



Bauerle's Bank Notes

CECL

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The Financial Accounting Standards Board (FASB) last month put the finishing touches on the latest hurdle to commodious relationships between banks and their business and consumer customers. Beginning in 2020, the Current Expected Credit Loss (CECL) rule will require bankers to create a financial loss reserve for every loan they make from the day it is made. In effect, before making a loan, bankers will be required to assume it will default and they will experience a loss.

The existing "incurred loss" rule only requires banks to create an accounting reserve for a loan when a credit loss is "probable". Likelihood greater than 75% is a rule of thumb for what "probable" means. In the future, reserves will be required based on the "expected" loss over the life of a loan, using currently available information, including "reasonable and supportable forecasts." The following illustration from the Federal Reserve Bank of Atlanta shows how it works.[\[i\]](#)

Required allowance on a \$10 million loan

Period	Accounting standard	Estimated probability of default (pd)	Estimated loss given default (lgd)	Required allowance	Required provision
1	Incurred loss	1%	40%	\$0	\$0
	Expected loss	1%	40%	\$40,000	\$40,000
2	Incurred loss	70%	40%	\$0	\$0
		90%	40%	\$3.6 million	\$3.6 million
	Expected loss	70%	40%	\$2.8 million	\$2.76 million
		90%	40%	\$3.6 million	\$3.56 million

As the table demonstrates, the increased reserve requirement kicks in at two junctures: at loan origination when \$40,000 is reserved based on the industry norm of a 1% provision for losses on loans, and when the probability of loss crosses the 70% threshold instead of at the 90% level. Again, the premise of the CECL rule is that some measure of loan default and loss are inevitable; the only questions are when and how much?

If the rule's logic seems perverse, it is. "If every loan will default, why make it?" you ask. To appreciate the rule's premise, one must return to 2007. In The Big Short,^[ii] Michael Lewis recounts a subprime mortgage lending industry conference in January of that year. Gathered in Las Vegas were seven thousand people who originated, packaged, sold and resold subprime mortgage debt. Lewis views the event through the prism of Steve Eisman, Daniel Moses, and Vincent Daniel, industry skeptics seeking to understand why others enthused over debts they believed were accidents waiting to happen.

The first sign . . . came at a speech that morning, given by the CEO of Option One, the mortgage originator owned by H&R Block. Option One had popped onto Eisman's radar screen seven months earlier, in June 2006, when the company announced a surprising loss in its portfolio of subprime mortgage loans. The loss was surprising because Option One was in the business of making loans and selling them off to Wall Street; they weren't meant to be taking risk. In these deals, however, there was a provision that allowed Wall Street to put the loans back to Option One if the borrowers failed to make their first payment. "Who takes out a home loan and doesn't make the first payment?" asked Danny Moses, putting the matter one way. "Who the fuck lends money to people who can't make the first payment?" asked Eisman, putting it another.

When the CEO of Option One got to the part of his speech about Option One's subprime loan portfolio he claimed that the company had put its problems behind it and was now expecting a (modest) loss rate on its loans of 5 percent. Eisman raised his hand. Moses and Daniel sank in their chairs. "It wasn't a Q&A," says Moses. "The guy was giving a speech. He sees Steve's hand and says, 'Yes?' "

"Would you say that five percent is a probability or a possibility?" asked Eisman.

A probability, said the CEO, and went back to giving his speech.

Eisman had his hand up in the air again, waving it around. *Oh no*, thought Moses, and sank deeper in his chair. "The one thing Steve always says is that you must assume they are lying to you," said Daniel. "They will always lie to you." Danny and Vinny both knew what Eisman thought of these subprime lenders, but didn't see the need for him to express it here, in this manner. For Steve wasn't raising his hand to ask a question. Steve had his thumb and index finger in a big circle. Steve was using his fingers to speak on his behalf. "Zero!" they said.

"Yes?" asked the obviously irritated CEO. "Is that another question?"

"No," said Eisman. "It's a zero. There is zero probability that your default rate will

be five percent."

Eisman, of course, was correct. The Option One CEO and 99.7% of the conference attendees were drunk on the subprime wine they had bottled and laid down in their cellars, where it grew rancid and risked the failure every bank and broker-dealer on Wall Street.

