CECL: The New Expected Credit Loss Standard a Big Loss for Small Banks

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I. INTRODUCTION

Famed science fiction writer Ray Bradbury once summed up his personal writing style by stating that he was not “trying to predict the future” but rather was “trying to prevent it.”¹ The Financial Accounting Standards Board (“FASB”) sets a similar goal with its newly released Current Expected Credit Loss (“CECL”) accounting standards.² Under CECL, FASB does not expect financial institutions to forecast the next economic downturn, but instead aims to adequately prepare these entities to prevent a major recession.³

FASB is an independent, private sector, not-for-profit organization that issues financial accounting and reporting standards for companies and not-for-profit organizations which adhere to Generally Accepted Accounting Principles (“GAAP”).⁴ In 2016, FASB sent shockwaves through the financial industry when it released a new standard for calculating credit losses.⁵ Credit losses are allowances that a lender sets aside based on the amount of a loan that is unlikely to be repaid.⁶ These losses will appear on both a bank’s income statement and

³. Id.
balance sheet.\(^7\) On an income statement, credit losses are listed as expenses.\(^8\) However, on a balance sheet, credit losses serve as a contra-asset reducing the value of recorded loans.\(^9\)

Registering credit losses provides a more accurate picture of a bank’s financial health because it shows how much loan revenue the bank actually expects to receive.\(^10\) It also gives the bank a backup source of funds which can be drawn from if the loan defaults.\(^11\) For example, if a ten percent risk accompanies a $100,000 loan, then the lender would need to allocate $10,000 for credit losses.\(^12\) This $10,000 would be added to the pool of credit loss loan reserves which can be drawn from if a loan defaults.\(^13\) The $10,000 would be deducted from the maximum $100,000 in accounts receivable on the balance sheet and the net amount of $90,000 would be recorded.\(^14\) On an income statement, this $10,000 would simply appear as an expense, limiting net profit.\(^15\)

Previously, FASB endorsed Financial Accounting Standard (“FAS”)-5 and FAS-114 for calculating credit losses.\(^16\) Both FAS-5 and FAS-114 required institutions to account for these losses only when they were “probable” to be incurred.\(^17\) As a result, credit losses were only noted when they were expected to be incurred within the next twelve to

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8. Id.
9. Id.
13. Id.
14. Id.
15. Id.
16. Kimner, supra note 5.
17. See id. (“Under the previous incurred-loss model, banks recognized losses when they had reached a probable threshold of loss.”).
fifteen months. One of the primary concerns with the FAS-5 and FAS-114 models was that organizations could not record losses that were forecasted but had not yet become sufficiently “probable.” This issue became especially apparent during the 2008 financial crisis when a high number of borrowers defaulted and banks had not adequately built up reserves. At the same time, analysts used long-term data to devalue institutions before they could note accounting losses.

In response to these concerns, FASB published its new CECL standards in June 2016. CECL requires accounting for all credit losses expected over the entire life of the loan, not just when losses become probable. This means that for a thirty-year mortgage, accountants must estimate expected future losses and set aside reserves for the entire loan period, regardless of whether it is paid off in thirty years or in five. Since fluctuations in loan loss reserves are a strong indicator of a bank’s financial health, one of the goals of CECL is to provide regulators with a more accurate picture of a bank’s assets. CECL should also incentivize banks to become more risk-averse since they will need to

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18. See id. (“Additionally, while current rules require an allowance for credit losses only expected to incur over the next 12 months, CECL removes the probable loss threshold and requires a lifetime credit loss allowance to be established on day one of each exposure.”).

19. See Credit Losses, FIN. ACCT. STANDARDS BD., https://www.fasb.org/creditlosses&pf=true [https://perma.cc/QPA4-JLBV] (last visited Jan. 24, 2020) (“This model has been criticized for restricting an organization’s ability to record credit losses that are expected, but do not yet meet the ‘probable’ threshold.”).

20. See id. (arguing that the global financial crisis highlighted the problems with the previous credit loss standards).

21. See id. (“In the lead-up to the financial crisis, financial statement users were making estimates of expected credit losses using forward-looking information and devaluing financial institutions before accounting losses were recognized. This highlighted that the information needs of users differ from what GAAP requires.”).

22. Frequently Asked Questions, supra note 11.

23. Kimner, supra note 5.


25. Walter, supra note 10, at 21 (stating that calculating loan loss reserves prevents examiners from being misled by apparent bank assets that are unlikely to be realized).

account for more default risk upfront rather than later on. Ultimately, CECL aims to better equip financial institutions to prevent severe recessions by increasing reserves and better aligning credit losses with expected future income.

CECL applies to all banks, savings associations, credit unions, and financial institution holding companies that follow GAAP. Public businesses that are SEC filers were the first institutions required to implement this method, starting in the fiscal year beginning after December 15, 2019. Public business entities that are non-SEC filers must be in compliance after December 15, 2022. Finally, the SEC stated that small reporting companies, as well as non-SEC public and private companies, will also have until the fiscal year beginning after December 15, 2022 to implement the new standard.

Specifically, CECL requires that expected losses be calculated using “relevant information about past events, including historical credit loss experience on financial assets with similar risk characteristics, current conditions, and reasonable and supportable forecasts that affect the collectability of the remaining cash flows over the contractual term of the financial assets.” Many banks experienced trouble interpreting this guideline, especially regarding what constitutes “reasonable and supportable.” What is clear, however, is that the challenge associated with generating this data for banks will be considerable.

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27. See Sheila Blair, Congress Should Stay Out of New Bank Rules on Loan Losses, FIN. TIMES (Aug. 4, 2019), https://www.ft.com/content/f699d7e0-ad28-11e9-b3e2-4df846f48f5 ("[I]t should make bankers a little more cautious in their lending decisions, as they will have to account for likely losses when the loan is made, not kick the can down the road until the borrower is actually in arrears.").

28. Zandi & deRitis, supra note 2 (arguing that CECL will incentivize banks to increase reserves during periods of growth to more adequately prepare for downfalls).

