

www.garp.org

How Will CECL Perform in a Typical Recession?

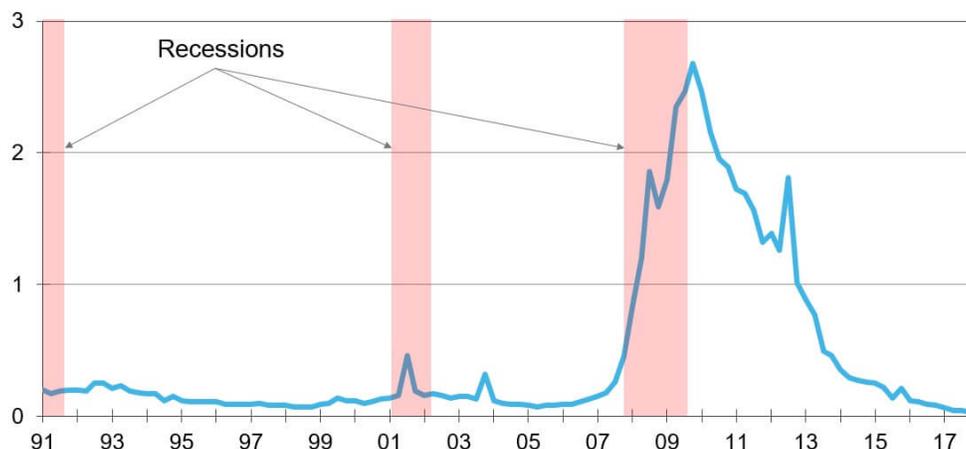
By Tony Hughes, August 24, 2018

<https://www.garp.org/#!/risk-intelligence/credit/all/a1Z1W000004AzmxUAC>

I watched [The Big Short](#) for the umpteenth time the other day. Watching the film, a young credit analyst may wonder how we could have been so collectively stupid. The monumental boom and bust was built on a single unsupportable premise: that house prices can never fall in a sustained manner at anything other than a local level. The subprime crisis simply pulverized this myth.

Resi Mortgages Were Safe Until They Weren't

Residential Mortgage Charge-off Rate, %, seasonally adjusted



Source: U.S. Board of Governors of the Federal Reserve System (FRB)

The myth did not form from thin air. By 2006, the U.S. had experienced a long sequence of post-war recessions in which the housing market really was bulletproof.

Apart from a brief decline during the early 1990s recession, national house price indexes had risen inexorably since the early 1970s. The decline in collateral values in 1991 triggered a slight rise in losses for banks, though this barely registers when placed alongside the disastrous [2008/09 financial collapse](#). The relatively mild [2001 recession](#), meanwhile, had precisely zero impact on observed mortgage industry credit losses.

The CECL Connection

There has been a spate of recent articles addressing the cyclicity of the new credit loss provisioning regulations. Research has typically proceeded with analysts imagining a parallel world in which the [CECL](#) or [IFRS 9](#) rules had been in place in the lead up to, and during, the [Great Recession](#).

Informed by our current understanding of potential risks in the mortgage market, the analysts take a credit loss model and apply it to a variety of macro forecast assumptions to project loss rates and calculate allowances. The results are then compared to provisions obtained using the old [incurred-loss methodology](#).

If a “perfect foresight” economic forecast is then applied, countercyclical provisions are found to pertain. In other words, if you know that a monumental recession is looming, CECL rules will force provisions to rise in advance of the downturn, and to fall when the light at the end of the tunnel is in sight.

When more realistic contemporaneous economic forecasts are employed, such as those from the published consensus or out-of-time projections from a vector autoregression, the countercyclicity is found to be dramatically reduced or lost entirely. Some [studies](#) even suggest that [CECL will exacerbate procyclicality](#) during a massive recession – the specific problem the rule changes were designed to fix.

CECL and the Next Downturn

CECL, though, must cope with the next recession, not the last one. So what happens if mortgages are found to behave like they did in 2001? Or in 1991? Or in 1981? If nothing else, readers must concede that if we made *The Big Short II*, based on events taking place in the 2018 U.S. housing market, it would be the most boring sequel since *Godfather III*.

