CRE Finance Council®
The Voice of Commercial Real Estate Finance

March 8, 2019

Mr. Wes Bricker
Chief Accountant
U.S. Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Mr. Russ Golden
Chairman
Financial Accounting Standards Board
301 Merritt 7 / P.O. Box 5116
Norwalk, CT 06856

Dear Mr. Bricker and Mr. Golden:

The Commercial Real Estate Finance Council (CREFC) appreciates the Securities and Exchange Commission's (SEC) and the Financial Accounting Standards Board's (FASB) engagement on the current expected credit loss (CECL) accounting standard, which is set to take effect for certain institutions in January 2020. The roundtable convened by FASB on January 28th represented a welcome opportunity for stakeholders to provide feedback on CECL implementation at this important juncture.

By way of background, CREFC's members represent U.S. commercial and multifamily real estate investors, lenders, and service providers – a market valued at an estimated $6.3 trillion supported by $4.2 trillion of commercial real estate (CRE) debt. Commercial banking organizations, life companies, REITs, debt funds, and the commercial mortgage-backed securities (CMBS) market represent the top sources of private debt for commercial and multifamily real estate. In general, CREFC promotes capital formation, encouraging commercial real estate finance market efficiency, transparency, and liquidity.

Our members believe that CECL is a well-intended effort to blunt the severity of future downturns by making the reserve process less procyclical, aligning financial institutions' reporting with future forecasts, and providing investors with better information. Our members, however, have also expressed concerns that the standard could result in negative impacts on long-term lending, be procyclical—even disincentivize lending (particularly during economic downturns)—and generally exacerbate many of the hurdles to extending credit that institutions are already facing in the wake of increased capital requirements.[1]

While many banks have argued for regulatory capital relief for CECL reserves from the prudential regulators, we have also heard from our nonbank members, and accordingly, are seeking an industry-wide measure that would apply equally to depository and non-depository institutions. In this letter we are asking for your assistance in alleviating unnecessary disruptions to credit creation by helping to facilitate more complete testing and better calibration. We intend for the below observations to bolster the initial feedback received already by the SEC and FASB,

[1] A fuller list of concerns includes the following: whether CECL accurately reflects changes in credit conditions, and takes into consideration issues such as the variance of approaches, reduction of comparability, potential earnings volatility, as well as balance sheet and operational costs.

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and to help demonstrate the need for regulators to collect additional information and execute a comprehensive analysis on the possible effects of CECL on lending markets and the economy.

Given the significance of CECL, we request that you delay the standard's effective dates to allow for the completion of a quantitative impact study. To clarify, at this time, we are not seeking a repeal of the CECL standard or major changes to it. Rather, we are asking for additional time to learn and assimilate the results of an impact study designed to assist all stakeholders to more fully prepare for the resource-intense transition that CECL requires.

Issues and Challenges Related to CECL Warranting Further Analysis Prior to the Standard's Effective Date

As a general matter, we note that there are several challenges associated with CECL that apply to both large and small institutions, as well as to banks and nonbanks. The broad array of institutions subject to the new standard may result in a high degree of variance in interpretation and implementation of CECL from institution to institution. For this reason and others, all stakeholders could benefit from an offline testing period prior to the standard's effective date.

Some of the issues we believe warrant additional pre-effective date study and analysis include:

1. **Macroeconomic indicators can be poor signals of cycle turns:** A recent analysis prepared by the Bank Policy Institute (BPI) provides evidence that had CECL been in effect during the financial crisis, bank capital ratios could have contracted by greater than one and a half percentage points more than actuals, and in response, aggregate bank lending would have declined by an additional nine percentage points.[2] BPI tested certain indicators (GDP, unemployment, housing price index, and commercial real estate values), and found there to be a sometimes significant long-term lag effect (sometimes as many as eight quarters), thus contributing to material model error of as much as 30% or more. The model error increases with the model horizon and becomes especially pronounced for forecasts of one year or more.

