BANKING

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INDUSTRY BRIEF

CECL Symposium Highlights: Still More Questions Than Answers

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This afternoon we hosted an investor symposium discussing the Current Expected Credit Loss (CECL) accounting standard and how it may impact banks and mortgage REITs, and potential ripple effects from the new standards. We gathered several industry experts and company executives to discuss the topic, including Greg Norwood, Managing Director of Financial Risk Advisory at Deloitte & Touche LLP, J. Robby Holditch, Director of Accounting and Regulatory Solutions at Moody's Analytics, Gary R. Buesser, Director and Research Analyst at Lazard Asset Management and is also a FASB Board Member, Robert Foley, Chief Financial and Risk Officer at TPG Real Estate Finance (TRTX), and Jay Shah, Project Manager at FASB. Topics discussed were wide ranging, and included: **(1) the variability in terms of disclosure, presentation and assumptions; (2) what entails "reasonable and supportable" forecasts (link) (3) potential ripple effects or unintended consequences from the new standards; (4) variances among regulated and non-regulated institutions; and (5) how to determine the magnitude and timing of reversion (link).** Below we present our conclusions from the discussions as well as several key highlights.

What is CECL?: CECL is a new accounting standard that modifies how companies estimate loan and lease losses, and affects all periods starting after December 15, 2019 (i.e., begins 1Q20). In the midst of the financial crisis in 2008, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) established the Financial Crisis Advisory Group (FCAG). FCAG believes it has identified a "weakness in current GAAP being the delayed recognition of credit losses that results in the potential overstatements of assets," which ultimately led to its recommendation for this new standard. The new standard requires financial institutions to use a combination of historical information, current conditions and reasonable forecasts to estimate the expected losses over the life of a loan. This is a significant shift from the current methodology, which relies on incurred losses. We note on day one of implementation, there will be a balance sheet adjustment, creating additional general reserves for expected credit losses and negatively impacting capital levels, but implying limited income statement impacts.

Conclusion: We walked away with more questions than answers, and anticipate a significant amount of variability in disclosures amongst the banks given the latitude FASB has provided in the standards. While many questions remain, FASB officials, consultants and management teams alike continue to work through the issues and are refining models as overall understanding of the standards improves. Fortunately, we anticipate regulatory capital relief for the banks as necessary, since capital levels remain elevated and the intent of the new standards was not to increase capital levels at the banks. However, we believe there could be some unintended consequences and potential ripple effects that will create further disruption in the space, potentially shifting assets out of the banking space and into the non-bank space, which has continued to gain share. Ultimately, we remain concerned with the uncertainty around CECL, anticipated volatility around disclosures and capital impacts, as well as potential negative implications on industry demand will serve to provide one more reason for investors to not own the space.

Key Takeaways:

- CECL is a principals-based approach vs. typical accounting standards which are rules-based, providing banks with more latitude and flexibility, which in turn creates room for more variability amongst banks disclosures and assumptions
  - For instance, one bank can assume a strong economy going forward while another assumes a downturn. This will create significant variation among banks, but it should be explained in the disclosures
  - Additionally, smaller banks will likely need to use more regional specific economic figures vs. national in determining outlooks

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- Qualitative adjustments are very important, as there are some portions of the standards that are difficult to put math around, which ultimately drives forecast variability
- There could be several unintended consequences and ripple effects from CECL, including pushing more loans out of the banking system into the non-bank space. Additionally, it could lead to rising borrowing costs within construction, given that unfunded commitments require complete reserving up front, thereby increasing the bank's cost of capital.
- There remains a significant amount of questions regarding the capital impacts from CECL, and how the banks will pay for it, as well as the implications for future capital return levels, including the pace of buybacks and dividend increases.
  - We expect that the regulators will adjust capital requirements as necessary based on outcomes from the new standards, but this will take time.
- There was discussion regarding non-GAAP reporting, where pre-tax pre-provision metrics could become more important, but will the SEC permit more non-GAAP disclosures?
- In mortgage REITS, given there is less data available, qualitative adjustments will be much more important
- Most companies remain in the testing and analysis phase, and should provide additional insights later in the year
- There could be potential impacts on M&A appetites, given the double counting of credit losses under CECL, but this did not seem to be of much importance to FASB
- The reversionary period must be a period of non-zero losses, which is difficult for some smaller and younger institutions that have not experienced many losses over the past 5-10 years.

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