S&P Global

RESEARCH & ANALYSIS

CECL will create large capital hit, earnings volatility for US banks

Monday, March 19, 2018 10:22 AM ET

By Nathan Stovall and Chris Vanderpool

While a new reserve methodology is far from popular among U.S. banks, it could prepare them for the next economic downturn.

The banking industry has bemoaned the new provision largely due to its complexity. The current expected credit loss model, or CECL, will require banks to set aside reserves for lifetime expected losses on the day of loan origination, resulting in a sizable hit to capital at adoption.

S&P Global Market Intelligence estimated the capital impact to the industry as part of our updated five-year outlook for the banking industry. We found that the upfront reserve build could allow banks to better withstand and earn their way through a downturn, which could begin when banks adopt the methodology in 2020. Banks are unlikely to take the change in stride, however, and will respond by raising prices on loans and slowing their balance sheet expansion.

Click here to read the full 2018 U.S. Bank Market Report.

Click here for supplementary data exhibits.

Click here for a U.S. banking industry projections template under our CECL scenario.

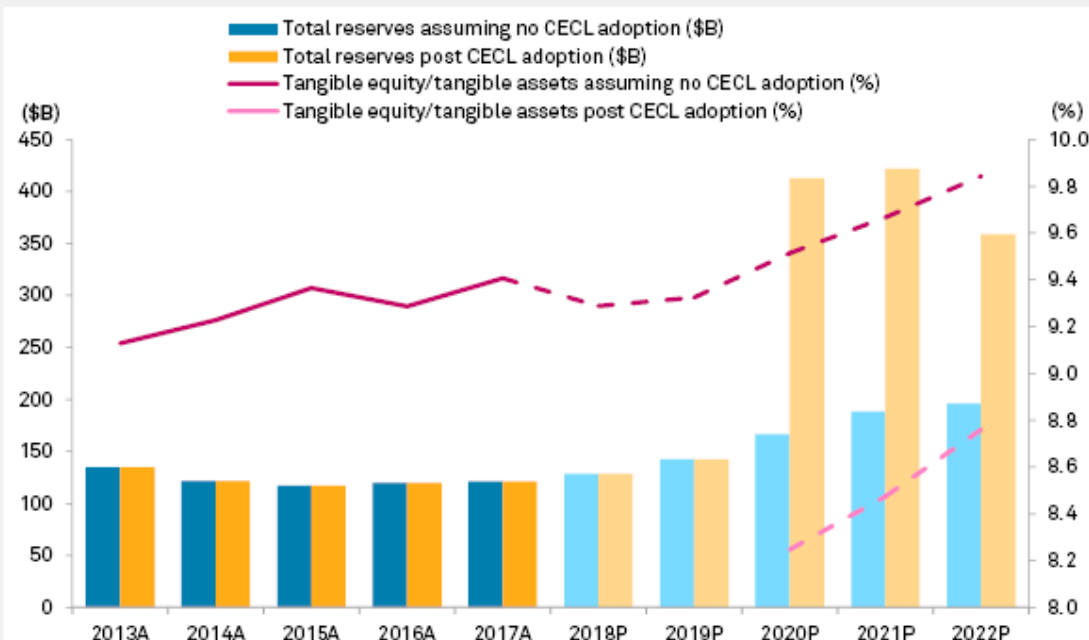**CECL will cause large hit to capital**

CECL becomes effective for many institutions in 2020 and will mark a considerable shift in practice. Banks currently set aside reserves over time, whereas the new provision requires them to substantially increase their allowance for loan losses on the date of adoption. If that adjustment exceeds retained earnings, the change will result in a capital hit to the industry.

S&P Global Market Intelligence believes the industry's tangible equity-to-tangible assets ratio could fall to 8.25% in 2020, assuming uniform adoption of CECL by all banking subsidiaries at that time. That level is 127 basis points below projected capital in our baseline scenario, which assumes that banks continue operating under the existing incurred loss model.

Our analysis was based in part on a white paper co-authored by Joshua Siegel and Ethan Heisler that estimated CECL's impact on banks with less than $50 billion in assets. Siegel is the managing partner and CEO of StoneCastle Partners LLC, and Heisler is president of the Bank Treasury Newsletter, which highlights industry trends for bank treasurers. They assumed that loans were originated at year-end and that the required reserve build would equal cumulative net charge-offs in the five years after adoption.