Let's assume perfect foresight of a recession mimicking the 2001 event. Bank analysts would then fire up their mortgage credit loss models, trained on the Great Recession, and find that projected losses rise by, say, 50%. These losses would be substantially less than the bank experienced during the subprime crisis; the event would be relatively mild and house prices would be assumed to remain steady. The bank would then increase its loss allowance commensurately.

Subsequently, the recession would hit ... and absolutely nothing would happen.

Some analysts may read this and say that their models are correctly specified and would immediately recognize the contours of a non-dangerous recession. They may be right. It would take a lot of guts, though, to stand up in front of a regulator and declare that the looming recession is of no consequence to the portfolio in question.

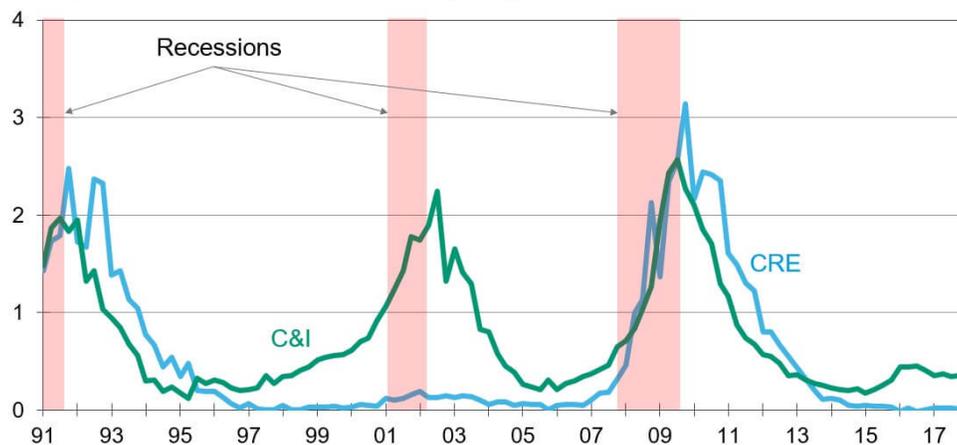
This situation highlights a key strength of the incurred-loss methodology: it responds to actual happenstances rather than perceived threats. The scenario we've described would also provide a clear win to IFRS 9 over CECL. If the flow of loans from the first stage of the IFRS 9 approach (when only one-year expected losses are calculated) into later stages (requiring lifetime losses) never accelerates, it will have the effect of capping the observed overall increase in allowance as the toothless recession unfolds.

We have focused on mortgages thus far, but such considerations apply across the banking book. The 2008/09 recession, considered the deepest in nearly a century, was unusual in that all lending products exhibited sharp deterioration.

Other recessions have typically spared many or most products. In commercial real estate, for example, the early 1990s recession was an unmitigated disaster – by far the worst in recorded history – but the subsequent 2001 recession did not cause a material increase in the rate of credit losses.

Commercial RE Missed the 2001 Recession

Charge-off Rate, %, seasonally adjusted



Source: U.S. Board of Governors of the Federal Reserve System (FRB)

Credit cards had a tough time in 2008/09, but the downturn of 2001 only triggered a loss rate rise of similar magnitude to that witnessed in 1997. Commercial lending, meanwhile, was the only major category that suffered during the 2001 event, demonstrating a pattern of losses that mirrored those of the Great Recession – a truly remarkable result given the relative depth of the two recessions.

Parting Thoughts

It's extremely difficult, of course, to predict which products will dodge the bullet in the next downturn. If the recession is a “normal” one – if it is not “Great” – CECL modelers will likely do a good job of forecasting the sectors that are impacted, but will overstate losses for those that are not. For a bank with a balanced portfolio of assets, this implies that aggregate allowances will clearly exceed the scale of ultimately observed credit losses.

In other words, elevated procyclicality of loss allowances is virtually assured in a lesser recession, even if economists correctly predict the event and everyone believes them.

Tony Hughes is the managing director of economic research at Moody's Analytics. His work over the past 15 years has spanned the world of financial risk modeling, from corporate and retail exposures to deposits and revenues. He has also engaged in forecasting of asset prices and general macroeconomic analysis.