An opportunity exists to level the playing field among international banks

We are quickly approaching the end of the comment period for the Notice of Proposed Rulemaking (NPR) regarding CECL transition. While the NPR answers many transition questions, it does not address the current unlevel playing field. Today’s different measurement approaches for banks’ allowance for credit losses and their corresponding impact on regulatory capital measurement rules create a competitive disadvantage for US banks.

Creating a level playing field among international banks is a hallmark goal of the Basel Committee on Banking Supervision (Basel). As reported recently, Federal Reserve Governor Randal Quarles renewed the US’s commitment to Basel noting the benefits of a level playing field.\(^1\)

Implementing the Basel accords in a manner that creates a level playing field is often difficult. Achieving a level playing field regarding capital measurement levels is even more elusive given the impact of disparate methods for measuring credit losses for financial statement purposes.

Unfortunately, today’s accounting differences universally disadvantage US banks because US accounting principles for measuring the allowance for credit losses, by design, result in higher amounts than their international peers. Such differences are not fully reflected in the regulatory capital rules.

US banks have excess, “trapped capital” that creates an unlevel competitive landscape.

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\(^1\) “The Death of the Basel Committee has been Greatly Exaggerated”, John Heltman, American Banker, April 24, 2018
Capital and the allowance for credit losses

The Basel II capital framework for reflecting the impact of the allowance for credit losses codified the concept that the allowance for credit losses should be sufficient to cover expected credit losses (ECL) and capital should be sufficient to cover unexpected credit losses (UCL). Additionally, the Basel efforts to improve the quality of capital after the great recession included the introduction of the Common Equity Tier 1 (CET1) definition. As Basel rightly acknowledged, CET1 is the primary focus of investors and regulators alike when assessing a bank’s capital adequacy. Both the capital framework and the CET1 definition are the very bedrock of today’s international capital regime, and any effort to level the current unlevel playing field should be aligned with these two principles.

Beginning almost a decade ago, the Financial Accounting Standards Board (FASB) and the International Accounting Standards Board (IASB) began a journey to rewrite their respective accounting principles for measuring the allowance for credit losses. During their independent processes, the FASB and IASB had joined forces around one solution only to diverge in the final lap, which resulted in the issuance of two appreciably different approaches for measuring expected credit losses. The differences between FASB’s current expected credit losses (CECL) and IASB’s three-stage credit model (IFRS 9) did not neutralize the current disadvantage for US banks. Rather, their very different designs widened the gap between the measurement approaches. In fact, on average, 90 percent of a bank’s loan portfolio’s estimated credit losses are measured using meaningfully different principles—lifetime ECL under CECL and one-year ECL under IFRS 9.

Our capital rules should be designed to fully and fairly address the differences in measuring the allowance for credit losses and to measure the combined loss absorption capacity of the allowance for credit losses and capital consistently across the globe. Today, we lack this consistency but correcting this inconsistency is within our reach.

Today, the consideration of the allowance for credit losses for regulatory capital measurement purposes in the US uses one of two approaches. Under the US standardized approach (SA), bank-defined “general reserves” are added to Tier 2 capital, not CET1, subject to an arbitrary numerical cap that does not consider a baseline ECL measurement. Under the internal ratings based (IRB) approach, the allowance treatment is asymmetrical. That is, if the allowance for credit losses calculated under applicable accounting principles is less than the regulatory “one-year expected loss,” the shortfall is deducted from CET1 capital, creating a capital floor. Alternatively, if the allowance for credit losses calculated under applicable accounting principles exceeds the regulatory one-year expected loss, the excess is added to Tier 2, again subject to an arbitrary cap. For SA banks, there is no explicit adjustment mechanism for allowance shortages when compared to a regulatory one-year expected loss amount. For IRB banks, the comparison of a bank’s allowance for credit losses to a regulatory one-year ECL appropriately treats a shortage as a deduction from CET1 but any excess is an add back to Tier 2 not CET1. This asymmetrical approach ignores the extra loss absorption capacity in the CET1 ratio and is, in effect, “trapped capital” for the important CET1 capital ratio. By appropriately recognizing the trapped capital imbedded in today’s capital regime, the true loss absorption capacity can be reported fairly.