29. See Accounting Standards Updates – Effective Dates, FIN. ACCT. STANDARDS BD., https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1218220137102 (last visited Jan. 18, 2020) (“Public business entities that meet the definition of a Securities and Exchange Commission (SEC) filer, excluding entities eligible to be smaller reporting companies as defined by the SEC, for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. All other entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.”).

30. Id.

31. Id.

32. Id.

33. Frequently Asked Questions, supra note 11.

34. Id.

35. See Banking: Current Expected Credit Loss (CECL), ABRIGO (Oct. 9, 2018), https://www.everycrsreport.com/reports/R45339.html
This Note proceeds in five parts. Part II explores why CECL will have a major impact on the banking industry as a whole. Specifically, Part II focuses on the significant increase in loan loss reserves expected as a result of CECL and the challenges presented in generating data to support this expected income. Part III explains why bigger banks are far better equipped to invest in CECL and handle these difficult data requirements compared to smaller banks. Part IV suggests steps that can be taken to alleviate this disproportionate impact on smaller banks. Finally, Part V offers a brief conclusion, summarizing the argument as a whole.

II. CECL WILL BE A DRAMATIC SHIFT FOR ALL BANKS

A. Most Banks Will Have to Greatly Increase Loan Loss Reserve Allocations

One of the most notable effects of CECL will be its impact on bank loan loss reserve allocations. When credit losses are estimated, banks are required to set aside funds as loan loss reserves. These reserves balance out revenue lost from loan defaults, late payments, and renegotiations. When a loss occurs, banks can use the reserve funds to cover the loss instead of reducing income at the time of the loss. Many

[hereinafter Banking: CECL] (“Adopting CECL may require upgrading existing hardware and software or paying higher fees to third-party vendors for such services.”).

36. See infra Part II.
37. See infra Part II.
38. See infra Part III.
39. See infra Part IV.
40. See infra Part V.
41. See Kimner, supra note 5 (“Perhaps more important to the bottom line is the more recent publication of revolutionary changes to accounting standards that determine the appropriate level of balance sheet reserves for credit losses.”).
42. See Walter, supra note 10, at 20 (“The federal banking regulators … require that all banks include in their financial statements an account named allowance for loan losses …. The account absorbs loan losses both from loans the bank can currently identify as bad loans and from some apparently good loans that will later prove to be uncollectible.”).
43. See Julia Kagan, Loan Loss Provision, INVESTOPEDIA (Apr. 9, 2019), https://www.investopedia.com/terms/l/loanloss provisioning.asp [https://perma.cc/88NL-DYSK] (“This provision is used to cover a number of factors associated with potential loan losses, including bad loans, customer defaults, and renegotiated terms of a loan that incur lower than previously estimated payments.”).
investors look to bank reserve increases as a problematic sign for banks.\textsuperscript{45} This is because when banks increase reserves, it often signals that they are engaged in more risky ventures or that some of their loans have already defaulted.\textsuperscript{46}

However, banks generally want to minimize the amount of funds they have tied up in reserves.\textsuperscript{47} The more a bank increases its reserves, the less liquidity it has to lend and generate profits.\textsuperscript{48} The “primary business of banking” is to use depositors’ funds in order to lend money and collect interest.\textsuperscript{49} Therefore, although loan loss reserve requirements are an important safeguard, they also directly undermine a bank’s efforts to maximize income.\textsuperscript{50}

CECL now requires banks to account for all expected losses during the life of a loan instead of just when losses become probable.\textsuperscript{51} Since the risk is generally estimated over a longer period of time, the amount of revenue that could be lost will likely increase.\textsuperscript{52} For example, a newly issued twenty-year fixed-rate mortgage may only have a minimal likelihood of loss from expected revenue over the first few years.\textsuperscript{53} This is because many borrowers have a certain amount of funds set aside to repay initial payments and have a strong sense of their immediate


\textsuperscript{46} See id. ("Investors care about changes in loan loss reserves because when a bank shores up its reserves, it signals that trouble is brewing.").

\textsuperscript{47} See Barone, supra note 44 ("[B]anks normally minimize their excess reserves and lend out the money to clients rather than holding it in their vaults.").

\textsuperscript{48} See id. ("Banks usually have little incentive to maintain excess reserves because cash earns no return and can even lose value over time due to inflation.").

\textsuperscript{49} Walter, supra note 10, at 20.

\textsuperscript{50} Barone, supra note 44.

\textsuperscript{51} See Kimmer, supra note 5 ("[T]he calculation of the expected credit loss is now computed over the life of the loan.").

\textsuperscript{52} Emilio Lopez & Dr. Janet Zhao, CECL Quantification: Commercial & Industrial (C&I) Portfolios, MOODY’S ANALYTICS (Mar. 2017), https://www.moodysanalytics.com/webinars-on-demand/2017/cecl-quantification-commercial-industrial-portfolios [https://perma.cc/TL3C-TJHT] ("62% of banks surveyed by Moody’s Analytics expect CECL compliance to increase their overall provisions.").

\textsuperscript{53} See Joseph Breeden, Dear Congress: Don’t Toss CECL Out, Work with FASB to Amend It, AM. BANKER (July 2, 2019, 9:00 AM), https://www.americanbanker.com/opinion/dear-congress-dont-toss-cecl-out-work-with-fasb-to-amend-it [https://perma.cc/HUP2-68X9] ("With IFRS 9, over 80% of a loan portfolio is allocated at a “single year” reserve amount, which is far different from that of CECL for a 30-year mortgage.").
economic outlook when they decide to borrow. Over the course of the twenty-year period, the probability of late payments or default increases substantially. This can be attributed to the larger role that macroeconomic trends begin to play during a longer timeframe.

Many top officials from the largest U.S. banks have issued statements supporting the notion that reserves will increase. Marianne Lake, Chief Financial Officer (“CFO”) for JP Morgan, predicted that CECL would cause her organization to increase its reserves by $5 billion, a thirty-five percent increase. Similarly, Bank of America’s CFO, Paul Donofrio, stated that his company forecasted a twenty percent increase in reserves as a result of CECL, amounting to an extra $2 billion. Other major institutions that issued statements regarding the impact of the new accounting standard include Citigroup, which stated that its reserves would increase by twenty to thirty percent, and Discover, which said that it would raise reserves by fifty-five to sixty-five percent.

