How An Accounting Change For U.S. Banks Could Affect Reserves And Ratings

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The Financial Accounting Standards Board (FASB) has made effective a change to credit loss reserve accounting for companies reporting under U.S. accounting standards (U.S. GAAP). The change will be effective in January 2020 for public business entities that are SEC filers, but a company can choose early adoption in 2019. S&P Global Ratings believes banks are most likely to feel the impact.

FASB is replacing the incurred loss methodology with a more forward-looking current expected credit losses methodology (CECL). CECL requires financial institutions to recognize lifetime expected credit losses for financial assets measured at amortized cost--different from the incurred loss methodology, which considers only past and current events. CECL allowances will also cover a broader array of financial assets than allowances currently taken under the incurred loss methodology because they will also include held-to-maturity (HTM) debt securities and certain loan commitments. The change in methodology will result in U.S. banks needing to take additional reserves to incorporate their expectations of lifetime losses of their loan books and, as a result, will have an immediate negative impact on capital.

From a ratings standpoint, we don't expect to take immediate rating actions based solely on the implementation of CECL. Accounting rule changes, on their own, should not alter a bank's creditworthiness, although the change in reserve methodology could alter banks' behavior and strategies. Banks could opt to hold shorter-dated loans on their books to ease reserve requirements or perhaps price loans higher to compensate for the additional reserves required. In addition, when CECL is in effect, we will need to make some modifications in our provision forecasts that are embedded in our projected risk-adjusted capital (RAC) ratios. Many U.S. banks' capital levels are already at the high end of what we consider adequate (7%-10% RAC ratios), and the impact from CECL is unlikely to push them below this level.

We conducted a hypothetical sensitivity analysis to determine how CECL could affect U.S. banks' capital ratios, and we estimate the results would be modest for most U.S. banks. Based on our analysis, we estimate that for each 10% increase in current reserves, the industry's--in aggregate--Tier 1 capital ratio could decline by about 7 basis points (bps) to 8 bps, and RAC ratios could decline by 5 bps to 6 bps (see charts 1 and 2). Although our sensitivity scenario assumes an immediate impact to regulatory capital, the actual effect could be further mitigated if a bank opted to phase in CECL over three years, if the recent proposal by banking regulators becomes finalized.

Overview

- CECL, which will become effective in 2020, will result in U.S. banks needing to take additional credit provisions to build reserves to incorporate their expectations of lifetime losses of their loan books.
- We don't believe the transition to CECL, on its own, will result in immediate rating actions for U.S. banks.
- We believe CECL will have a modest negative immediate impact on regulatory capital (which could be partially offset if banks choose a proposed three-year regulatory phase-in option).
- Based on our analysis, we believe for each 10% increase in reserves, the industry's--in aggregate--Tier 1 capital ratio could decline by about 7 basis points (bps) to 8 bps and RAC ratios could decline by about 5 bps to 6 bps.
- CECL also will make comparative analysis more difficult among banks, particularly global banks, and could lead to banks changing their lending strategies (to favor shorter-duration loans).

The introduction of CECL will have other ramifications as well. It could result in bank management teams opting to hold higher capital levels. Indeed, although the initial impact of CECL will be lower capital levels, banks may opt to increase their capital over time to ensure they don't breach minimum regulatory capital thresholds as they add more loans to their books.

But CECL will also make comparative analysis more difficult among banks, particularly global banks. That's because the International Accounting Standards Board (IASB) put into effect IFRS 9, which is a different model than the U.S. for deriving credit losses and has been in effect since Jan. 1, 2018. International banks that adopted this methodology only recognize 12-month expected credit losses for their performing loans. Only upon a significant increase in the credit risk of the credit asset will lifetime losses be recognized. Even within the U.S., comparisons of loan loss reserves may be more challenging than they are currently. For example, individual banks may have different macroeconomic views regarding reserving for their loans books. Still, we understand that enhanced required disclosures are intended to enable investors to better discern the rationale behind a bank's loan reserve.

A Sensitivity Analysis To Determine The Impact Of CECL On U.S. Banks' Capital Ratios

To assess the impact of CECL on U.S. banks' capital ratios, we applied a sensitivity stress test. Using a base reference point of the U.S. banking industry reserves at the end of 2017, we increased the current reserves in increments of 10%--up to a 100% increase--to account for the incorporation of expected lifetime losses required by CECL. We believe a 100% reserve increase is a conservative scenario for most banks. So far, only Citigroup has provided an indication of CECL's impact on reserves. In the bank's March 10-Q filing, Citi estimated that CECL's overall impact will be an approximate 10%-20% increase in reserves. The aftertax impact (assuming a tax rate of 25%) of additional reserves on capital--both Tier 1 regulatory and RAC ratios--is depicted in the charts.