The CECL rule is important because it will increase the cost of bank credit. That is not necessarily a bad outcome, although it will require a shift in thinking on the part of borrowers accustomed to the last decade's zero interest rate policy of the Federal Reserve. Banks will price loans to include the additional reserves they must set aside. If the reserves approximate banks' loan losses in the first recession that follows CECL's implementation, then the result will be as intended.

By reinforcing bankers' risk-averse nature, the rule is also likely to constrict further the availability of credit, especially to more marginal customers like small businesses. Scarcity of bank credit for entrepreneurs has been a reality of the current business cycle. CECL will prolong the phenomenon.

The rule's effect on bank equities is more difficult to forecast. Smoothing out bank earnings should make bank stocks less volatile and more attractive to dividend-oriented investors. On the other hand, banks will be competing for a smaller universe of customers whose higher credit quality will correlate to thinner loan spreads over cost of funds. That may compound pressure on banks' net interest margin and profitability.

Bankers, especially community bankers, opposed CECL. They said the crisis of 2008 was confined to the Wall Street securitization machine and the remedies should be too. "Another punch in the gut to the banking industry," is how Pat McCune, CEO of Community Bank in Washington, Pennsylvania, described CECL in the [Pittsburgh Business Times](#).^[iii]

CECL requires banks, especially large ones, to use computer simulations to model declining market scenarios and prove the adequacy of their loan loss reserves. Community banks argued they cannot afford the cost of the computer models and do not need them to determine adequate loan loss reserves. In the final version of the rule, FASB afforded them some relief from that requirement, although one suspects over time the models will become de rigueur throughout the industry.

The broader question is whether the rule will serve its stated purpose. In our view, the rule's emphasis on "reasonable and supportable forecasts" risks the same overreliance on math models that swamped Wall Street a decade ago. Lewis reconstructs a model-centric negotiation between Deutsche Bank and Morgan Stanley as the former tried to cash in a bet against the subprime market.

In early July [2007], Morgan Stanley received its first wake-up call. It came from Greg Lippmann and his bosses at Deutsche Bank, who, in a conference call, told Howie Hubler and his bosses that the \$4 billion in credit default swaps Hubler had sold Deutsche Bank's CDO desk six months earlier had moved in Deutsche Bank's

favor. Could Morgan Stanley please wire \$1.2 billion to Deutsche Bank by the end of the day?

[According to Deutsche Bank, the underlying assets were now] only worth 70 cents on the dollar. Howie Hubler had the same reaction. *What do you mean seventy? Our model says they are worth ninety five*, said one of the Morgan Stanley people on the phone call.

Our model says they are worth seventy, replied one of the Deutsche Bank people.

Well, our model says they are worth ninety-five, repeated the Morgan Stanley person, and then went on about how the correlation among the thousands of triple-B-rated bonds in his CDOs was very low, and so a few bonds going bad didn't imply they were all worthless.

At which point Greg Lippmann just said, *Dude, fuck your model. I'll make you a market. They are seventy-seventy-seven. You have three choices. You can sell them back to me at seventy. You can buy some more at seventy-seven. Or you can give me my fucking one point two billion dollars.*

The exchange is a reminder that in a financial panic, assets are never worth what bankers can and should lend against them in markets operating at equilibrium. It is prudent to plan for and practice responding to financial crises. But it is naïve to think that financial models constructed by or at the behest of regulators will unerringly predict future upheavals any more than those of Morgan Stanley or Deutsche Bank in 2007. Panics happen because *everyone* piles into a particular trade, convinced that the value of the assets in question *must* move in a particular direction. Until the trend stalls, by which time there are no buyers, only sellers. The CECL rule, like the contagion it seeks to avert, risks being too much of a good thing. Bankers and their supervisors must temper its implementation with common sense and experienced judgment.

[i] <https://www.frbatlanta.org/cenfis/publications/notesfromthevault/1308.aspx>

[ii] Lewis, Michael, The Big Short: Inside the Doomsday Machine, New York, NY: W.W. Norton, 2011.

[iii] <http://www.bizjournals.com/pittsburgh/news/2016/06/17/change-in-accounting-for-loan-losses-a-punch.html>.

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