Since FASB has delayed CECL implementation for small institutions until late 2022, the majority of smaller, regional banks have declined to issue public forecasts on the expected impact of CECL. However, Pinnacle Financial Partners Inc., a Nashville bank with roughly

54. See id. (arguing that short term mortgage risk is far less than risk over an extended period).


56. See id. (stating that changes in the ability to pay are the primary reason for mortgage default).

57. See Brian Riley, CECL Impact to Chase: 35% Increase Raises Loss Reserves by $5 Billion, Mostly Credit Cards, PAYMENTS J. (Apr. 15, 2019), https://www.paymentsjournal.com/cecl-impact-to-chase-35-increase-raises-loss-reserves-by-5-billion-mostly-credit-cards/ [https://perma.cc/N8ZR-9MJV] (“JP Morgan Chase chief financial officer Marianne Lake said the financial institution expects to have to increase reserves by about $5 billion, or about 35 percent, on day one of its implementation of the current expected credit loss standard, or CECL.”); see also White, supra note 45 (stating that other institutions acknowledged that their reserves will go up but did not want to comment until closer to the implementation date).

58. Riley, supra note 57.


60. White, supra note 45.

61. See id. (“Nearly all mid-size and smaller financial institutions are still mum about the looming impact of what is considered the biggest change to bank accounting in decades.”).
$25 billion in assets, stated that its loan loss reserve increase would likely be somewhere between twenty and sixty percent. Even if adjusted gradually over the next few years, these reserve increases represent another substantial cost for smaller entities that already face challenges as a result of increased compliance expenses.

Because CECL typically raises the calculated allowance for consumer loans but decreases it for commercial loans, some institutions are actually predicting a reduction in their loan loss reserves. Wells Fargo, for instance, expects its loan loss reserve allocations to be reduced by up to one billion dollars as a result of CECL. The reason for this difference is that commercial loans tend to extend for shorter time periods and carry less risk than consumer loans. Wells Fargo’s portfolio has a much larger percentage of commercial loans than other top financial institutions.

Wells Fargo’s situation illustrates why banks may rebalance their loan portfolios away from consumer loans as a result of CECL. With a lower loan loss reserve burden, commercial loans could effectively stretch the liquidity of banks by allowing them to issue more loans overall. Alternatively, if banks want to continue issuing the same amount of consumer loans, the burden of CECL compliance could be shifted to the consumer. Because the loan loss reserve requirements tend to make consumer loans less profitable for banks, borrowers may be forced to pay higher interest rates or settle for shorter

62. Id.
66. See Haslett, supra note 64 (stating that shorter term commercial loans result in lower default risk than longer term commercial loans).
67. Duren, supra note 65.
68. Haslett, supra note 64 (purporting that CECL could impact loan terms and pricing).
70. See CECL Spells Trouble, supra note 63 (“CECL will drive up costs and those costs will either be passed along to consumers or force institutions to curtail lending.”).
repayment periods in order to rectify the difference.\footnote{See Joshua Ronen, \textit{A New Accounting Rule on Loan Losses Could be Disastrous for the Economy}, \textsc{MarketWatch} (Apr. 22, 2019, 8:16 AM), https://www.marketwatch.com/story/a-new-accounting-rule-on-loan-losses-could-be-disastrous-for-the-economy-2019-04-22 \[https://perma.cc/5C5C-FLE6]\ (“The American Bankers Association …warned against some of the injurious effects of CECL: increased volatility of regulatory capital, the necessity of increased capital at all times, higher interest rates for borrowers and favoring shorter term loans over longer term ones including residential mortgages and student loans.”).} Finally, CECL may greatly deter banks from issuing riskier loans in the first place because of the impact on loan loss reserves.\footnote{See \textit{Large Banks Push for a CECL Extension}, \textsc{Abrigo}, https://www.alll.com/alll-regulations/fasb-cecl/large-banks-push-cecl-extension/ \[https://perma.cc/KE69-MNX5]\ (last visited Jan. 20, 2020) (arguing that “CECL may have a disproportionate impact on longer-term assets of high risks” and could thus reduce loan availability).} Regardless of whether a bank increases its loan loss reserves or is one of the few that can reduce loan loss reserves like Wells Fargo, changes in loan loss reserve allocations as a result of CECL will impact the business of banking moving forward.\footnote{See \textit{Duren}, supra note 65 (stating that Wells Fargo’s reserves will experience a significant decrease while competitors will have to build up reserves).}

\section*{B. The CECL Data Requirement Generates an Unprecedented Need for Information}

CECL will require a substantial adjustment to the means by which many institutions calculate future losses.\footnote{\textit{Frequently Asked Questions}, supra note 11.} Due to the extended life of the loan requirement, organizations must now estimate risk for far longer than they ever had to before.\footnote{\textit{Id}.} As a result, new factors will need to be considered in order to generate the reliable data required by FASB.\footnote{See \textit{id}. (“Input to allowance estimation methods will need to change to properly implement CECL.”).} In particular, macro-level information will become more impactful on loss calculations than it has been in the past.\footnote{See \textit{Kimner}, supra note 5 (“Macro-level data and risk factors will need to be analyzed to assess the impact of various scenarios on credit losses.”).} For example, under the previous incurred model, systemic risk in the housing market was unlikely to make a large impact on default probability due to the short-term nature of the evaluation.\footnote{\textit{Frequently Asked Questions}, supra note 11 (stating that CECL is more forward-looking and recognizes losses even before they have defaulted).} Now, however, banks must provide adequate weight to the probability of another financial housing crisis or