   This long-term lag effect of macroeconomic forecasts may cause over-reserving, even if the economy has begun to move into a recovery period. This may have the effect of limiting banks' lending ability to lend at the exact point in time when it would be most important. Over-reserving of this type is not only contradictory to good financial reporting, but is also potentially distortive of an institution's or a sector's credit quality.

2. **Rising balance sheet usage costs may incentivize lenders to reduce credit availability or significantly change terms:** While nothing in the CECL standard itself restricts lenders' ability to approve borrowers or to offer longer terms, the costs of increased balance sheet usage can lead financial institutions to make changes in

[2] https://bpi.com/wp-content/uploads/2018/07/CECL_WP-2.pdf.

their products and borrower criteria. Ultimately, these decisions may manifest in reduced credit availability.

3. **Inaccurate parameterization of models and/or calibration of inputs may lead to procyclical decision making:** In some cases, CREFC members found that their CECL models indicated that they should release reserves now, either because of the influence of optimistic macroeconomic indicators or because of some other change in the reserving methodology (e.g., moving from loss assumptions based on contractual life of loan to "expected life of loan"). Even when a covered institution adheres to the CECL requirements faithfully, outcomes can run counter to what may seem logical and require additional calibration and/or weighting of input factors to avoid procyclical decision making.

   We recognize that the SEC and FASB responded to industry members' arguments for a principles-based regime, and yet this may lead to variance. Ultimately, there is a significant potential for small inaccuracies in calibration to lead to relatively major earnings and balance sheet impacts. Why, how, and when such calibration of input factors should be conducted within the CECL framework are important questions for further study. This is particularly true given that even the most robust of systems and resources can produce inaccurate results at times. There are any number of moments within CECL that require judgment, which are opportunities to course correct and for error.

4. **Data compliance and auditability considerations can drive the decision to use proxy data from other subsectors, which presents modeling challenges and increases error rates:** Even if institutions were to collect all of the relevant data on their own loans and losses necessary to produce forward loss curves, all but the largest institutions may have data gaps, and this may be especially true for institutions that have acquired legacy portfolios. In addition, institutions with relatively few observable losses over time do not have the ability to generate statistically significant model outcomes. In these cases and more, companies are being forced to use proxy data related to products and sectors that only partially represent a given portfolio.

   The use of proxy data can increase error rates significantly. Many lenders may choose to outsource to one of the limited number of companies that have sufficient data and modeling capabilities. This may solve a few immediate challenges related to data compliance and auditability but could also increase certain system-wide risks.

5. **CECL has a wider reach than just loans:** Because the standard applies to Held for Investment (HFI) and Held for Maturity (HTM) portfolios, CECL may change the way losses are booked on securities held in those portfolios. Consequently, CECL also may have the potential to affect demand for and pricing of securities in HFI and HTM portfolios, including some retained interests on CMBS and other securitizations held in satisfaction of risk retention.

Importance of Smooth Implementation and Timing Considerations

Unlike capital rules that apply to a particular set of financial institutions or disclosure rules that apply to a limited number of product types, CECL will apply to a broad range of financial institutions and across most commercial and consumer loan and lease products—as well as securities under certain conditions. More specifically, CECL will apply to banks, asset managers, REITs, insurance companies, endowments, and foundations, and will cover the largest whole loan markets, including residential and commercial mortgages, commercial and industrial loans, small business loans, student loans, and many others. While some institutions are more fortified against disruptions due to diversified funding and capital sources, others with small networks and more limited resources could be significantly disrupted by any unintended negative consequences stemming from CECL's implementation.

Complicating matters further, CECL will be implemented simultaneously with many other major accounting and policy changes. New approaches to loan treatment and revenue recognition are also slated to go into effect starting on January 1, 2020. Banks and other large institutions will have to comply with new capital (e.g., stress capital buffer, market risk, counterparty credit limits, and others) and liquidity (e.g., net stable funding ratio) requirements, to name a few. Each one of these rules will likely alter income and/or balance sheet statements for some of the largest lenders and lessors in the country. Taking all of these developments together, CECL will be implemented during a period in which a variety of policy shifts are expected to impact lending behavior—with yet unknown real world effects.

