Testimony of

R. Scott Blackley

On behalf of

Capital One Financial Corporation

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of the

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Assessing the Impact of FASB's Current Expected Credit Loss Accounting Standard on Financial Institutions and the Economy

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Abstract

CECL is a byproduct of the 2007-2009 financial crisis era and was developed by the FASB in response to the view that banks increased their "allowances" to absorb loan losses too late in the cycle, thereby intensifying the effects of the financial crisis. However, since that time, Congress enacted sweeping reforms under the Dodd-Frank Act, and financial regulators have instituted significant new regulations and tools to help ensure that future crises would be either averted or their impact diminished.

While the FASB's efforts in developing CECL were laudable, it is likely to create significant unintended consequences that could be harmful to the availability, accessibility and affordability of credit for consumers and small businesses, especially those in already underserved segments of the market – particularly during an economic downturn.

Today, banks book credit losses on loans when those losses are probable and estimable based on conditions that exist at that moment, including where we are in the economic cycle. Under CECL, companies will be required to recognize all future estimated losses on loans before recognizing any revenue. This accounting distorts the earnings cycle of prudently underwritten loans and the economics of lending to consumers and small businesses, most significantly to those with less than perfect credit. During a recession, banks will be less likely to lend when CECL requires taking all of the estimated lifetime credit losses – reducing capital – before generating any revenue.

Another aspect of CECL is that it requires banks to predict losses based upon their views of the economy in the future. Many believe that this will exacerbate the procyclicality of loss allowances. Even the best economists and other forecasters have difficulty predicting the timing

and depth of turns in the economy. Misestimations in economic forecasts will drive uncertainty and volatility in Allowance for Loan Losses that will result in increased procyclicality.

When a downturn occurs, the rapid changes in economic forecasts will impact projections for credit losses multiple years in the future, and CECL requires banks to immediately reserve for the changes driven by this forecast volatility. As banks increase reserves, this naturally reduces the level of capital available to lend. In a downturn, bank capital positions are reduced while the capital needed to originate new loans under CECL would be materially higher than under the current framework. This would mean that banks would be further limited in their ability to lend during a crisis, which is damaging not only to consumers and small businesses but also to the economy more broadly. As demonstrated by the financial crisis, driving more lending out of regulated banks and into unregulated financial institutions will harm both consumers and the financial system. Furthermore, it is reasonable to conclude that these increases could be passed onto consumers in the form of higher pricing particularly in longer lived and other non-prime lending products.

In conclusion, the robust post-crisis regulatory regime, especially the stress tests mandated by the Dodd-Frank Act, raise serious questions as to whether CECL is even needed. At a minimum, the adoption of CECL should be delayed so that a quantitative impact study may be conducted to conclusively understand the magnitude of the potential negative impacts to consumers, businesses and the overall economy.

Chairman Luetkemeyer, Ranking Member Clay, members of the subcommittee, I want to thank you for allowing me to testify this afternoon. I am pleased to be here to represent Capital One and express our concerns regarding the Current Expected Credit Loss (“CECL”) accounting standard that has been issued by the Financial Accounting Standards Board (“FASB”). I am

also here to provide you with some possible solutions to mitigate the concerns we and other financial institutions have with this standard.

Capital One is one of the nation's 10 largest banks based on deposits and offers a broad array of financial products and services to consumers, small businesses and commercial clients. A Fortune 500 company, Capital One has one of the most recognized brands in America.

I have been with Capital One for more than seven years and Chief Financial Officer since May 2016. I previously served as Capital One's Principal Accounting Officer and Controller. Prior to my time at Capital One, I held various executive finance roles at Fannie Mae, I was a Partner with KPMG and a Professional Accounting Fellow in the Office of the Chief Accountant at the Securities and Exchange Commission.