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\item See Joshua Ronen, \textit{A New Accounting Rule on Loan Losses Could be Disastrous for the Economy}, \textsc{MarketWatch} (Apr. 22, 2019, 8:16 AM), https://www.marketwatch.com/story/a-new-accounting-rule-on-loan-losses-could-be-disastrous-for-the-economy-2019-04-22 \[https://perma.cc/5C5C-FLE6]\ (“The American Bankers Association …warned against some of the injurious effects of CECL: increased volatility of regulatory capital, the necessity of increased capital at all times, higher interest rates for borrowers and favoring shorter term loans over longer term ones including residential mortgages and student loans.”).
\item See \textit{Large Banks Push for a CECL Extension}, \textsc{Abrigo}, https://www.alll.com/alll-regulations/fasb-cecl/large-banks-push-cecl-extension/ \[https://perma.cc/KE69-MNX5]\ (last visited Jan. 20, 2020) (arguing that “CECL may have a disproportionate impact on longer-term assets of high risks” and could thus reduce loan availability).
\item See \textit{Duren}, supra note 65 (stating that Wells Fargo’s reserves will experience a significant decrease while competitors will have to build up reserves).
\item \textit{Frequently Asked Questions}, supra note 11.
\item \textit{Id}.
\item See \textit{id}. (“Input to allowance estimation methods will need to change to properly implement CECL.”).
\item See \textit{Kimner}, supra note 5 (“Macro-level data and risk factors will need to be analyzed to assess the impact of various scenarios on credit losses.”).
\item \textit{Frequently Asked Questions}, supra note 11 (stating that CECL is more forward-looking and recognizes losses even before they have defaulted).
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other such systemic risk when generating expected future credit losses on mortgages.79

Adding to the complication, relevant factors for one bank may be wholly irrelevant for another depending on the size and composition of its portfolio.80 The CECL guidelines are “intentionally non-prescriptive” so that institutions may customize them to fit their unique portfolios.81 One of the key problems is that missing even a small piece of information can have significant implications for the whole calculation.82 In a 2019 article for Accounting Today, Mary Ellen Biery wrote that “[c]ore conversions, incomplete data fields, missing data fields, and a lack of historical losses in a loan segment or in an institution’s portfolio can cause problems with running a particular CECL model or being able to produce a meaningful result with a particular CECL methodology.”83 CECL’s ambiguity has become a huge cause of concern for banks.84

Due to initial uncertainty with CECL data requirements, banks may greatly adjust the means by which they calculate expected future losses, even after implementation.85 This will likely lead to volatility in reserve allocations and seemingly undermines FASB’s goal of increasing balance sheet transparency.86 The challenge presented in estimating new data sources could

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79. See id. (stating that “historical loss information” will be a key component of the new CECL calculation).
82. See id. (“Put simply, if an institution does not have the right data in an accessible format, scenarios and parallels can’t be performed.”).
84. See id. (“Only 43 percent of respondents expressed confidence that the data they have will be sufficient for CECL.”).
85. See Brice Luetkemeyer, Bankthink CECL: A Solution in Search of a Problem, AM. BANKER (July 29, 2019), https://www.americanbanker.com/opinion/cecl-a-solution-in-search-of-a-problem [https://perma.cc/C89-D8FN] [hereinafter A Solution in Search of a Problem] (“By requiring banks to account for the expected lifetime losses of a loan at the time of origination, there will eventually be shorter maturities on loans. This will result in more economic volatility, placing swings on the back of the consumer.”).
86. See id. (arguing that CECL will create volatility in loan loss reserve allocations).
further exacerbate this issue.\textsuperscript{87} One of the problems encountered by financial analysts in 2008 was determining the long-term risk of the newly popularized subprime securities.\textsuperscript{88} Under CECL, banks seeking to estimate data points that have yet to be tested will face the same problem.\textsuperscript{89}

In order to become CECL-compliant, many banks have turned to third-party vendors.\textsuperscript{90} A recent survey by Abrigo indicates that most bankers believe their institutions will turn to outside sources in order to implement this new model.\textsuperscript{91} In that survey, thirty-seven percent of bankers said they would use the models developed by a third-party, while another thirty-three percent said they would rely on the third-party entirely.\textsuperscript{92} Only fifteen percent of respondents stated that they would rely solely on their own resources in order to implement CECL.\textsuperscript{93} While vendors are certainly a useful source for generating necessary data, this added cost has become a significant challenge to many banks’ profit margins.\textsuperscript{94} Effectively, the use of a third-party shifts the issue from being a data problem to a financial problem.\textsuperscript{95}

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\bibitem{87} See \textit{The Data Dilemma}, supra note 83 (stating that CECL creates a variety of data challenges in generating reliable data).
\bibitem{88} Martin Hellwig, \textit{Systemic Risk in the Financial Sector: An Analysis of the Subprime-Mortgage Financial Crisis}, \textit{De Economist} 157, NO. 2, 2009 129, 132 [https://link.springer.com/content/pdf/10.1007/s10645-009-9110-0.pdf] ("The IMF itself has suggested that, for at least some of these securities, market prices may be significantly below the expected present values of future cash flow and therefore, that market values may not provide the right signals “for making long-term value-maximizing decisions.”.")
\bibitem{89} See \textit{The Data Dilemma}, supra note 83 (stating that estimating loan-level data presents a new challenge to institutions).
\bibitem{91} See id. ("A majority of bankers expect their financial institutions to use third-party vendors or a combination of advisors and third-party vendors to help them implement the current expected credit loss model, or CECL, according to an informal poll released by Abrigo and MST.").
\bibitem{92} See id. ("Thirty-seven percent of those polled said they plan to use models developed through advisory services and third-party vendors/products, and 33 percent said they plan to use an external product alone. In other words, more than two-thirds of those polled will rely on external models rather than internally prepared models.").
\bibitem{93} See id. ("Only 15 percent plan to rely solely on their own resources.").
\bibitem{95} See id. (arguing that even though third-party vendors are useful for gathering information, they still represent a significant cost to institutions).
\end{thebibliography}
In sum, CECL represents far more than just a shift in the way that banks estimate credit losses.\textsuperscript{96} The new standard and the challenges associated with meeting its daunting requirements necessitate a fundamental alteration in how banks assess expected future risk.\textsuperscript{97} As a result, many banks will be forced to take on a greater financial burden by investing in third-party vendors.\textsuperscript{98} The success that each institution has in developing an accurate forecast for future risk will undoubtedly play a major role in the implementation of CECL and the overall economic health of that institution.\textsuperscript{99}

