No Reason For Fear

by Steve Brown

People are certainly weird critters. Many of the banker variety sadly suffer as well from a horrible dual-affliction known as metathesiophobia and tropophobia. While we have heard some brightly colored pills may help with these issues, we would bet those medications may also have crazy side effects - like loss of hair or cause gas and bloating perhaps. Maybe it is just easier if bankers get over their fear of change (metathesiophobia) and fear of getting moving (tropophobia).

That's right - we are talking about the recent change in the way banks will have to estimate allowances for credit losses under the current expected credit loss methodology (CECL).

As we said above, people hate change, so given how new CECL is the natural tendency is to gripe about it to anyone who will listen. After all, implementation of the standard is still a few years out, so griping is certainly in vogue right now. We want to reassure you that we have looked at this issue closely and CECL is not as scary as it's being played out.

For starters, the new standard requires you to think about what your losses will be over the life of your loan portfolio. That is a change from what we all do now which is to set aside what you're going to incur over the near term. That change sounds scary and like a whole lot of work when you look at it in a vacuum.

However, the impact of this change will be mitigated. This is because the average life of a loan portfolio at a typical community bank is about 2.5 to 3.0Ys. So, average losses incurred over this time interval should be about what we have historically maintained in our allowance for loan and lease losses (ALLL). Ta-da!

Indeed, looking at FDIC call report data back to 1992, we find reserves and charge-offs (assuming an average loan life of 3Ys) were in sync with the exception of the Great Recession. In short, this was an exceptionally abnormal event by definition.

Next, if you are concerned about how to actually measure the life of a given loan, just knock on your CFOs door. He or she already has this information because they have to for asset-liability committee (ALCO) analysis. This analysis also includes the impact of changing rates on prepayment optionality.

Basically, bankers need to know how loan balances will decline over time, in order to apply the applicable loss rates to these declining balances. Put another way - this just means that different areas of your bank (lending and finance) are going to have to talk to one another more to get the information necessary to calculate the reserve under CECL.

Lastly, it's been bandied about that bank reserves might need to go up by 30% to 50% as a result of CECL. We believe as things stand now this is hooey. We say this because as previously noted banks have been over-reserving under the current rule for a long time. This is because qualitative considerations (Q factors) and unallocated reserves have made up the majority of ALLL for most bankers as they strive to account for "uncertainty". Given that CECL will "account" for some of this

uncertainty with life-of-loan and forward-look components, much of the qualitative and unallocated reserves will need to be substantially dialed-back. While no one knows for sure yet, these may all offset each other.

For all these reasons, banks don't need to panic or resist this change. While your bank will undoubtedly have to adjust to the new accounting approach, in our view you shouldn't feel the need to take a pill to deal with a case of metathesiophobia or tropophobia.

BANK NEWS

Wells Fargo

The bank will pay a fine of $185mm related to the opening of some 2mm unauthorized consumer bank accounts, the largest penalty the CFPB has ever levied against a bank. Wells fired 5,300 employees as a result of this issue. The CFPB called to conduct "outrageous" and "a violation of trust and an abuse of trust" and vowed that it would not happen again at any bank.

Branch Closures

BB&T ($222B, NC) said it plans to close an undisclosed number of branches by year end, as it seeks to further downsize its network. Meanwhile, SNL Financial reports US banks and thrifts over the past 3 months closed 505 branches, with 120 in Aug, 236 in Jul and 149 in Jun.

Mobile Payments

JPMorgan reports mobile payment usage rates for Apple Pay, Android Pay and Samsung Pay collectively account for less than 1% of all retail point-of-sale payments.

No Multitasking

Research by the US Naval Research Laboratory finds that when people are interrupted for 2.8 seconds the risk of making an error doubles, while increasing the interruption to 4.4 seconds triples the risk.

Digital Strategy

Research by Deloitte and MIT on digital disruption finds 52% of respondents either agree or strongly agree that their organization has a clear and coherent digital strategy.

Millennial Risk

A FICO survey finds millennial banking customers are 2x to 3x more likely to close all of their accounts at their primary bank than people in other age groups. Fees and convenience are the two primary reasons for the difference.

Customer Cost

Forbes reports Bank of Ireland and Royal Bank of Scotland are now charging large depositors to hold their deposits, given ongoing negative rates in some global markets.

Settlement

Bank of America will pay $12.8mm to settle claims with 270 Merrill Lynch advisors that the company wrongfully withheld certain deferred compensation back in 2008.