A few points regarding our sensitivity analysis and the impact of CECL implementation on reserves:

- To frame the analysis, we note that the U.S. banking industry's reserves increased 75% from 2007 to 2008.
- The macroeconomic conditions at the time of banks' CECL modeling will affect the amount of additional reserves required. Specifically, the worse the expected macroeconomic environment, the larger the impact on reserves and capital ratios.
- The higher percentage of consumer loans a particular bank holds versus commercial, the higher the amount of reserves the bank will need to add due to CECL. (It's possible if a bank were to hold a majority of a particular type of long-dated loan, the 100% increase in reserves may not be conservative enough.)
- The more problematic loans a bank currently has on its books, the less of an impact CECL will have because the bank will have already taken expected losses for these problematic loans.
- The creation of additional deferred tax assets in conjunction with CECL will lessen the impact of any decline in capital ratios. This is not incorporated in our sensitivity analysis.
- CECL allowances will include HTM debt securities, though our analysis does not include the impact of this on capital ratios.

Chart 1

CECL Impact On Tier 1 Capital Ratio: All FDIC Banks

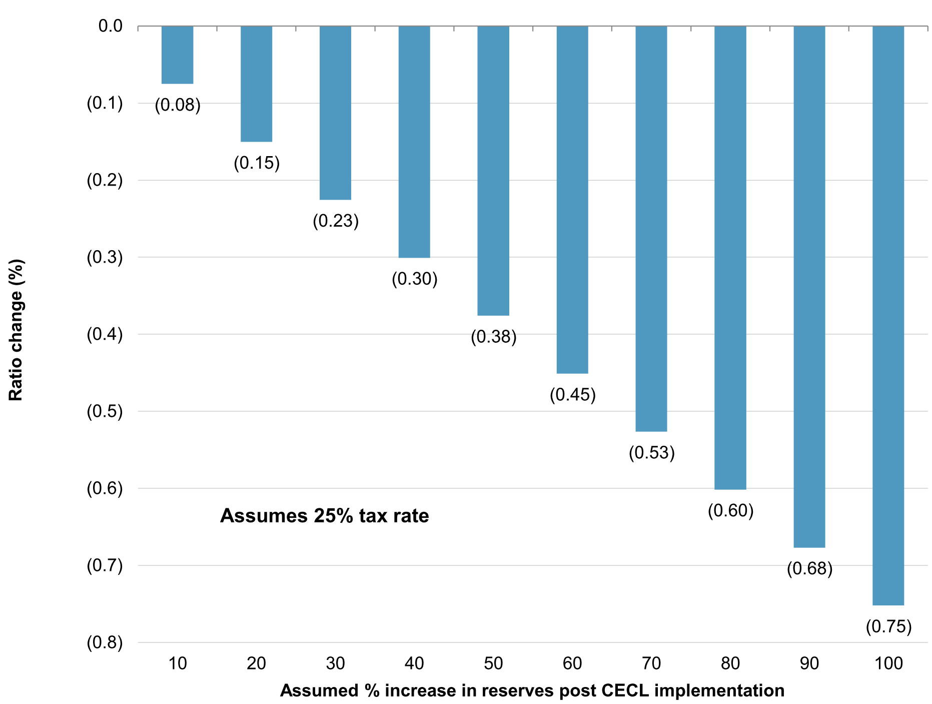
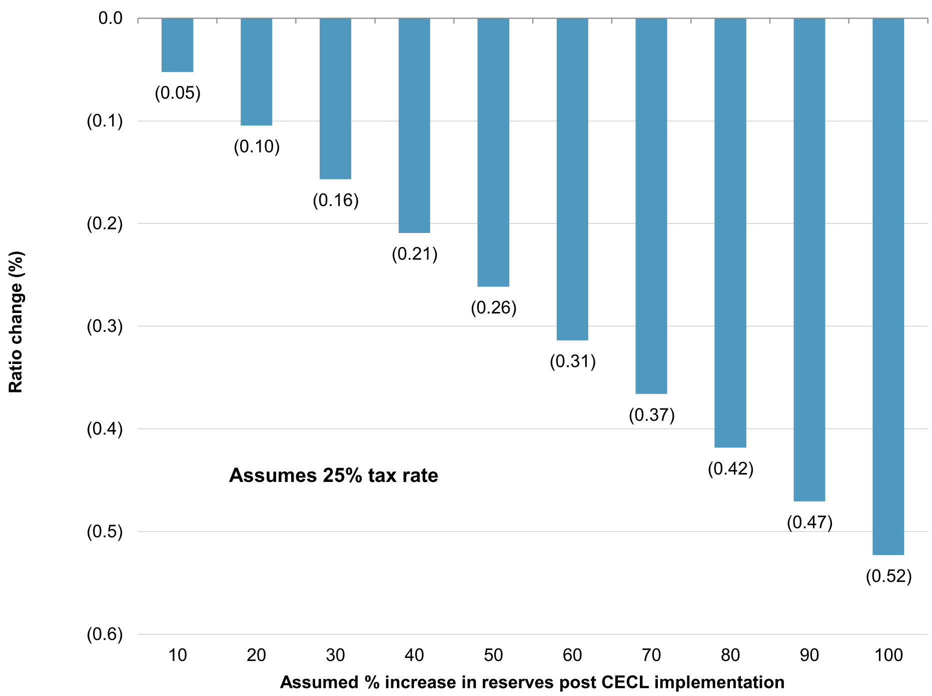