III. SMALLER BANKS WILL BE DISPROPORTIONATELY HARMED BY CECL

When asked about CECL in April 2019, JP Morgan’s CEO, Jamie Dimon, testified before the House Financial Services Committee that “[f]or JP Morgan, I don’t have concerns” but added that “I do think you should be looking at what [CECL] will do to smaller banks.”\textsuperscript{100} Dimon went on to state that in a time of economic crisis, “[small banks] will virtually have to stop lending.”\textsuperscript{101} Dimon’s comments stem from recent studies indicating that, had CECL been in place during the 2008 financial crisis, banks would have had a much harder time issuing loans due to CECL’s high loan loss reserve requirements.\textsuperscript{102}

Dimon’s statements should serve as a strong warning to FASB that CECL will not affect all banks equally.\textsuperscript{103} In particular, CECL will

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96. See First Look, supra note 80 (arguing that CECL will result in major loan loss reserve adjustments, consequently changing the industry).
97. See id. (stating that CECL will result in big changes in both small and large institutions).
98. Gnanaraiah, supra note 94.
99. The Data Dilemma, supra note 83 (“Whether a financial institution has enough or the right kind of data for estimating the allowance for credit losses under CECL will really be determined on an institution-specific basis,” said Paula King, Abrigo senior advisor and a former bank CFO and co-founder.”).
101. Id.
103. Haggerty, supra note 100 (stating that small banks will be more adversely impacted than larger institutions).
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adversely impact small banks in two main ways. First, CECL represents both a significant upfront and continuing investment that smaller banks may not be in a position to make. Second, research indicates that under CECL, a recession will hinder the ability of smaller banks to make loans more drastically than it will for larger banks.

A. Large Banks Are Far More Equipped to Invest in the Cost of CECL Implementation

JP Morgan, Bank of America, Citigroup, and Wells Fargo each have assets of over $1.89 trillion. In comparison, some community banks may only have $20 million dollars in assets. Even still, each of these vastly different entities will have to invest in the new CECL model. While the largest banks will certainly have to develop a more robust and thus more expensive model, smaller banks will likely feel a deeper impact. This is because, among other reasons, larger banks have more methods of raising capital from investors and frequently have higher profit margins.

FASB acknowledged the challenge CECL poses in developing systems and generating data, and responded by granting implementation extensions to some institutions. Small reporting companies and credit

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104. See id. (stating that CECL will be especially harmful to smaller banks); see also CECL Spells Trouble, supra note 63 (“CECL will drive up costs and those costs will either be passed along to consumers or force institutions to curtail lending.”).

105. See CECL Spells Trouble, supra note 63 (arguing that, for smaller banks, CECL will present “onerous operational challenges.”).

106. Haggerty, supra note 100.


108. Rebecca Harrington, How to Start Your Own Bank, HUFFINGTON POST (May 6, 2016), https://www.huffpost.com/entry/how-to-start-your-own-bank_n_497261 [https://perma.cc/5ZBK-B7K3].


110. See CECL Spells Trouble, supra note 63 (stating that smaller banks will not create benefits but will present major challenges).


unions will now have until January 1, 2023 to implement CECL. 113 Although this delay will give smaller entities more time to invest and collect data, they will still need to eventually become CECL-compliant and generate much more information than ever before.114

When examining the financial impact of CECL, it is also critical to take into account the rising cybersecurity and compliance expenses. 115 No other industry loses more money as a result of cyberattacks than the financial industry.116 In 2017, banks lost a whopping $16.8 billion to cybercriminals.117 As a result, banks have invested heavily in preventative measures to avoid cybercrimes.118 JP Morgan spends about $600 million per year on cyber protection.119 According to a 2019 Deloitte survey, the average cybersecurity cost per worker was $2300.120


114. *See FASB to Delay CECL Implementation for Some Institutions*, AM. BANKING J. (July 17, 2019), https://bankingjournal.aba.com/2019/07/fasb-to-delay-cecl-implementation-for-some-institutions/ [https://perma.cc/BB6C-UNLP] (“FASB’s vote to delay CECL for certain smaller banks offers further proof that the required efforts to implement this costly standard are far greater than the board has previously led bankers to believe,” said American Bankers Association President and CEO Rob Nichols after the vote.”).

115. *See Kathryn R. Edge, Bank on It: Predictions from the Bank Lady*, 52 TENN. B. J. 29, 32 (2016) (“The cost of protecting the banking system, when coupled with the cost of compliance and CECL, makes margins so tight that many community bankers wonder if they can afford to stay in business.”).


117. Id.

118. See id. (“Given the value that breaches destroy, financial institutions are bolstering cybersecurity as executives seek to mitigate the risk of cyberattack.”).


This investment eats directly into profit margins and reduces bank capital.121

Compliance is also an increasing burden, especially in the wake of the 2008 financial crisis.122 Since that time period, compliance costs have increased by over sixty percent for retail and corporate banks.123 Moreover, the Dodd-Frank Act has cost banks an estimated $36 billion since its passage.124 For banks with less than $100 million in assets, compliance costs account for an average of 8.7% of their non-interest expenses per year.125 Banks in the one to ten billion dollar range spent 2.9% of their annual non-interest expenses on compliance regulation.126

CECL represents yet another cost hurting the profitability of banks.127 As previously mentioned, CECL is likely to increase the loan loss reserve requirements for most banks.128 In particular, banks with a large percentage of consumer loans in their portfolio will be impacted the most.129 This reserve increase removes the amount of available funds from banks to drive profit.130 Additionally, CECL compliance will require a significant investment for banks to conduct internal analysis or engage a third-party and pay the vendor to calculate loan loss reserves.131 More data than ever will be required to evaluate default probability for

121. See Barone, supra note 44 (stating that banks attempt to minimize vault cash whenever possible in order to seek profits).
123. Id.
125. Id. 126. Id.
127. See CECL Spells Trouble, supra note 63 (stating that CECL will represent a significant cost to banks).
128. Riley, supra note 57.
129. See Haslett, supra note 64 (stating that consumer loans “tend to increase” under CECL while commercial loans “tend to decrease.”).
131. See A Solution in Search of a Problem, supra note 85 (“[T]he cost of each employee’s time to compile information, manage third-party vendors, data feeds and modeling will be significant.”).
the life of each loan. Viewed as a whole, CECL compliance costs combined with the already substantial cybersecurity and compliance burdens will likely be a problem for smaller banks.

