banks", Keynote Address to the 15th Annual Convention of the Global Association of Risk Professionals, New York, 4 March 2014. https://www.bis.org/speeches/sp140304.htm
[4] Wall, Larry, "Measuring Capital Adequacy", Federal Reserve Bank of Atlanta Working Paper 2013-15, December, 2013.

If properly implemented, CECL should also increase incentives to restructure troubled debt by providing needed loan modifications in recessionary period, since potential losses from troubled debt restructurings should be incorporated into forecasts in advance.[5]

In sum, replacing the backward-looking incurred loss accounting for loan losses with the forward looking CECL methodology offers macroeconomic benefits and a greater potential for the understanding of risks and losses by regulators, investors, the public, and banks own credit risk managers.

CECL and regulatory capital ratios

One immediate effect of introducing CECL will be to reduce banks Tier 1 equity capital. As of the beginning of the first reporting period after adoption of CECL, banks will have to record an adjustment to their allowances for credit losses equal to the difference between its pre- and post-CECL amounts of credit loss allowance. This adjustment to credit loss allowances will be recorded in banks financial statements with offsetting adjustments to retained earnings. Since retained earnings are included in common equity tier 1 (CET1) capital, the one-time adjustments to allowances for credit losses, retained earnings, and DTAs will affect the calculation of a banking organization's regulatory capital ratios. Specifically, the increased allowances contemplated in CECL are expected to generally reduce banks retained earnings and consequently their measured CET1 capital.

Banking organizations and industry groups are objecting vociferously to this increase in required capital, arguing that current bank capital standards are "calibrated" to previous incurred loss accounting and bank capital minimums should somehow be reduced through an ongoing and continuous "adjustment" to eliminate any effects of CECL introduction on required capital.[6] However, current minimum capital requirements are not calibrated to past accounting standards, but instead to macroeconomic estimates of the costs and benefits of capital.[7] Furthermore, as AFR has mentioned in previous letters, there is extensive evidence that current minimum capital requirements are below the range of socially optimal levels from a macroeconomic cost-benefit perspective and are therefore calibrated at too low a level.[8] This literature suggests that the

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[5] Whether this potential benefit of CECL is fully realized will depend in part on technical issues in loss forecasting.

[6] For example see: David Wagner, "Arrival of CECL triggers new bank capital debate," The Clearing House, Blog post, February 8, 2018, available at: https://bit.ly/2mhfFfK; or the letter from the American Bankers Association on this rule proposal, dated July 13, 2018 and available at https://www.regulations.gov/document?D=OCC-2018-0009-0013

[7] See e.g. Bank of International Settlements, "An Assessment of the Long-Term Economic Impact of Stronger Capital and Liquidity Requirements", August, 2010. Available at https://www.bis.org/publ/bcbs173.pdf

[8] Firestone, Simon, Amy Lorenc, and Ben Ranish (2017), "An Empirical Economic Assessment of the Costs and Benefits of Bank Capital in the U.S.", Finance and Economics Discussion Series 2017-034. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.034; Passmore, Wayne, and Alexander H. von Hafften (2017). "Are Basel's Capital Surcharges for Global Systemically Important Banks Too Small?," Finance and Economics Discussion Series 2017-021. Washington: Board of Governors of the Federal Reserve System, https://doi.org/10.17016/FEDS.2017.021; Cline, William, The Right Balance for Banks: Theory and Evidence on Optimal Capital Requirements, The Peterson Institute, May, 2017; Fabrizio Perri and Georgios Stefanidis, "Capital Requirements and Bailouts," Federal Reserve Bank of Minneapolis, August 21, 2017, available

introduction of an accounting standard that would lead to some decline in measured Tier 1 capital would be completely appropriate.

In addition, continuously adjusting capital requirements to essentially negate the effect of CECL on equity capital could undo many of the benefits for which CECL was designed. As loan loss forecasts under CECL led to increases in advance loan loss reserves and declines in retained earnings, regulators would simultaneously reduce the amount of equity the bank would have to hold, therefore permitting continued payouts of retained earnings to shareholders. The increase in advance loss provisions in one area of the bank balance sheet would simply be counterbalanced by the decline in advance provision for losses in another area. It hardly seems reasonable to require the effort to implement the new CECL accounting standard while at the same time negating many of its practical effects.

Banks are also arguing that although CECL on the face of it appears to be clearly counter-cyclical, it could in practice be pro-cyclical if expected loss modeling is systematically and significantly mistaken in predicting the severity of loan loss experience in recessions.[9] No doubt a wide variety of negative effects could occur if expected loss modeling under CECL is systematically flawed. However, this should be addressed through proper supervision of such loss modeling, not by dropping the CECL concept or by blunting its effects through adjustment of bank capital. Conceptually, the advance loan loss reserving that is created by CECL accounting is clearly counter-cyclical if properly implemented and can hardly be more pro-cyclical than simply failing to reserve against loan losses until such losses have already happened, as occurred during the 2008-2010 financial crisis and recession.