We assume that CECL reserves would match charge-offs over the life of loans, estimated at three and half years, beginning in 2020, and accordingly projected that the required reserve build for the industry that year could reach $246.4 billion, or 1.5x the level of reserves projected under our baseline scenario.

CECL will cause large initial increase in reserves, hit to equity

Legend:
- Total reserves assuming no CECL adoption ($B)
- Total reserves post CECL adoption ($B)
- Tangible equity/tangible assets assuming no CECL adoption (%)
- Tangible equity/tangible assets post CECL adoption (%)

Projections current as of March 2, 2018. Data compiled between Feb. 19 and March 2, 2018.
CECL = Current Expected Credit Loss model, a new reserve methodology most banks must implement beginning in 2020
CECL scenario assumes uniform adoption of the accounting standard by all banking subsidiaries at Jan. 1, 2020; that all loan portfolios have an average life of 3.5 years based on current portfolio composition across the banking industry; and that required reserves under CECL equal projected cumulative net charge-offs in the 3.5 years after adoption.
Net charge-off projection based on a longer-term outlook for credit quality, which assumes losses peak in 2022 and then decline thereafter.
Sources: Federal Reserve, Fannie Mae, Freddie Mac, S&P Global Market Intelligence, proprietary estimates

Major CECL scenario assumptions

- **Loan portfolios have a weighted average life of 3.5 years, based on the current loan composition across the industry.**
- **Reserves equal cumulative net charge-offs in the 3.5 years after adoption.**
- **All banking subsidiaries uniformly adopt the provision at Jan. 1, 2020.**
- **Average life of loans: mortgages seven years; multi-family loans six years; commercial and industrial loans 1.6 years; commercial real estate credits 3.8 years; and consumer loans two years.**
- **Average life of loans rises modestly over the next few years, continuing a trend exhibited by some banks in recent quarters as institutions reach further out the yield curve to bolster income.**

Reserves will jump when CECL is adopted

Legend: ■ LLR/Loans without CECL ■ LLR/Loans under CECL

The expected level of charge-offs stems from our longer-term outlook for credit quality. While improving sentiment among consumers and businesses should support relatively strong asset quality in 2018, credit standards should begin to slip in 2019 as banks compete more aggressively to win new business. Competition should increase because economic growth is not expected to be quite strong enough to create sufficient opportunities for banks to lever the additional capital created by tax reform.

The windfall from tax reform will serve as an effective capital raise for banks, many of which already believe they have excess capital. Many banks will use the newfound capital to go on the offensive and look to take market share.

Banks will likely compete on price but could also change terms and conditions to entice borrowers. That would come on top of 18 months of easing in underwriting standards, according to the OCC's most recent semiannual risk survey.

Changes in the competitive environment could coincide with regulatory relief efforts. The current presidential administration and a Republican-controlled Congress have pushed to soften a number of regulations enacted shortly after the credit crisis. Even if logical, the changes likely could open the door to further weakness in underwriting. And this will occur as interest rates move higher, increasing the cost of debt service for borrowers. The higher costs could be enough to push some borrowers to the brink or, even worse, into default.

Against that backdrop, we expect that loan portfolios will begin deteriorating more significantly in 2020, with net charge-offs eventually peaking at 1.36% of average loans in 2022.

We assumed that the environment would recover after 2022 and improve over the next few years, with nonaccrual loans and charge-offs declining by similar magnitudes witnessed in the most recent recovery.

Street Talk is a podcast hosted by S&P Global Market Intelligence.

In the latest episode, we discuss the impact that CECL
will have on bank balance sheets and the competitive landscape.