B. Under CECL, Small Banks Will Have a Harder Time Responding to a Recession than Larger Banks

As indicated in early studies, one of the main critiques of CECL is that it might fall short of its goal of being countercyclical. Under this system, CECL would increase loan loss reserves in strong economic times when banks issue more loans and decrease reserves in more turbulent periods when banks are encouraged to be risk averse. However, findings show that CECL actually has the opposite effect and is more likely to be procyclical. This means that it is highly correlated with the economy and market risk.

A study conducted by the Bank Policy Institute found that if CECL had been in effect during the 2008 financial crisis, the recession would have had an even more profound impact and would have lasted longer. This finding was based on the idea that banks were unlikely to have built up adequate reserves prior to the collapse. As a result, once defaults started to increase, CECL would have made it tougher to lend. A similar belief fueled American Bankers Association Senior Vice President (“SVP”) Mike Gullette’s suggestion that CECL could “prevent banks from lending at exactly the moment the nation would want them

132. See Smith, supra note 130 (“But while many banks have old records on hand, they may lack historical data covering highs and lows in an economic cycle, given how long ago the last recessions occurred.”).

133. See Edge, supra note 115, at 32 (arguing that CECL costs should be viewed in conjunction with other compliance obligations).

134. See Tony Hughes, CECL is in Trouble But There’s a Fix, AM. BANKER (Jan. 11, 2019, 10:01 AM), https://www.americanbanker.com/opinion/cecl-is-in-trouble-but-theres-a-fix [https://perma.cc/79V4-2QDD] (“CECL was implemented primarily to force banks to maintain countercyclical reserves.”).

135. See id. (“For true countercyclicality, proportional allowances need to be high when lending growth is high and low when growth is low or falling.”).

136. See id. (“All thorough analyses of the effect of the new rules have shown, to differing degrees, that allowances will continue to be procyclical after CECL comes into force during 2020.”).

137. See id. (arguing that CECL is more procyclical and will build up reserves more dramatically in times of recession).

138. BANK. POL’Y. INST., supra note 102.

139. Id.

140. Id.
lending to help the economy rise out of an economic slump.”

Although more focused on small banks, this is the same problem that Dimon seemed to suggest. Gullette took his statements even further by entirely rejecting the notion that CECL will help prevent another recession and asserting that “CECL could actually make any new crisis even worse because of its procyclicality.”

The fear alluded to by Gullette and Dimon is that if banks find themselves in a recession without significant loan loss reserves, bailing themselves out could be far more difficult than in the past. As projections indicate, CECL will likely increase loan loss reserve requirements, and a recession greatly increases default probability. When these two factors combine, banks will have diminished capital to make loans and will issue fewer as a result. This could lead to increased rates and more burden placed on the borrower. Even worse, fewer loan opportunities could stagnate economic recovery and lead to a prolonged recession.

Although this critical issue has the potential to harm banks of all sizes, CECL will particularly harm smaller banks. The fallout of the 2008 crisis demonstrates that small banks are less likely to benefit from recession-based stimulus programs. Under CECL, small banks will


142. Haggerty, supra note 100.

143. Gullette, supra note 141.

144. See id. (arguing that CECL would have made the past recession worse by making it more difficult to lend); see also Haggerty, supra note 100 (arguing that smaller banks would “virtually have to stop lending” during a recession).

145. Lopez & Zhao, supra note 52.

146. See Barone, supra note 44 (stating that when reserves increase banks have less assets to invest).

147. See A Solution in Search of a Problem, supra note 85 (highlighting that the many costs associated with CECL will be passed from the lenders to the consumers).

148. See Gullette, supra note 141 (purporting that CECL would have made the past recession worse by making it more difficult to lend); see also Haggerty, supra note 100 (arguing that smaller banks would “virtually have to stop lending” during a recession).

149. See CECL Spells Trouble, supra note 63 (arguing that CECL will cause significant harm to small banks and consumers).

150. Laura Layden, Banks Fell in the Great Recession, but They’re Stronger Now, USA TODAY (March 14, 2018, 5:00 AM), https://www.usatoday.com/story/money/2018/03/14/banks-fell-great-recession-but-theyre-stronger-now/394354002/ [https://perma.cc/K8SU-ZKSJ] (“About 85% of banks that failed in the U.S. from 2008 to 2011 were smaller ones with assets of less than $1 billion.”).
struggle even more than under past standards.\textsuperscript{151} This is because during a recession the default probability increases, and banks will need to increase loan loss reserves.\textsuperscript{152} As loan loss reserve requirements increase, more money will be tied up by issuing the same loans.\textsuperscript{153} Small banks will struggle far more than large banks to meet these rising capital demands because they do not carry the same advantages as larger institutions.\textsuperscript{154}

IV. REFORM SUGGESTIONS

Before introducing CECL reform suggestions, it is necessary to first establish who has the power to implement change. Since FASB is a private, not-for-profit organization, Congress does not have the power to influence FASB directly in the way it does other institutions.\textsuperscript{155} The SEC has been delegated the authority to dictate accounting standards for the private sector.\textsuperscript{156} In turn, it delegates this authority to FASB.\textsuperscript{157} Due to this delegation structure, the following recommendations are divided accordingly into: (1) suggestions for FASB, and (2) suggestions for Congress.