CECL History

The global financial crisis of 2007-2009 highlighted what some called a weakness in the traditional "incurred loss model," under which companies recognize credit losses on their loans once those losses are "probable." During the crisis, balance sheet loss allowances grew at a rate considered "too little, too late" by critics who believed that lenders should be able to use more forward-looking information to establish reserves for loan losses rather than waiting to reserve until after the loss is probable. The delayed recognition of credit losses was cited by the Financial Crisis Advisory Group ("FCAG") as a weakness in generally accepted accounting principles ("GAAP"). In an attempt to address these perceived deficiencies, the FASB initiated a project in 2008, issuing forward-looking reserve proposals that culminated in the issuance of CECL in June 2016, replacing the existing "incurred loss" framework with a new model requiring immediate recognition of credit losses expected over the contractual life of the underlying financial instrument.

CECL was developed to reduce the procyclicality of credit loss recognition. The standard removes the “probable” threshold and the concept of “incurred” that financial institutions have used for over 40 years. In its place, CECL requires financial institutions to consider forward-looking information in order to estimate expected lifetime credit losses. CECL was intended to ensure that loss reserves accurately reflect not just the present but the future as well. Reserves are considered “procyclical” when they are overstated at the trough of an economic cycle (the downturn) and understated at the peak of an economic cycle. Procyclical reserves threaten to overinflate economic peaks and make economic downtowns worse. As noted by the Financial Stability Forum[1], "addressing procyclicality is an integral part of strengthening the macroprudential or systemic orientation of regulatory and supervisory frameworks. A macroprudential orientation focuses policy on avoiding damage to the financial system as a whole with an eye to the impact on the real economy.”[2]

CECL distorts the accounting and economic relationship

CECL requires banks to estimate losses for the entire life of a loan including the prediction of future economic conditions which necessitates anticipating exactly whether - and precisely when - a downturn will occur. Because such perfect foresight is impossible, banks will be forced inevitably to adjust their expectation of lifetime credit losses once a downturn occurs, increasing projected loan losses at that point. Thus, loss reserves (and without regulatory capital relief, required capital) will rise as the economy worsens. The effect on capital would reduce lending, and could be harmful to consumers and small businesses through higher pricing, reduced loan tenors, and less access to credit for already underserved borrowers.

[1] The Financial Stability Forum was an institution of major national financial authorities and international financial bodies that promoted international financial stability.
[2] Financial Stability Forum publication: “Report of the Financial Stability Forum on Addressing Procyclicality in the Financial System,” April 2, 2009

CECL will also discourage normal bank lending, even during healthy economic periods, by front-loading the capital costs of originating loans. Under CECL, when a bank increases its lending, all of the estimated losses over the life of those loans reduce capital on the day of origination. In the depths of a recession, when banks must look more carefully for revenue opportunities, banks are less likely to lend when lifetime losses must be recorded before the first dollar of revenue.

This divergence, combined with the procyclicality of CECL and the conservative bias expected of banks as it relates to loan loss reserves, will result in increased costs to extending credit. At a minimum, if these concerns are realized, it will discourage lending during a weak economy, limiting constituents' access to credit when it is needed the most. Consumer and small business lending products will generally become less attractive to lenders once CECL is adopted, with the potential to either become less available in the market, or possibly repriced to reflect the additional costs incurred to provide them. Notably, this effect will be felt most acutely by underserved borrowers, where higher historical loss rates will exacerbate CECL's negative effects, further raising costs and reducing the availability of credit.

CECL is more procyclical

Research has cast doubt upon CECL's central claim that it would reduce procyclicality of credit loss recognition. Federal Reserve Board ("FRB") Staff analyzed the procyclicality of CECL and concluded that provisions are generally less procyclical compared to the incurred loss model, but only "to the extent that risk managers have a capacity, even somewhat limited, to predict near-future macroeconomic trends."[3] This assumption is highly problematic. Both empirical data and academic research show that macroeconomic forecasters' ability to predict even short-

[3] Chae, Sarah, Robert F. Sarama, Cindy M. Vojtech, and James Wang (2018). "The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves," Finance and Economics Discussion Series 2018-020.

term trends, especially the ability to predict the timing and/or magnitude of the onset of an economic downturn (or an upturn), is critically limited, and is especially limited at the turns of economic cycles.

