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CECL Issue Summary

In June 2016, the Financial Accounting Standards Board (FASB) published the Current Expected Credit Loss (CECL) standard, an accounting methodology for how banks account for credit loss. CECL represents the most significant rewrite of U.S. GAAP accounting standards in 40 years. Under the current U.S. GAAP standard, banks are required to set aside capital based on an "incurred loss" model, meaning that it is probable that a loss has occurred and that the size of the loss can be estimated. In contrast, under CECL, banks will need to establish reserves upon origination of a loan to offset all future "expected losses" that could arise over the entire life of a loan.

BPI's Position

While proper provisioning for loan loss reserves is an important accounting and regulatory policy objective, CECL's approach would not accurately reflect banks' credit losses, and CECL's flaws would have significant negative consequences. For example, BPI research found that adopting CECL could significantly exacerbate economic downturns. This will be felt by banks of all sizes, as accounting standards apply in the same way across the entire banking industry, making the stakes high for the entire economy. Regulators have proposed a three-year phase in only for the capital impact of CECL upon adoption under GAAP beginning in 2020.

Recommendation: Before moving forward, regulators should conduct a thorough analysis of the economic impact of implementation and, under any circumstances, banking agencies should offset the impact of the change in the accounting standards on bank regulatory capital until the behavior of CECL reserves during an economic downturn is better understood.

Procyclical, Not Countercyclical

A regulation is "procyclical" if it exacerbates business cycle fluctuations and "countercyclical" if it mitigates them. CECL supporters argue that it will make banks recognize losses in advance of a crisis, so they will have pre-built reserves when an economic downturn hits, and therefore will not have to begin reserving for them only as losses build. Unfortunately, no one – banks included – has perfect foresight or the ability to predict a recession in advance. Analysis from BPI found that because of this inherent difficulty to predict turning points in the business cycle, CECL would make future economic downturns worse, as banks retract from lending due to higher expected losses they would have to assume. CECL thus runs counter to FSB's goal of countercyclical reserving, as it would force the industry to hold much higher reserve on loans during an economic downturn, making it, instead, procyclical.

The stakes are high: BPI research, which estimated the impact that CECL would have had on the 2007-2009 financial crisis, showed that had CECL been in place, bank lending would have fallen much further, amplifying the decline in credit availability during the recession.

Economic Impact of Adopting CECL

The intersection of CECL, stress testing and the Federal Reserve's proposed stress capital buffer may have significant unintended consequences on lending which must be fully reconciled. This impact will be most significant during an economic downturn when lending is most vital to a recovery and consumers. CECL would have a direct impact on lending, particularly to low-to moderate-income borrowers, and would slow any recovery during an economic downturn. Even in good times, CECL will strongly encourage banks to reduce lending to customers with less than perfect credit scores, because it requires banks to book an immediate loss, with no compensating gain, for each loan they make. It also will result in reducing the pricing and availability of credit for residential mortgage loans, student loans, and small businesses lending.