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US Bank Credit Loss Reserve Coverage Reverts to Pre-Pandemic Levels

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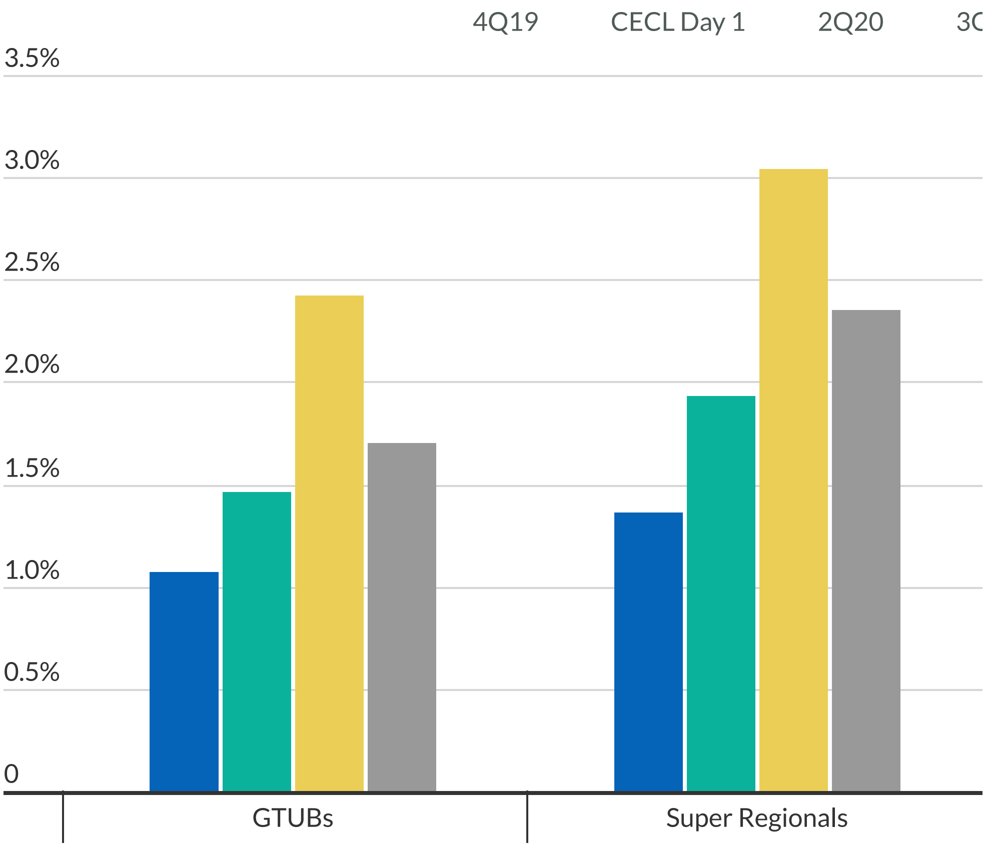
Fitch Ratings-New York/Chicago-18 November 2021: Reserve coverage for many U.S. banks is declining toward pre-pandemic Current Expected Credit Loss (CECL) Day 1 coverage levels, as the economic fallout from the global pandemic subsides and stabilizing or improving economic outlooks of the past 12-18 months are incorporated in CECL model forecasts, Fitch Ratings says. Fitch-rated banks have seen a convergence in allowance for loan losses as a percentage of total loans from peak levels in mid-2020, signaling a return to a new normal. Lower coverage ratios are typically a credit negative, but Fitch does not view the shrinking coverage levels negatively for most banks given the improving economic backdrop.

CECL coverage rates are particularly sensitive to the economic outlook as well as other considerations such as loan type, sector and geography, duration, underwriting terms and loss history. Most banks had modest increases in reserve levels upon CECL adoption on Jan. 1, 2020, but saw a steep increase in reserve coverage in early 2020 as the negative outlook from the global pandemic was incorporated into loss allowances, displaying the pro-cyclicality of the CECL models.

Banks began to release reserves in 2H20 and early 2021 as the economy proved more stable than previously anticipated. Many banks are nearing pre-coronavirus reserve levels, signifying a somewhat stabilized economic outlook, following several quarters of releases.

U.S. Banks Allowance for Loan Loss Coverage

Pre-CECL Adoption Through 3Q21



Note: GTUBs include BAC, C, GS, JPM, MS. Super Regionals include TFC, COF, PNC, USB, WFC. Large Regionals include CFG, CMA, FHN, FITB, FRC, HBAN, KEY, MTB, RF, ZION.

Allowance coverage levels for the majority of Fitch-rated banks remain slightly above Day 1 coverage levels, apart from JP Morgan and First Republic Bank. On average, the Global Trading and Universal Banks (GTUBs), Super Regional and Large Regional Fitch-rated banks' coverage ratios remain 22 bps above Day 1 levels. Large regional banks, which had the smallest reserve coverage increase in 2020, have been the quickest to converge on Day 1 levels, only 16 bps on average above pre-pandemic coverage at 3Q21. Super regionals remain highest at 42 bps on average above Day 1 coverage.

U.S. Banks' Allowance for Loan Loss Coverage

Allowance Coverage Is Converging on CECL Day 1 Levels

Note: Allowance for loans and leas losses as a percentage of total loans. COF Excluded for Scale Purposes: CECL Day 1: 3.96%, 2Q20: 6.69%, 3Q21: 4.43%. CECL - Current expected credit loss. GTUB - Global trading and universal banks.
Source: Fitch Ratings.

The conversion to pre-pandemic coverage levels is somewhat arbitrary, as loan portfolios have changed from the CECL Day 1 pre-pandemic compositions. Additionally, while economic outlooks have generally stabilized, uncertainty remains regarding supply chain constraints, interest rate hikes, continued inflation and the impact of waning federal stimulus.

Fitch's U.S. macroeconomic forecasts as outlined in the September 2021 Global Economic Outlook show improvements in the projections for GDP, consumer spending, and fixed investment yields compared to the pre-pandemic December 2019 Fitch Global Economic Outlook. However, this is weakened by higher inflation and unemployment levels and lower net trade contribution. As such, CECL models may be producing similar allowance coverage to CECL Day 1, but the drivers of the outcome may have changed.

Fitch anticipates that allowance coverage ratios will bottom out in 4Q21 or 1Q22 and that provision expenses will begin to increase in 1H22 should lending pick up. However, the return of provision expenses is not expected to raise allowance coverage ratios meaningfully above CECL Day 1 levels. Should allowance coverage ratios fall significantly below CECL Day 1 levels, Fitch may view the diminishing coverage levels as a credit negative.

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Oct. 29, 2019: Financial Institutions Dashboard: CECL Impact Varies by Bank

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