A. FASB Should Provide More Structured Guidelines to Calculate Future Risk

Issuing more specific rules for applying CECL will help small banks reduce both their cost burden and procyclicality.\textsuperscript{158} In developing CECL, FASB sought to provide more flexibility to banks to give them

\textsuperscript{151} See Gullette, supra note 141 (arguing that CECL could make it more difficult to lend during a recession).
\textsuperscript{152} Barone, supra note 44.
\textsuperscript{153} See id. (stating that the higher banks reserves, the less money for investment).
\textsuperscript{154} See CECL Spells Trouble, supra note 63 (arguing that smaller banks will be disproportionately harmed in times of recession).
\textsuperscript{155} See Banking: Current Expected Credit Loss, EVERYCRSREPORT, https://www.everycrsreport.com/reports/R45339.html#ftn14 [https://perma.cc/7J6W-MJQP] (last visited Jan. 20, 2020) [hereinafter EVERYCRSREPORT] (“Congress has delegated authority to the bank regulators and the Financial Accounting Standards Board (FASB) to address credit loss reserves.”).
\textsuperscript{156} See id. (“Currently, the SEC recognizes the Financial Accounting Standards Board (FASB) as the designated organization for establishing GAAP for the private sector.”); 15 U.S.C.S. § 77s (2019).
\textsuperscript{157} Id.
\textsuperscript{158} See Smith, supra note 130 (arguing that CECL’s ambiguity creates a huge challenge for banks).
the freedom to calculate the potential risks on their own.\textsuperscript{159} FASB’s only
significant guideline was “reasonable and supportable data” to back up these risk assessments.\textsuperscript{160} However, the tremendous uncertainty as to what qualifies as “reasonable and supportable” has led many banks to potentially waste time and financial resources with excess information.\textsuperscript{161} One of the primary reasons that CECL costs are so high is that the information is highly variable from institution to institution.\textsuperscript{162} While it is true that each bank portfolio is different, FASB should issue more structured guidance as to how each type of loan or security should be quantified regarding risk.\textsuperscript{163} It should also answer key questions, such as the way in which long-term data should be estimated for new products.\textsuperscript{164} A more streamlined approach would aid in driving down the cost of third-party vendors since these vendors would not be tailoring their services to individual banks to the same extent.\textsuperscript{165}

Another major benefit of more structured guidance is increased reliability of reported credit losses.\textsuperscript{166} Under the current rules, two banks with a similar portfolio could account for their default probability in dramatically different ways.\textsuperscript{167} This discrepancy creates a major risk, not only for the banks themselves, but also for investors who use loan loss reserves as a means to assess bank health.\textsuperscript{168} One of the chief purposes of CECL is to improve the alignment of assets and credit losses.\textsuperscript{169} The issuance of more concrete standards will directly aid this goal.\textsuperscript{170}

\textsuperscript{159} See id. (“FASB has offered examples and a few pieces of guidance on how to make the calculation without issuing hard-and-fast rules on how to comply with the new accounting.”).

\textsuperscript{160} Banking: CECL, supra note 35.

\textsuperscript{161} See Smith, supra note 130 (“Any time an accounting standard calls for judgment, companies and auditors need to back up their reasoning. This puts pressure on finding reliable data from numerous sources and forecasts that banks can use to make what’s considered one of the most sensitive estimates on their balance sheets.”).

\textsuperscript{162} A Solution in Search of a Problem, supra note 85.

\textsuperscript{163} See Smith, supra note 130 (arguing that one of the main challenges with CECL is “applying an accounting standard that’s big on principles and scant on specifics”).

\textsuperscript{164} See id. (stating that methods for calculating long-term risk could encompass numerous factors).

\textsuperscript{165} Gnanaraiah, supra note 94.

\textsuperscript{166} Banking: CECL, supra note 35.

\textsuperscript{167} See First Look, supra note 80 (“The impact of CECL could also vary significantly based on each institution’s current or forecasted view of the economic environment.”).

\textsuperscript{168} See White, supra note 45 (“Investors care about changes in loan loss reserves because when a bank shores up its reserves, it signals that trouble is brewing.”).

\textsuperscript{169} Zandi & deRitis, supra note 2 (stating that CECL will help banks account for long term risk and not just that which has been incurred).

\textsuperscript{170} Smith, supra note 130.
As loan loss reserve volatility decreases, it will also help to mitigate the procyclical fears surrounding CECL.\textsuperscript{171} Each of the studies that suggested CECL could exacerbate a recession focused on the initial premise that banks were not adequately capitalized in the first place.\textsuperscript{172} If structured rules were installed, all banks would follow the same basic system.\textsuperscript{173} Therefore, any changes to CECL would be more easily implemented across all banks, and systemic risk would be lessened.\textsuperscript{174} This differs from the current CECL model, where one bank could do an excellent job forecasting credit losses but still suffer increasing default probability simply because other banks were not as successful.\textsuperscript{175} Ultimately, this more unified banking structure would be more responsive to market fluctuations and thus better positioned to increase reserves ahead of economic downturns.\textsuperscript{176}

B. Congress Should Provide Financial Incentives to Small Banks

Now is finally the time for Congress to stop ignoring smaller banks. The costs of compliance, cybersecurity, and CECL have created a huge financial barrier to growing a bank.\textsuperscript{177} Each requirement carries very important motives.\textsuperscript{178} However, Congress should not lose sight of the fact that banks are businesses at their core and rely liquidity to generate profit.\textsuperscript{179} They also must acknowledge the dramatic size differences among banks and begin treating small community banks differently than major entities like JP Morgan and Bank of America.\textsuperscript{180} Under our current CECL model, bank consolidations and fewer new banks will result in a greater concentration of power in a smaller number

\textsuperscript{171} See Hughes, supra note 134 (stating that CECL will likely be procyclical and highly reactive to adverse changes in the economy).

\textsuperscript{172} Id.

\textsuperscript{173} Id.

\textsuperscript{174} Id.

\textsuperscript{175} Kimner, supra note 5.

