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From: Brice A. Luetkemeyer [redacted]
Sent: Monday, October 21, 2019 3:21 PM
[redacted]
Subject: [EXTERNAL MESSAGE] Comments concerning Proposed Interagency Policy Statement on Allowances for Credit Losses - October 17, 2019

Please see the attached Op-Ed that I wrote and my list of concerns that I compiled as I read through the accounting standard (CECL) and started to apply to our Bank. I included some of the comments from FASB officials that they made, when I discussed my concerns with them.

Please call if you have any questions ! Thank you !

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BankThink CECL: A solution in search of a problem

By Brice Luetkemeyer
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More in CECL,Community banking,Small business,Small business lending,Accounting methods,Accounting standards,Russell Golden,FASB

As a banking professional for more than 40 years, I'm baffled at comments by the head of the Financial Accounting Standards Board, which show a clear disconnect from the reality that community bankers are facing with one of the most significant changes to accounting standards in recent memory.

The FASB Chairman Russell Golden recently said that the primary reason for the new current expected credit loss, or CECL, standard is to give more information to potential investors and stakeholders; and that investors favor CECL.

However, a recent survey conducted by investment house Janney (then FIG Partners) indicated that 75% of bank investors opposed CECL. Even accepting Golden's premise, he neglected to say that a majority of U.S. banks are not publicly traded, which means those banks should not be subject to the CECL standard meant for publicly traded firms.

It is interesting that Golden said "the board believes the benefits justify the cost." The FASB was required to do a cost benefit analysis, but didn't.

There are certainly a few costs that come to mind: the reduced availability of credit in the next economic downturn; the increased cost of credit to consumers and small businesses; the additional cost to buy a house; the yet-to-be determined additional reserves required for Fannie Mae and Freddie Mac; and additional operational costs for all financial institutions.

All of these costs will be passed on to the consumer. This sounds like a benefit for investors on Wall Street, at the expense of people on Main Street. How can anybody conclude that the benefits justify the cost, when we don't know what the cost will be?

Golden also does not mention that the additional pro-cyclicality of CECL would lessen the availability of credit to those most in need during the next recession.

Generally, lending is a greater part of a smaller bank's business than it is for large institutions. This means that smaller institutions are likely to be hit the hardest during the next recession by this incoming standard.

The CECL standard could be devastating to thousands of small business owners who mostly rely on their local community bank for lending. Especially in a recession, small business owners will need their local banker to work with them instead of facing delays because of the immediate impact CECL has on financial statements.

By requiring banks to account for the expected lifetime losses of a loan at the time of origination, there will eventually be shorter maturities on loans. This will result in more economic volatility, placing swings on the back of the consumer.

Consumers and small businesses will, in turn, be more hesitant to borrow because of the uncertainty of credit availability and greater interest rate volatility. This will particularly hit any consumer with marginal credit history. And many loans will simply move to the shadow banking sector, where federal regulators have limited purview.

I fundamentally disagree with recognizing credit loss expense at the time of booking the loan, while not recognizing the interest income earned on the same asset until much later. In other words, this standard forces an undeniable understatement of the bank's capital and assets.

Golden does point out that FASB has given smaller institutions a longer time to implement the standard and is considering further delay. I'm glad that he is finally recognizing the massive efforts needed and that there are costs involved.

However, even for the small institutions it is still the same pain, just delayed. But the cost of each employee's time to compile information, manage third-party vendors, data feeds and modeling will be significant and be passed on to the consumer.

The standard also tries to justify itself by saying that there is diversity in the current practice of incurred loss methodology. But the various 'suggested' methods in the standard guidance show a diversity in results, even when using perfect foresight or hindsight.

When examiners come into my bank, our justification for doing everything has to be rock solid. We can't tell them something and then say we disagree with our justification later, when it doesn't fit the narrative.

From a practical application, CECL effectively 'regulates' the adequacy of the loan loss reserves for the financial institutions, taking responsibility from the federal and state banking regulators.