Agency Proposal

To addresses the potential reduction in CET1 capital, the agencies propose giving banking institutions the option to phase-in the day-one effects of the CECL standards over a three-year transitional period. If an eligible bank does not elect to use the transition option in its first regulatory reporting period after implementing CECL, it will not be permitted to elect it on subsequent periods. Upon electing the phase-in option, banks would calculate the difference between pre- and post-CECL allowance for credit losses, retained earnings, and DTAs and would be able to adjust their regulatory capital calculations by transitional amounts for three years.

We support the proposal to phase in CECL impacts on capital. However, we strongly believe that such impacts should be fully reflected and that their recognition should not be excessively

at: https://bit.ly/2um03wf; "The Minneapolis Plan To End Too Big To Fail," Proposal by The Federal Reserve Bank of Minneapolis, November 16, 2016, available at: https://bit.ly/2mcIdHo.

[9] ABA Letter

delayed. Any further delay beyond the already generous three year phase-in period provided in this proposal would not be appropriate.

Additionally, we believe it is important that the forthcoming rule maintain the proposed increase to total leverage exposure by the respective CECL transitional amount, for the purposes of the supplementary leverage ratio calculation during the three-year transition period. Adjusting the denominator of the supplementary leverage ratio (i.e., total leverage exposures) to align it with the adjustments to the numerator (Tier 1 capital) is essential to maintain consistent, effective leverage buffer requirements that take into account risk exposures that could materialize as losses for the a bank.

Specific questions in the proposal

Question 3: The agencies seek comment on the sufficiency of the proposed three-year transition period. Would a different time period be more appropriate? If so, why?

The three-year phase-in period is an appropriate amount of time for banking organizations to smooth out the potential day-one adverse effects on regulatory capital of adopting the new CECL methodology. This period should be sufficient for these organizations to transit to the new standards and to bring their regulatory capital ratios into compliance with the agencies' capital rules. In fact, and as noted in the proposed rule, since the Financial Accounting Standards Board issued the new accounting for credit loss methodology in 2016, banking organizations will have had four years to prepare for CECL in addition to the three contemplated in the transition period.

The transition adjustment already effectively allows banks to postpone recapitalization for three years—for those banks which would need to under the new CECL standards. It would be worrisome if the agencies were to grant any extension of the three-year period to phase-in immediate reductions in regulatory capital as a result of the new accounting standards. Not only we oppose a longer transition period, but requests of such nature, this late in the game, should be taken as representative of inadequate capital planning by a banking organization.

Implementing a forward-looking model of credit loss recognition is a significant strength of the CECL framework vis-à-vis the incurred loss methodology—and delaying full compliance would be inappropriate.

Question 7: The agencies are requesting comment on the proposed CECL transitional amount limitation for certain advanced approaches banking organizations that have an ECR shortfall. What, if any, are the associated advantages and disadvantages of the alternatives provided by the agencies?

We are concerned that banks with eligible credit reserves (ECR) shortfalls could experience a fictitious increase in their core loss-absorbing capital requirements. Under current rules, banking organizations using the advanced approaches capital framework (and that have completed the parallel run process) can include in their adjusted total capital any amount of ECR in excess of their regulatory expected credit losses, up to 0.6 percent of credit risk-weighted assets. While if their ECR are lower than the expected credit losses—i.e., they have an ECR shortfall—they are required to deduct the shortfall from CET1 capital. We believe this is an appropriate deduction from the CET1 capital to provide a more accurate picture of the core loss-absorbing capital a bank has to weather rainy days.

The changes contemplated in the proposal would allow an additional transitional amount in the calculation of the ECR, to phase-in the immediate increase of these reserves upon adoption of CECL. However, even with the phase-in method, the ECR increase would close the shortfall gap between those reserves and the expected credit losses. In other words, the ECR increase carries a concurrent reduction in the ECR shortfall that can be deducted from CET1 capital. As a result, and ceteris paribus, advance approaches banking organizations that have ECR shortfalls pre-CECL would end with greater post-CECL CET1 capital.

The agencies' joint proposal clearly states that the "CECL transition provision is designed to phase in the day-one *adverse* [emphasis added] impact on a banking organization's regulatory capital ratios resulting from its adoption of CECL."[10] Specifically, the stated objective of the proposal is alleviating the CET1 capital reductions that banks would generally experience as a result of the increased credit loss allowances and subsequent reduction in retained earnings, immediately after implementing CECL. We support the transitional amount limitation and believe it is important to avoid contradictory, "undue" benefits to banking organizations with an ECR shortfall prior to adoption of CECL and that may experience an increase in CET1 capital instead of a reduction.

Concluding comments

Thank you for the opportunity to comment on these proposals. If you have questions, please contact AFR's Policy Director, Marcus Stanley, at marcus@ourfinancialsecurity.org or at 202-466-3672. Thank you in advance for your attention to this letter.

Sincerely,
Americans for Financial Reform Education Fund

[10] Proposal, at p. 22317.