Research by The Bank Policy Institute ("BPI," formerly The Clearing House) concludes that had CECL been implemented prior to the global financial crisis, loss provisioning would have been "highly procyclical" and likely would have "exacerbated the impact of the 2007-2009 financial crisis." BPI noted that macroeconomic models and forecasters are "generally unable to predict turning points. Most of the time, the models predict that economic conditions in the future will be similar to the present while gradually reverting to the mean."[4] In other words, BPI concluded that forecasters err by believing the future will be too much like the present. This is particularly relevant because, due to intentions to minimize management bias, companies will likely rely on such forecasters for assumptions of how the economy will look in the future when estimating lifetime loan losses under CECL. Therefore, they will likely be slow to pick up the worsening and then slow to pick up the recovery.

BPI also noted that forecast errors are generally small prior to a recession but rise significantly when a recession begins. For example, utilizing macroeconomic models, the forecast error for the unemployment rate was determined to be -0.1 percentage points for forecasts ending in Q4 2007, but that error rate exceeds 3.75 percentage points ending in Q4 2009.[5] This is critical, as CECL credit loss expectations will be highly sensitive to forecasts of economic indicators, and changes to those forecasts, particularly at cycle turns, will greatly amplify the level of procyclicality under the new lifetime CECL model. BPI's research concluded that at this critical point when the economic cycle changes, forecasts are the most inaccurate.

[4] The Clearing House Staff Workpaper 2018-3: "Current Expected Credit Loss: A Top Down Approach"
[5] The Clearing House Staff Workpaper 2018-3: "Current Expected Credit Loss: A Top Down Approach"

Similarly, an FRB Staff working paper identified many challenges associated with forecasting, including changes in the structure of the macroeconomic environment, forecaster bias and measurement of input data. The FRB Staff paper indicated that “the December 2008 forecasts of the December 2009 unemployment rate ranged from under 5 percent to almost 10 percent.”[6] As noted by the American Bankers Association (“ABA”), unemployment forecasts by the Federal Reserve Bank of St. Louis (“FRBSL”) did not sufficiently recognize the extent of the eventual increase in unemployment in its forecasts until late in 2009.[7] However, subsequent FRBSL forecasts then overshot both the severity and the length of the economic decline.

Having overseen the loan loss allowance at financial institutions for over a decade, I believe I have a good perspective to judge the future under CECL. I believe that the inability of forecasters to predict economic changes will inevitably cause CECL to be more procyclical than the incurred loss model. Prior to an economic downturn, allowances will be based on an economic forecasts heavily driven by the then current environment. As the economic downturn evolves, forecasters will increasingly incorporate worsening economic assumptions, driving up CECL allowances.

The process of setting the allowance of loan loss is intended to be prudently conservative. As we work through an economic cycle, there is a strong bias from auditors and regulators to continue to forecast economic worsening until there is evidence of economic improvement. This process most often results in the peak allowance occurring after the peak of the economic worsening. There have been no innovations in forecasting since the creation of CECL that will mitigate this effect. These factors will result in CECL's impact on reserves being significantly

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[6] Chae, Sarah, Robert F. Sarama, Cindy M. Vojtech, and James Wang (2018). “The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves,” Finance and Economics Discussion Series 2018-020.

[7] American Bankers Association response to “Regulatory Capital Rules: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations” (Docket OCC-2018-0009; FRB Docket No. R-1605/RIN 7100-AF04; FDIC RIN 3064-AE74)

more procyclical than the current accounting model and thus functioning contrary to its intended purpose by exacerbating, rather than limiting, the effect of an economic downturn.

As one analysis summarizes, “if banks fail to anticipate turning points well in advance or to adopt additional precautions during good times, the more forward-looking provisioning methods may paradoxically mean that banks experience more sudden falls in regulatory capital right at the beginning of contractionary phases of the business cycle,”[8] which would amplify the procyclicality currently observed in the incurred loss model. Essentially, CECL estimates relying on such forecasts would have resulted in inappropriately higher reserves during the financial crisis than those recognized with incurred loss accounting and would have maintained those high reserves longer, even as the economy was stabilizing, potentially creating a drag on the recovery.