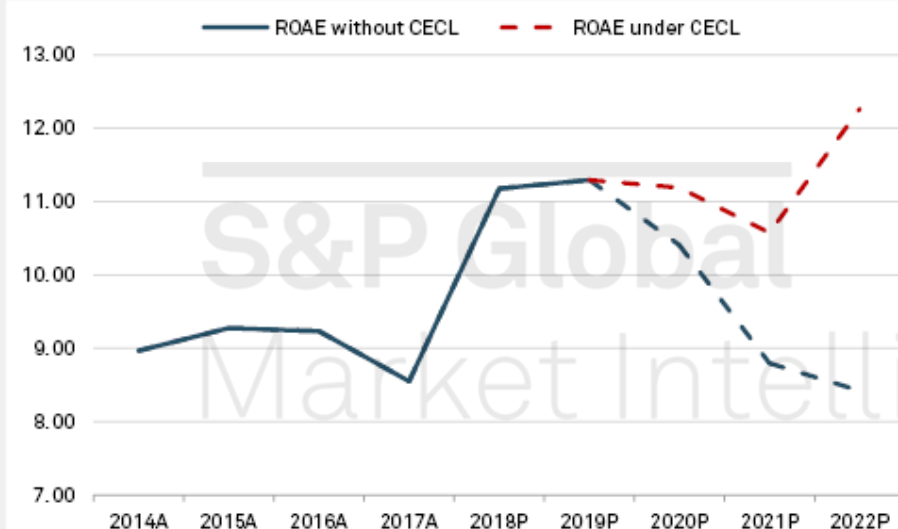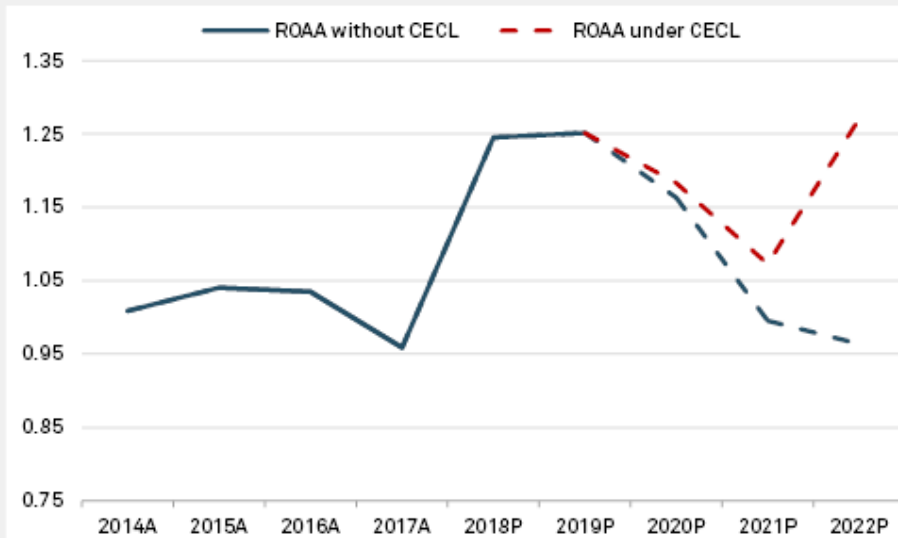Listen on **SoundCloud** and **iTunes**.

Banks not taking CECL lying down

We expect banks to react to CECL by raising rates on newly originated loans, particularly longer-dated real estate credits that will require a larger reserve build under the provision. Incorporating a higher rate on new loans pushes the industry's loan yield several basis points higher after adoption.

We have also assumed that loan growth will be slower than it would have otherwise been as banks with thinner capital ratios hoard cash and work to rebuild their capital bases.

The industry as a whole is expected to do that through the normal course of operations and should earn back a considerable amount of the capital hit from CECL several years after adoption. Since CECL requires banks to reserve for the full life of loans at the date of adoption, much of the required reserves in future years will have already been set aside in 2020. That means additional increases in the allowance for loan losses would be minimal in 2021 and 2022, resulting in lower provisions for loan losses than would have been recorded under the current reserve methodology.

Given that change, earnings would jump in 2022 under our CECL scenario, causing capital ratios to rebound right as credit losses are peaking. Banks' returns on equity would also be considerably higher since institutions will report stronger earnings against a lower capital base.

If the cycle bottoms several years after CECL's adoption, the new accounting provision might work as intended. Banks will have set aside considerable reserves well ahead of a downturn and pull forward losses, meaning their earnings will be stronger when credit quality reaches a low point.

However, if losses peak as the industry implements the new reserving methodology, the hit to capital could prove even more severe and leave banks on weaker ground to weather a downturn.