Creating symmetry around the loss absorption capabilities of the allowance and capital within the CET1 capital ratio will level the playing field.

Loan portfolio measurement categories

Directionally, 90% of IFRS Banks’ loans are Stage 1
Capital and the allowance for credit losses

To frame the current playing field, none of the US IRB traditional commercial banks have a capital deduction from CET1 for an allowance for credit losses shortfall as calculated under the existing “incurred loss” model. Under CECL, this trapped capital increases. Conversely, many international banks do have a deduction for a shortfall even after adopting IFRS 9.

Importantly, the impact of the asymmetrical treatment of the allowance for credit losses in capital measurement also must be addressed within the regulatory stress testing regime. Simply stated, the impact of the asymmetrical treatment will create its largest competitive disadvantage for US banks in the stress testing capital assessment process.

The Basel's October 2016 discussion paper, “Regulatory treatment of accounting provisions,” discussed, but did not solve, the disparate capital impacts of measuring the allowance for credit losses under CECL and IFRS 9 principles. However, the discussion paper did introduce a new capital concept—a standardized regulatory ECL—that could serve as the foundation to level the playing field regarding the interplay between measuring capital and allowance for credit losses.²

One approach to level the playing field could be accomplished through two changes to the existing capital framework. For the IRB approach to capital measurement, delete the provisions pertaining to the capital floor deduction, replacing it with symmetrical language. Simply, when comparing the regulatory one-year EL loss estimates to the allowance for credit losses calculated under respective accounting principles, shortfalls would be deducted from CET1 and the excesses would be added to CET1 capital. This change to the IRB approach would have the effect of measuring capital levels similarly regardless of whether an institution's accounting principles approximated ECL or not. To level the playing field under the standardized approach to capital measurement, a standardized regulatory ECL for each risk-weighted asset category could be developed. The development of a standardized ECL is not without a noteworthy effort but certainly within reach as bank regulators have massive amounts of information subject to their review and approval. A standardized ECL could be developed using information supplied by the existing IRB banks' Basel II models and data, as well as information supplied as part of the Comprehensive Capital Analysis Review modeling efforts. Standardized ECLs should be subject to annual updates reflecting changing economic outlooks that generally would correlate to CECL’s changing “reasonable and supportable” forecasts. These changes would create symmetry in the treatment of the allowance for loan losses for capital purposes. Adapting the concepts of this symmetrical regulatory and standardized EL approach also could be considered for inclusion in the stress testing measurement regime.

Understanding that thoughtful rulemaking requires time, an immediate, temporary step should be considered as well. To better level the playing field today, the numerical cap on the Tier 2 capital ratio could be eliminated. While this will not level the unlevel playing field, eliminating the caps will allow banks to better plan their capital management strategies to minimize the cost of the transition to CECL prior to a long-term solution.

In summary, there’s an opportunity to take an important step to level the playing field regarding the interplay of the measurement of the allowance for credit losses and capital. By eliminating the arbitrary distinction between the loss absorption capacity of the allowance for credit losses and CET1 capital included in today's capital framework, financial reporting by banks regarding their true loss absorption capability will be more valuable to both regulators and investors. Furthermore, even if the US acts unilaterally, large international banks would not be disadvantaged unless and until their allowance for credit losses exceeds their regulatory one-year ECL.

In commenting on the current NPR, banks have an opportunity to suggest alternatives, which could include the two-step approach discussed, that would level the playing field regarding the disparate measurement approaches for the allowance for credit losses and their effect on capital measurement and capital stress testing.

Now is the time to reflect the “trapped capital” in capital measurement and stress testing.

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² Basel Commission on Banking Supervision, Discussion Paper—Regulatory treatment of accounting provisions, October 2016, pages 1, 2