CECL is bad for investors and lacks comparability

Based on our active and extensive dialogue with investors, it is clear to us that institutional investors are generally opposed to CECL. As previously noted, accounting under CECL is inconsistent with the economic flows of lending. As this occurs, investors will likely turn to non-GAAP measures to understand the difference between financial and economic performance. They believe that the necessity but inability of banks to predict the timing and magnitude of economic cycles will increase the procyclical volatility of bank financial statements. Higher volatility will increase both the required amount of capital and the cost of that capital, resulting in lower and less predictable returns, even as the real underlying economics of lending will not change. Additionally, investors believe financial statements will be less reliable and less comparable after CECL is implemented. Accuracy and reliability will decrease as assumptions about economic and credit cycles, which are empirically unreliable, cause and amplify changes

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[8] Abad, Jorge, and Javier Suarez (2018), “The Procyclicality of Expected Credit Loss Provisions”

in financial results as those forecasts and assumptions are adjusted in reaction to real cyclical movements. This impact is at its worst during periods of economic stress.

As institutions with similar asset classes may make different judgments about the future performance of their portfolios, readers of financial statements will be forced to reconcile the differences in management judgment to fully understand the comparability of financial results. This problem will be particularly acute for portfolios of long dated assets where the estimated loss recognized at origination will change over time with changes in economic assumptions and may never align the provision expense with the economics of the long-term loan. The economics would require the institution to realize the earnings as the borrower performs against the obligation over a period of time.

The net effect of all these factors is that investors, who should be the intended beneficiaries of changes in financial reporting requirements, do not see CECL as a positive. To the contrary, they will be less willing and able to allocate their investment dollars to the banking sector, thus making it more challenging for banks to access capital, particularly during periods of stress when banks, their customers, and the economy need it most.

CECL is duplicative of more effective post-crisis reforms

Banks use capital as a buffer against credit losses. The Federal Reserve notes that "[c]apital provides a buffer to absorb losses that may result from unexpected operational, credit, or market events."[9] Given substantial advances in prudential regulation in response to the financial crisis, CECL is duplicative of other, far more effective tools, specifically Basel III and the capital stress testing regimes of the Dodd-Frank Act. Basel III has increased both the quality and quantity of capital, and stress testing ensures that banking institutions have the capital

[9] Federal Reserve Board, Supervision and Regulation Report, November 9, 2018,

resilience to withstand severe and sustained economic downturns and related impacts to revenues and loan losses.

The Federal Reserve has concluded that "[s]ince the financial crisis, the Federal Reserve has implemented new rules that have significantly raised the requirements for the quantity and quality of bank capital, particularly at the largest firms."[10] The Federal Reserve's Comprehensive Capital Analysis and Review ("CCAR") (including the federal banking agencies' recent Stress Capital Buffer ("SCB") proposal) in particular is far more effective at achieving CECL's goal, and unlike CECL, it does not have the procyclical impacts since it is scenario-based and monitored in advance of a crisis. The SCB proposal makes CECL's redundancy especially apparent. The SCB framework would ensure that bank capital levels adjust concurrently with the economic cycle and changes in a bank's risk profile, all in advance of a downturn. Put another way, SCB implementation would force banking organizations to recognize and capitalize for potential economic downturn losses sooner, just as CECL is intended to do.

Abandon CECL; or other options

We support the efforts of FASB to improve financial reporting, as reliable and useful financial statements are a bedrock of our financial markets. Nonetheless, we believe CECL should be abandoned because it is duplicative of other, more effective post-crisis capital reforms, and poses potential economic threats to consumers and small businesses, especially those in underserved segments of the market.

If not abandoned, then delayed and studied

As the adoption date nears, banks, banking regulators, consultant firms and trade groups have published studies attempting to estimate the impacts of CECL. In our view, this research shows

[10] Federal Reserve Board, Supervision and Regulation Report, November 9, 2018,

that CECL will be procyclical, duplicative, and detrimental to our economy. We recognize that other good faith efforts have come to conflicting conclusions on these points. In some cases, the studies rely on expectations of perfect, or near-perfect foresight of future economic conditions, are limited in the dataset availability to support their respective analysis, or involve simplifying assumptions that could greatly impact the outcomes of the studies. Clearly, more research is needed. That is why we and many other banks, trade groups, and members of Congress have requested a delay in the adoption of CECL so that a quantitative impact study can be conducted to determine conclusively whether CECL will have any potentially negative impacts, and if so, provide an opportunity to address those impacts prior to its required adoption.