As a bank examiner from 1978 through 1988, I saw firsthand the recession of the early 80s and was responsible for overseeing the closure of several insolvent banks. While I held it to be a very sad and sickening situation, there were lessons learned by examiners, who realized what was important in analyzing credit risk and loan losses.

Those processes have continued to improve since the 2008 recession. Today, the examiners require bankers to properly justify their reserves, as they should. The current process and reserve levels have improved significantly and are working quite well, even prior to CECL's implementation.

It is clear that this standard is a solution in search of a problem. It should be scrapped immediately.

Brice Luetkemeyer

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CECL Concerns:

I have continued to study this standard, and am more concerned than ever for the following reasons:

1. The reason given for the standard is so potential investors and stakeholders have more information. (This is the same reason given a few years ago for the mark-to-market accounting standard proposal, that was later withdrawn) Of course, investors and stakeholders (most of which appear to be organizations that won't have the expense of complying with this Std) would be all for something that doesn't cost them anything. Also, publicly traded banks already do some of this disclosure. Therefore, I don't believe there is a good reason why any bank, much less, non-publicly traded banks should be subject to this standard. Who are these stakeholders? How many non-publicly traded banks wanted this additional requirement/burden? It is death by a thousand regulatory cuts.
   FASB response: More information is better, and should include non-publicly traded banks.

2. FASB is trying to regulate the adequacy of the ALLL. But, it is the Regulators' job to regulate that. The regulatory agencies should really care about this and try to push back on this, because it will definitely increase volatility (financial instability) in the banks in an economic downturn. The volatility occurs because of the requirement to calculate provisions for the life of the loan, which will multiply the amount needed with each downgrade of a loan portfolio. Example – the banks in our peer group are currently expensing/provisioning 9 basis points. The same banks provisioned 40 basis points each year through the 2009 – 2011 recession. So, the current reserve would be approximately 9 basis points times our bank's 5 year average maturity, which equals 45 basis points. If we would suddenly go into a similar recession, like we did then, the requirement for ALLL would be 45 basis points times 5 years or 200 basis points, or, decrease the capital to assets ratio from say 9% to 7.5%.

   Currently under CECL:

Peer group provisioning	9 basis points	Peer 2009-11	40 basis points
Times average maturity	5 years		5 years
Bank's CECL required ALLL	45 basis points	Needed in sudden recession	200 basis points

   For even an average bank, they would need to provision 155 additional basis points, or capital to assets ratio would reduce 1.55% to fund ALLL. A bank just outside the 'average', say 10 basis points are needed now and 60 basis points during the recession – so 60 bp times 5 years equals 300 basis points, and during recession would have its capital to asset ratio decrease from say 9% to 6.5%, or 8% to 5.5%, to fund ALLL. Any additional or unexpected risk multiplies the provision and problem. These average, or close to average, banks will be required by their regulators to find more capital (or shrink the bank to the capital available). Ultimately, it will force more (particularly small) banks to sell and/or consolidate, if they don't fail. Then limiting customer choice.

FASB response: Since the bank's start out with an increased ALLL, that later increase is smaller. FASB also said they "didn't focus on the pro-cyclicality of the standard", but didn't think that it would cause a problem in this area.
As you can see by my simple calculation, I can't possibly agree with their conclusions, and in fact, makes it considerably worse.

3. Because of the requirement to calculate on maturity or length of loan, it will take additional reserves and capital, and will result in an even greater reduction in longer term maturity mortgages going out of the banking sector. Since federal government entities that lend, such as Farm Services Agency, who make longer term loans and are not subject to this Standard, will have yet an additional competitive advantage. An unintended consequence is, by limiting consumer options, it ultimately becomes a higher cost of credit to the consumer.

