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Regulators offer phase-in but risk-based capital could get 'pummeled' under CECL

By Kiah Lau Haslett **July 11, 2018**

Regulators have proposed offering banks some relief once a new reserve methodology goes into effect, but they have not fully addressed the hit that will come with its adoption.

> **CECL**
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> The current expected credit loss model is a forward-looking impairment approach that impacts the way banks and credit unions record losses on their assets. It requires institutions to book the expected lifetime losses of the loan on the first day of origination. It goes into effect in 2020 for some institutions and 2021 for others.
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> In contrast, the current system records losses when it becomes probable that a loan will be impaired. CECL will also impact the way financial institutions account for securities and assets such as purchase-impaired credits.

Banks are expected to take a capital hit when adopting the current expected credit loss model, or CECL, since the provision will cause institutions to notably increase their allowance for lifetime loan losses. Regulators proposed a phase-in approach to allow banks to space out the initial hit over three years.

However, they have not changed the treatment of reserves in total risk-based capital, or TRBC, which are capped under Basel III rules. While the phase-in will soften CECL's blow to equity, a number of banks could see their risk-based capital come under pressure.

"[Banks'] total risk-based capital will be severely pummeled," said Joshua Siegel, chairman and CEO at StoneCastle Financial Corp., an investment company that works with community banks.

Current capital rules allow banks to include reserves up to 1.25% of total risk-weighted assets in their Tier 2 capital calculations if they are not subject to an advanced capital approach. As reserves are expected to rise — perhaps substantially — when banks adopt CECL, the increase will be deducted from equity, reducing total risk-based capital. Siegel believes a number of banks could increase reserves beyond the 1.25% level, reducing TRBC even further.

In response, banks may need to raise more capital at the same time they build reserves to stop capital levels from potentially dipping below regulators' standards for being "well-capitalized" or "adequately capitalized."

"It's like wearing a belt and suspenders at the same time," said Rick Weiss, chief bank strategist at Ambassador Financial Group.

This capital dynamic could play out in various ways across the banking industry. Weiss pointed out that one way for banks to control the reserve build is to reduce lending and decrease the amount of risk-weighted assets. Bankers could also issue Tier 1 equity to boost TRBC, but that might dilute existing shareholders.

Siegel suggested banks issue subordinated debt to build a "CECL buffer" in a 2017 white paper he co-authored with Ethan Heisler, a senior director with Kroll Bond Rating Agency. Subordinated debt can count as Tier 2 capital and does not have a limit on the amount a bank could raise. However, Heisler acknowledged that executives may not want to speculatively raise capital before they are sure they will need it. StoneCastle has conducted sub debt offerings for some banks, but none of them have been driven by a need to bolster Tier 2 ratios un der CECL, Siegel said.

> **A primer on selected CECL changes**
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> - Bank observers, regulators believe banks will record a considerable increase in reserves.
> - At adoption, the change in reserves will come out of equity.
> - Regulators have proposed phasing in the initial change to equity over three years.
> - But, reserves exceeding 1.25% of risk-weighted assets for non-advanced approach firms will still be excluded from Tier 2 capital.
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> Source: Federal bank regulators

“A regulator could easily say, ‘These are reserves that you believe will end up in a loss. Why should that be counted as capital in the first place?’” Weiss said. Regulators could also increase the reserve cap to a level that accounts for the expected increase in allowances, but there are downsides to that approach as well. One potential pushback against increasing the 1.25% reserve cap in the Tier 2 calculation is that reserves and capital have different purposes, Weiss said. A bank funds its reserves to cover explicit, expected loan losses but usually earmarks equity capital for different uses.

Large and regional banks have reportedly begun exploring how CECL will change their balance sheet and communicating those changes with regulators this year, according to Michael Gullette, vice president of accounting and financial management at the American Bankers Association. However, he said many are not yet identifying specific impacts and recommending changes. He added that most community banks are behind their larger peers on modeling and preparing for CECL’s potential impacts on capital.

Beyond the CECL phase-in, regulators have stayed quiet on the issue of CECL and its impact on capital.

“I think regulators, before they change anything, are just going to see where we are, and I think that’s the right approach,” Heisler said.

The Federal Reserve declined to comment on specific capital questions, but a spokesperson said they are accepting comments on the broader CECL proposal and the proposed phase-in. Banking agencies said they will monitor the cap’s impact on regulatory capital and bank lending, and consider whether future changes to how the allowance is treated in capital rules are warranted.

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