Chart 2

CECL Impact On S&P Global Ratings RAC Ratio: All FDIC Banks



The Impact On Bank Ratings And Our Capital Forecasts

Changes in accounting rules, in themselves, should not lead to changes in issuer credit ratings. However, they could change the behavior of a bank, which in turn, could lead to a change in a bank's credit quality. One such strategy change is that as a result of CECL, bank management teams may opt to hold higher capital to ensure they don't breach regulatory minimum thresholds. Along with higher reserves, we would consider this a credit positive, and it's possible, over time, that could lead to positive rating actions. But, banks may also change the composition and duration of their loan portfolios, which could affect the credit quality of an issuer, either positively or negatively.

The day one impact, though, from CECL is that higher loan loss provisions will reduce our measure of capital--total adjusted capital (TAC), which is the numerator in our RAC ratio--thereby reducing the RAC ratio. (We do not add back a build-up of reserves in our TAC calculation.) The projected RAC ratio is a key element of our capital and earnings assessment--one of the four bank-specific rating factors we consider--and a lower projected ratio could lead to a lower assessment. But that is not a mechanistic or automatic outcome. Rather, it depends on a number of factors, including whether we expect the ratio to cross the thresholds set out in our criteria. For example, a projected RAC ratio of 7%-10% would ordinarily mean that we consider the capital and earnings assessment to be neutral to the issuer credit rating (assuming the starting point of the rating--the anchor SACP--is at least 'bbb-'). If the application of higher credit loss provisions from CECL means that a bank's RAC ratio falls below 7%, we would consider the extent to which that decline is likely to persist.

The introduction of CECL will add some complexity to our RAC ratio projections. Assuming we expect economic conditions to remain relatively stable over a two-year horizon, and we believe banks have taken adequate lifetime expected loss reserves for the economic conditions we foresee, we will need to lower our forecasted provisions. Indeed, in such a scenario, our provisions estimate should only include the expected lifetime losses of the new loans we forecast a bank to book. All else equal, the amount of provisions for banks that have higher growth strategies will be larger than for banks that have more modest growth strategies.

Separately, while a lower capital and earnings assessment would imply some pressure on the rating, it is possible that this could be offset by our assessments of other rating factors. In particular, we derive our view of a bank's relative capital strength and asset quality from our combined assessment of its capital and earnings and its risk position. While the capital and earnings assessment measures a bank's ability to absorb expected and unexpected losses, our risk position assessment considers a broader array of related factors, such as asset quality, underwriting standards, and provisioning relative to peers. The combined impact of these assessments can be positive, neutral, or negative to the issuer credit rating. We would view a higher reserve figure resulting from CECL--all else equal--as a credit positive to the risk position.

An Increase In Deferred Tax Assets

Deferred tax assets (DTAs) arise due to differences in measurement of financial reporting versus income taxes paid. A large portion of DTAs are the result of the timing difference between actual charge-offs (a taxable event) and provisions (a financial reporting event). Hence, the increase in provisions associated with CECL will likely lead to the recognition of additional DTAs on the balance sheets of banks. That said, DTAs will only have a limited positive impact in offsetting the negative effect of higher reserves on capital. Specifically, DTAs can amount to no greater than 10% of common equity Tier 1 capital as it pertains to regulatory capital ratios. These amounts also get risk weighted at 250% for Standardized Approach banks.

Regarding our RAC ratios, if the amount of DTAs arising from temporary differences exceeds 10% of intermediate adjusted common equity (ACE), we deduct from intermediate ACE the amount of DTAs in excess of the 10% threshold that are not considered "readily convertible." The DTAs that we include in ACE get risk weighted at 375%. As a result, the positive benefits from DTAs are limited somewhat from a capital standpoint.