Finally, with respect to implementation timing, many CRE industry participants believe that we are likely nearing a turn in the business cycle. The volatility that comes with this transition period can often reduce the value of macroeconomic forecasts, as the BPI study authors concluded. A downturn can also break down well-established correlations, causing input assessments and calibrations to be less reliable and increase model error. Early 2020 is shaping up to present challenges for all forecasting efforts, and the consequences of underestimating the potential for error are material. In a worst case scenario, faulty CECL implementation could impact firms' funding, capital, and credit ratings, and for consumer and institutional borrowers, access to capital could be unnecessarily disrupted.

Lessons from the Bank Regulators and the Value of Impact Studies

Regarding implementation, the Basel Committee on Banking Supervision (BCBS), which develops regulatory capital standards internationally, has been rolling out Basel III risk-based capital requirements iteratively for roughly a decade with numerous testing periods, multi-year phase-ins, and many revisions along the way. Most recently, the BCBS revised already-final market risk standards to mitigate unintended consequences and better calibrate outcomes.[3] In this

[3] After reviewing additional data, the BCBS revised methodologies, correlations, and calibrations from the previously finalized minimum capital requirements for market risk adopted on January 14, 2016, in the newly reissued version on January 14, 2019.

particular case, the related regulatory capital rules[4] had yet to be proposed in the U.S., and prior impact studies were useful in identifying and avoiding unintended consequences.

As the regulatory body overseeing FASB, we recognize the important role the SEC has in the CECL process. Namely, the SEC's Division of Economic and Risk Analysis is well suited to fully analyze the implementation challenges and potential impacts associated with CECL.

Ideally, an impact study would address several dimensions of CECL in order to provide decision-useful information to all stakeholders, including the SEC and FASB, such as:

- Measure average implementation and ongoing costs;
- Catalogue often-used inputs and assumptions;
- Analyze market-wide data specific to given products, and if possible, segmented by vintage and other criteria (e.g., credit quality, geography);
- Compare forecasts and actuals during different periods of the cycle; and
- Study the effects of day-one reserving on loan pricing, structures, terms, etc.

With analyses of the above, it should be possible to answer important questions, such as:

- How much CECL will cost the average institution, both to launch the program and to run it ongoing;
- How much earnings volatility firms may expect and how long might it take to optimally calibrate models; and
- What are the real world impact on earnings, balance sheet capacity, and any potential effects on critical downstream functions, such as funding, capital, and/or ratings.

[4] Often referred to as "Fundamental Rule of the Trading Book" (FRTB).

<u>Conclusion</u>

We continue to support the work and independence of standard setters such as FASB, and we strongly oppose any efforts to impose inappropriate political or other influence on accounting standards' development. Congress has long recognized the independence of FASB and designated the SEC as the primary agency with oversight of FASB. We believe this system has served our capital markets extremely well and that the SEC and FASB are the appropriate bodies to spearhead the ongoing discussions and review of CECL.

For all of the reasons outlined above, we encourage you to delay the effective dates of the CECL standard so you may conduct further analysis of the challenges related to CECL's implementation and a comprehensive impact study.

Thank you for your attention and engagement on this important matter. We look forward to working with you during this process, particularly with regards to the impact study.

Sincerely,

Lisa A. Pendergast

Lisa Pendergast
Executive Director
CRE Finance Council

cc: Senator Mike Crapo, Chairman—Senate Banking Committee
Senator Sherrod Brown, Ranking Member—Senate Banking Committee
Rep. Maxine Waters, Chairwoman—House Financial Services Committee
Rep. Patrick McHenry, Ranking Member— House Financial Services Committee