Though FASB has done much good-faith work in designing CECL, its focus does not extend to CECL's broader economic impact. As part of its standard-setting process, the FASB conducts a significant level of outreach to financial statement preparers, audit firms, banking regulators, and users of financial statements to develop standards that improve upon financial reporting. Prior to issuing a standard, the FASB conducts a cost-benefit analysis on the impact of the standard. In this case, however, the cost aspect of these analyses focused solely on the operational implementation and execution costs to provide the benefits of improved reporting, rather than potential broader costs to economic activity. This analytic is both significant and critical. Typically, the economic impacts of new reporting standards measured in this manner are de minimis, and thus their exclusion does not materially impact the outcome of the analysis.

Evidence strongly suggests, however, that the potential for CECL to impact economic activity is both unique and profound. Therefore, the FASB's cost-benefit analysis for this standard should be expanded to incorporate potential costs to the economy more broadly. There is still time to delay the implementation of CECL to perform a quantitative impact study to understand and resolve its impacts on lending and regulatory capital.

Alternative proposal submitted to FASB

In the absence of any such rescission or delay, twenty-one financial institutions (including Capital One) submitted a proposal (the “Proposal”) to the FASB to initiate a dialogue regarding how the CECL standard could be amended in order to avoid or limit the unintended consequences to the economy. The Proposal retains the FASB’s intent of establishing an allowance for the lifetime of an asset on the balance sheet, but recognize the provision for credit losses in three parts: (1) for non-impaired financial assets, loss expectations within the first year would be recorded in earnings as a provision for losses with (2) loss expectations beyond the first year recorded to Accumulated Other Comprehensive Income (“AOCI”) and (3) for impaired financial assets, lifetime expected credit losses would be recognized entirely in earnings.

We believe this Proposal better aligns the accounting under CECL with the economics of lending, while still providing financial statement users with decision-useful information on an institutions lifetime expectation of losses. Additionally, the Proposal retains the flexibility of the CECL standard and is not prescriptive of modeling methodologies enabling institutions to apply an approach that is commensurate with their size, complexity, and risk management systems.

The Proposal could be leveraged by the banking regulators to reduce the impact of CECL on regulatory capital by allowing banks to opt-out of the portion of losses in AOCI, thereby avoiding the unintended consequences of additional capital cost passed on to consumers and small businesses through higher pricing, reduced loan tenures, and reduced access to credit for already underserved borrowers. Additionally, the opt-out of CECL losses recorded in AOCI aligns with the recent banking regulatory proposal to change applicability thresholds for regulatory capital and liquidity requirements, as the Proposal provides a framework to quantify the AOCI amount through well governed and controlled processes.

A primary objective of CECL, to provide financial statement users with more decision-useful information about the expected credit losses on financial instruments at each reporting date, would not change with the adoption of the Proposal. Instead, the Proposal attempts to leverage the primary features of CECL (e.g., incorporating forward-looking information, estimates of expected credit losses over the contractual term of the underlying financial assets), while reflecting a more accurate depiction of the economics of lending transactions in the income statement (credit losses are typically experienced well after origination, clustered in economic downturns, and are offset by interest income from performing loans). The Proposal would provide financial statement users with enhanced visibility into an entity's expected lifetime credit losses and more appropriately align the income statement recognition of credit losses with the FASB's concept statement related to recognition and measurement in an entity's financial statements.

We would like to thank you and the members of the Subcommittee for holding this important hearing and look forward to continuing to work with you to ensure we achieve an appropriate balance between the objectives of FASB, the prudential regulatory expectations of the banking agencies, the safety and soundness of the banking industry, and the availability and affordability of credit to consumers and small businesses.