The Implications For Banks' Comprehensive Capital Analysis And Review

The implementation of CECL could exacerbate the losses banks will need to model in the Fed's annual stress test--known as the Comprehensive Capital Analysis and Review (CCAR)--because provisions under the Fed's scenarios will then incorporate a lifetime loss expectation (rather than the current practice of incurred loss). This means banks and the Fed will need to model what lifetime losses will look like during severe economic conditions--for example, a rise in unemployment to 10%. The issue of provisions for CCAR under CECL becomes complicated because the stress test assumes conditions improve at some point over the two-year stress test timeframe. That said, we believe it is likely that bank provisions will increase under CECL, which would result in lower minimum capital levels (thus higher capital burndown--i.e., decline in capital ratios) under stressed conditions. But under the recent CECL proposal by U.S. regulators, this wouldn't affect CCAR until the 2020 stress cycle, per the implementation dates.

Separately, recent changes to the tax code (a lowering of the tax rate, which is a negative when a bank incurs losses during a CCAR simulated event), along with a limitation of net operating loss carrybacks to be included in DTAs, will likely amplify the decline in capital from CCAR. All in all, this could result in lower capital payouts for banks or banks altering their loan portfolios to minimize the impact of CCAR.

More Variability In Reserving Policies Across U.S. Banks

A key aspect of modeling expected lifetime losses will hinge on bank management teams' assessments of macroeconomic conditions over the coming years. The more negative a bank management team is in this regard, under CECL, the higher its current reserves will likely be. In addition, how long banks expect certain loan categories to stay on their books will likely vary. Prepayment assumptions, which can vary across loan classes, depend on customer behavior and interest rate expectations. Assumptions will likely differ across banks. The longer a bank expects a loan to be on its books, the higher it will need to boost reserves under CECL over time. With regulatory input, assumptions could converge, but at the outset there may be a wide divergence in assumptions.

Separately, certain loan categories, such as credit cards, are difficult to gauge in terms of loan duration. As such, banks may have different views on the amount of reserves they will need to take in regards to CECL.

Finally, we believe the lack of convergence between IFRS and U.S. GAAP, regarding the methodology for estimating credit losses, will further complicate peer analysis globally. In the end, what will be helpful to financial statement users is more detailed disclosure on the assumptions being made (both economic and loan duration) to derive reserve levels.

Loan Strategy Changes

CECL could lead to some banks shifting their lending strategies, favoring shorter-duration loans over longer-term loans to mitigate the impact on earnings of booking these types of loans. Certain loan categories could also feel the brunt of CECL more than others. The greater the loss rates and duration of a loan type, the greater the increase in reserves for a particular bank when CECL gets implemented. Banks also may add renewal options to contractual terms to shorten the duration of certain commercial loan products. Bank management teams may also react to CECL by increasing the pricing for these loan categories to try to make up for the immediate economic impact of booking these loans.

Finally, the introduction of CECL could disadvantage banks that are looking to grow significantly versus a lower-growth strategy. That's because for a bank looking to grow, there will be a relatively large upfront capital cost versus a slower growing bank that is mostly rolling over maturing loans.

Other Implications

With the introduction of CECL, bank management teams may opt to maintain higher capital levels than they otherwise would have without CECL in place. That's because they may be concerned about the possible impact on capital should economic conditions worsen. The introduction of CECL, though, may make banks more loath to lend as economic conditions worsen, in an attempt to ensure their capital stays above minimum required levels.

A Lot To Consider With The Implementation Of CECL

Although it is only an accounting change, CECL still brings with it a lot of changes and aspects to consider. Overall, we expect the immediate impact of CECL for U.S. banks likely will be higher loan loss provisions, which will result in an immediate reduction to our measure of capital. But, if bank management teams decide to hold higher capital levels to ensure they don't breach regulatory minimums, and at the same time holder higher reserves, that could, over time, lead us to raise ratings.

Related Criteria

- Risk-Adjusted Capital Framework Methodology, July 20, 2017
- Banks: Rating Methodology And Assumptions, Nov. 9, 2011

Related Research

- The Fed's New Proposals Could Lead To Lower Capital For Some U.S. Banks, April 24, 2018
- Asia-Pacific Banks Are Well-Positioned To Adopt IFRS 9 Reporting Standards, April 11, 2018
- The Adoption Of IFRS 9 And Bank Ratings, Feb. 19, 2018
- How IFRS 9's Expected Credit Loss Framework Will Affect Canadian Banks' Loss Provisioning In 2018 And Beyond, Dec. 18, 2017
- Could Ballooning Loss Reserves From New Accounting Rules Deflate Bank Capital Ratios?, Sept. 9, 2014