As capital declines, late-cycle returns expected to be higher under CECL (%)

ROAA without CECL — **ROAA under CECL**

Chart showing ROAA without CECL (solid) and ROAA under CECL (dashed) from 2014A to 2022P, y-axis 0.75 to 1.35.

ROAE without CECL — **ROAE under CECL**

Chart showing ROAE without CECL (solid) and ROAE under CECL (dashed) from 2014A to 2022P, y-axis 7.00 to 13.00.

Projections current as of March 2, 2018. Data compiled between Feb. 19 and March 2, 2018.
CECL = Current Expected Credit Loss model, a new reserve methodology most banks must implement beginning in 2020
CECL scenario assumes uniform adoption of the accounting standard by all banking subsidiaries at Jan. 1, 2020; that all loan portfolios have an average life of 3.5 years based on current portfolio composition across the banking industry; and that required reserves under CECL equal projected cumulative net charge-offs in the 3.5 years after adoption.
Net charge-off projection based on a longer-term outlook for credit quality, which assumes losses peak in 2022 and then decline thereafter.
CECL scenario assumes yields on newly originated loans rise in 2020, while loan growth slows as banks react to CECL's capital hit.
Sources: Federal Reserve, Fannie Mae, Freddie Mac, S&P Global Market Intelligence, proprietary estimates
©2018. S&P Global Market Intelligence. All rights reserved.

Scope and methodology

S&P Global Market Intelligence analyzed nearly 10,000 banking subsidiaries, covering the core U.S. banking industry from 2005 through 2017. The analysis includes all commercial and savings banks and savings and loan associations, including historical institutions as long as they were still considered current at the end of a given year. It excludes several hundred institutions that hold bank charters but do not principally engage in banking activities, among them industrial banks, nondepository trusts and cooperative banks. The analysis divided the industry into five asset groups to see which institutions have changed the most, using key regulatory thresholds to define the separation. The examination looked at banks with assets of $250 billion or more, $50 billion to $250 billion, $10 billion to $50 billion, $1 billion to $10 billion, and $1 billion and below.

The analysis looked back more than a decade to help inform projected results for the banking industry by examining long-term performance over periods outside the peak of the asset bubble from 2006 to 2007. S&P Global Market Intelligence has created a model that projects the balance sheet and income statement of the entire industry and allows for different growth assumptions from one year to the next.

The outlook is based on management commentary, discussions with industry sources, regression analysis, and asset and liability repricing data disclosed in banks' quarterly call reports. While taking into consideration historical growth rates, the analysis often excludes the significant volatility experienced in the years around the credit crisis.

The projections assume future Fed funds rates and 10-year Treasury yields based on a monthly survey of more than 60 economists conducted by *The Wall Street Journal*. Interest rate assumptions for 2021 and 2022 are based on the Congressional Budget Office's annual outlook. S&P Global Market Intelligence does not forecast changes in interest rates or macroeconomic indicators and aims to project what the banking industry will look like if the future holds what most economic observers expect.

The outlook is subject to change, perhaps materially, based on adjustments to the consensus expectations for interest rates, unemployment and economic growth. The projections can be updated or revised at any time as developments warrant, particularly when material changes occur.

Interest rate, macro assumptions based on external sources

	2018	2019	2020	2021	2022
Unemployment rate (%)	4.00	3.90	4.18	4.90	4.96
GDP growth (%)	2.83	2.30	2.00	1.90	1.90
Fed funds (%)	1.80	2.54	2.86	3.10	3.10
10-year Treasury (%)	2.89	3.31	3.51	3.70	3.70

Data compiled March 2, 2018.
Figures for the federal funds rate and 10-year Treasury yield through 2020 are based on three-point averages including estimates provided in The Wall Street Journal's monthly survey of more than 60 economists. Figures for 2021 and 2022 are estimates from the Congressional Budget Office.
Unemployment rate figures through 2020 are three-point averages calculated from estimates provided in The Wall Street Journal survey. The 2021 and 2022 figures are based on the CBO estimates.
GDP figures through 2020 are based on estimates from The Wall Street Journal survey. The 2021 and 2022 figures are based on the CBO estimates.
Actual reported figures used when available.