4. The Standard talks about 'both financial institutions and users of their financial statements expressed concern that current GAAP restricts the ability to record credit losses that are expected, but do not yet meet the 'probable' threshold.'
   FASB response: Congress mandated GAAP accounting after the 1980s recession.
   I disagree, as examiners currently make the banks' reserve for some level of historical losses plus specifically identified amounts of risk with identified risk in specific credits. Banks have always had some differences in accounting for taxes, depreciation, book figures, etc. Why should this be any different?

5. The Standard talks about 'the delayed recognition of credit losses that results in the potential overstatements of assets.' I just fundamentally disagree with recognizing credit losses at the time of booking of the loan, and <u>NOT</u> recognizing the interest earned on those <u>same</u> assets until <u>later</u>. Therefore, the Standard forces an <u>understatement</u> of the Bank's capital account and assets.
   FASB response: We know that we will have 'some' loss every year, therefore, the banks need to take it now, rather than by the current incurred loss standard.

6. The Standard also tries to justify itself by saying that there is diversity in the current practice of applying the incurred loss methodology. The various 'suggested' methods in the Standard appear to show a diversity in results, <u>even using perfect foresight/hindsight</u>.
   FASB response: <u>FASB disagrees with a study it used in its own presentation to justify the Standard</u>.

7. The Standard talks about the measurement of expected credit losses based on past history, current conditions and forecasts. While I think that the banking industry as a whole could probably do a better job of (short term) forecasting and therefore provisioning a little sooner, that is exactly what we are required to do right now – probably stretching current GAAP requirements by looking forward slightly.
   FASB response: They had a Study that showed banks that provisioned earlier, made a lot more loans through the recession.
   As we all know, the majority of Banks restrict credit through times of economic downturn, not increase them, as provisions increase and capital is impacted. And this hits the lower end of credit-worthiness borrowers the hardest.

8. The GSEs (Fannie Mae and Freddie Mac) are subject to GAAP and therefore, will have to somehow increase reserves. Does that mean increased guarantee fees, increased mortgage costs, and/or decreased availability of mortgages – particularly to lower income borrowers? Which 'stakeholders' wanted GSEs included??

9. The Standard requires that the Banks must partly base the measurement of expected credit losses on the Bank's own economic forecasts. Everyone can see how bad the FRB has done forecasting over the past couple decades, ie. greatly understated unemployment early in the recession and then greatly overestimated both the severity and the length of economic problems. So, how can the Banks be expected to do better than the highly educated and acclaimed FRB economists?

10. FASB and IASB (International Accounting Standards Board) jointly established a Financial Crisis Advisory Group to advise each board on the global environment after the financial crisis. IASB independently issued IFRS 9, the international version of CECL. Many experts in the financial industry believe that the IASB's credit loss model would result in lower reserves than CECL. The ABA has stated, this new Standard would require banks in the United States to hold significantly higher reserves than foreign banks that follow IFRS 9 (IFRS 9 is a 12 month default estimate, of which the US regulatory agencies have noted, is sufficient). So, why are the regulatory agencies agreeing to enforce an unfair accounting standard change, considering that the FED, OCC, FDIC and our State, as part of our ongoing examination process, already do a great job of doing an extensive analysis of our loan quality to insure the adequacy of our Loan Loss Reserve?

11. No cost vs benefit analysis for this Standard. FASB did <u>not</u> follow their <u>own</u> rules in promulgating this Standard.
    FASB response: Just a continuing thought process, continuing to revise as they get more feedback. Also, non-public institutions don't have to do some of the disclosures.

12. CECL requires banks to identify loss in loans at the time of booking, so that looks like fertile ground for directors to be sued about approving loans with loss, if the bank fails. It would appear to give attorneys additional arguments in that situation. Also, how will insurance companies that issue Directors and Officers Liability coverage handle this? Increase premiums, limit coverage, or refuse to issue coverage?

13. If CECL is expected to be implemented, it should be delayed so that Basel III and other capital rules can be revisited before implementation. This is because risk-weighted assets and capital buffers do not appear warranted and are duplicative when ALLL is more comprehensive in identifying and reserving for losses for the life of loan compared to the current incurred loss methodology.