

CECL Accounting Standard for Credit Losses

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Issue Update

FASB's Current Expected Credit Loss ("CECL") accounting standard requires banks to record allowances for credit losses on loans and held-to-maturity debt securities at origination, based on a so-called "life of loan loss" expectation. Issued in 2016, CECL requires forecasting all future losses, a process that increases the complexity of this highly judgmental area of accounting, adds to the volatility of regulatory capital and may also add to the procyclicality of the banking industry. Its upfront loss recognition requirement also changes the economics of lending, as more capital is required at the time of origination. The standard will be effective in 2020 for SEC registrants, 2021 for non-registrant banks with outside equity/debt holders, and 2022 for privately-held and mutual banks.

Many factors will determine the regulatory capital impact of CECL for each bank. However, preliminary estimates indicate that the CECL standard can increase the ALLL and its volatility by multiples for products that are long-tenored, such as residential mortgages, and for those loans that are issued to non-prime borrowers. Due to the inability of professional economic forecasters to foresee turns in the economy, banks are also noting that, had CECL been in place prior to the Financial Crisis, CECL would have added to the procyclicality in the industry. Further, the punitive effect of recording a lifetime loss upon origination severely curtails the incentive to provide credit during such times.

In addition to the regulatory capital impacts, larger U.S. banks will also be subjected to a capital disadvantage from CECL, compared to foreign banks that apply the more lenient international standards. Community banks will be heavily impacted, too, as a recent study noted that several hundred should consider raising capital just for CECL's impact and capital volatility will also be higher within smaller bank portfolios. Their biggest challenge, however, may be the operational impact. Costly new systems and processes to track loan performance are normally needed to be purchased or developed for banks of all sizes. While regulators insist the sophistication of a bank's CECL process should be consistent with the sophistication of its operations, significant procedural and data challenges will, nevertheless, be faced both in implementation and on an ongoing basis, especially in the face of increasingly stringent auditing standards.

Why it Matters To Your Community

Higher and more volatile ALLL levels and higher operational costs will reduce available capital and limit a bank's ability to meet credit needs, especially during an economic downturn.

Recommended Action Items

- The banking agencies must revisit Basel III regulatory capital rules to ensure consistency with CECL. In the meantime, until such a regime is finalized, the incremental CECL levels compared to current accounting should be added back to CET1 capital levels.
- The agencies should perform a quantitative impact study to:
 - a. Assess the impact of CECL on the industry and lending throughout an economic cycle.
 - b. Assess the costs of CECL to smaller banks, considering stringent auditing standards.