\textsuperscript{176} Id.

\textsuperscript{177} See Edge, supra note 115, at 32 (arguing that the addition of CECL costs to existing compliance burdens represents a major challenge to banks).

\textsuperscript{178} See id. (stating that many of the compliance and security costs are aimed at preventing future harm and correcting mistakes of past recessions).

\textsuperscript{179} See Walter, supra note 10, at 20 (stating that collecting deposits and making loans are the “primary business of banking”).

\textsuperscript{180} Phaneuf, supra note 107.
of entities, which could diminish the number of community banks responsive to local needs.\textsuperscript{181}

One possible way of minimizing the impact of CECL is to provide tax write-offs to smaller banks for offsetting the cost of CECL data collection.\textsuperscript{182} Money allocated to future losses is not usually tax deductible until the debt has been charged off.\textsuperscript{183} However, a minor alteration could allow banks to increase capital by attaining early benefits for expected future losses.\textsuperscript{184} Specifically, Congress could tailor these tax benefits to banks under a certain asset size in order to help level the playing field.\textsuperscript{185} CECL serves an important role in making banks more responsive to financial hardship.\textsuperscript{186} A tax allowance created by the government could prevent future bailouts and be viewed as money saved down the line.\textsuperscript{187} This type of incentive could be an extremely impactful benefit for smaller banks struggling to turn a profit or risking forced consolidation.\textsuperscript{188}

Another possible incentive would be to put CECL aside and simply provide tax benefits to new or small banks.\textsuperscript{189} Aiding the institutions that are disproportionately harmed by the rising compliance, cybersecurity, and CECL costs will help to rectify the primary issue.\textsuperscript{190} One possible plan would be to offer tax benefits to small banks providing loans in certain designated “opportunity zones.”\textsuperscript{191} Similar programs

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\textsuperscript{181} CECL Spells Trouble, supra note 63 (“By requiring financial institutions to account for the expected lifetime losses of a loan at the time of origination, CECL threatens to eliminate some lending services . . . .”).
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\textsuperscript{182} See Keith Foster, Yes, CECL Affects Taxes Too, BKD (Dec. 12, 2017), https://www.bkd.com/article/2017/12/yes-cecl-affects-taxes-too [https://perma.cc/X8BH-PLJB] (“In general, an allowance for bad debts isn’t deductible for tax purposes. The deduction is delayed until there’s a charge off. This means when CECL increases a GAAP allowance, it will increase expense and reduce capital without resulting in a corresponding tax deduction.”).
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\textsuperscript{183} Id.
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\textsuperscript{184} Id.
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\textsuperscript{185} Id.
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\textsuperscript{186} CECL Spells Trouble, supra note 63 (stating that banks are responsive to community needs and CECL impacts will extend to conumers).
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\textsuperscript{187} Foster, supra note 182.
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\textsuperscript{188} See Tom Kimner, CECL: Are U.S. Banks Ready?, SAS, https://www.sas.com/en_us/insights/articles/risk-fraud/cecl-are-us-banks-ready.html [https://perma.cc/DH5M-3FF6] (last visited Jan. 31, 2020) (“Perhaps more important to the bottom line is the more recent publication of revolutionary changes to accounting standards that determine the appropriate level of balance sheet reserves for credit losses.”).
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\textsuperscript{189} Foster, supra note 182.
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exist and serve to incentivize investing in locations facing economic hardship.192 This plan would be unique in that smaller banks, rather than all institutions, would receive this benefit.193 It would allow smaller banks to continue the important role of serving local communities while still investing in CECL.194 Preventing the closing of small banks also helps to maintain a more diversified banking system.195

V. CONCLUSION

The new CECL accounting standards will dramatically alter the means by which expected credit losses are calculated.196 Banks will likely increase loan loss reserves and bank portfolios could shift as a result.197 This change also represents an enormous data challenge, and many banks have been forced to turn to third-party vendors for assistance.198 These changes will weigh far more heavily on smaller banks than on larger institutions.199 Large financial institutions are in a better position to invest in the new CECL model than smaller banks.200 Furthermore, increased reserves are more likely to hurt small banks in times of recession.201 In order to alleviate data concerns, FASB should first look to provide more structured guidelines so that CECL implementation can become more efficient and cost-effective.202 The legislature should also explore incentives such as tax write-offs to assist

192. Id.
193. Id.
194. Id.
195. Id.
196. See Jonathan Jacobs, CECL Standard Expected to Make a Major Impact, ACCT. TODAY (November 12, 2019, 2:18 PM), https://www.accountingtoday.com/opinion/cecl-standard-expected-to-make-a-major-impact [https://perma.cc/HC2T-9N3U] (“CECL represents a significant change from prior GAAP, which is still used by most entities.”).
197. See Lopez & Zhao, supra note 52 (arguing that most banks expect CECL to increase loan loss reserves).
198. 3rd-Party Vendors, supra note 90.
199. See CECL Spells Trouble, supra note 63 (“For smaller institutions … it will present onerous operational challenges.”).
200. Id.
201. See Gullette, supra note 141 (arguing that community banks do not have the same ability to cope with a recession as larger institutions).
202. See Smith, supra note 130 (arguing that one of the main challenges with CECL is “applying an accounting standard that’s big on principles and scant on specifics”).
smaller banks. \footnote{CECL Spells Trouble, supra note 63.}

In conclusion, FASB’s effort to straighten out credit loss recognition with CECL poses an extreme risk to the future of many small banks. \footnote{See id. (stating that CECL poses a major threat to small banks due to high cost burden and decreased lending ability).}

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\footnote*{I would like to thank my good friend, Mark Vuono, for providing the inspiration for this topic. I am also very grateful to Professor Lissa L. Broome, Devon Tucker, Morgan Schick, Brianne Marino Glass, Rachel Brinson, and the rest of the North Carolina Banking Institute Journal editorial board for providing valuable mentorship and guidance throughout the publication process. Finally, I would like to thank my family for offering constant support and allowing me to pursue my dreams at the University of North Carolina School of Law.}