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Minding the GAAP: What You Need to Know About the Current Expected Credit Losses Methodology

Robert C. Azarow, Helen Mayer Clark, and Amber A. Hay*

The federal banking agencies have issued a final rule addressing pending changes to credit loss accounting under U.S. generally accepted accounting principles, including implementation of the current expected credit losses methodology developed by the Financial Accounting Standards Board. The authors of this article discuss the rule.

Late in 2018, the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, the "Agencies") issued[1] a final rule[2] (the "Final Rule") addressing pending changes to credit loss accounting under U.S. generally accepted accounting principles ("U.S. GAAP") developed by the Financial Accounting Standards Board ("FASB") in June 2016. Chief among those changes is the implementation of the current expected credit losses methodology ("CECL"). The Final Rule will affect the Agencies' regulatory capital rule, stress testing rules, and certain regulatory disclosure requirements. For most banking organizations, the implementation of CECL will result in earlier recognition of credit losses, an increase in credit loss allowances, as well as reductions in retained earnings and common equity tier 1 ("CET1") capital. In recognition of this outcome, the Final Rule provides the option for a three-year phase-in of the day-one adverse effects of the changes for purposes of computing regulatory capital ratios.

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[1] https://www.occ.gov/news-issuances/news-releases/2018/nr-ia-2018-142.html.

[2] https://www.occ.gov/news-issuances/news-releases/2018/nr-ia-2018-142a.pdf.

APPLICABILITY

The Final Rule applies to banking organizations that are subject to the Agencies' regulatory capital rule,[3] banking organizations that are subject to stress testing requirements, and banking organizations that file regulatory reports consistent with U.S. GAAP.

CHANGES TO U.S. GAAP

Drawing on lessons learned during the global financial crisis, in June 2016, FASB issued Accounting Standards Update 2016-13, Financial Instruments—Credit Losses ("ASU 2016-13"),[4] which introduced the CECL methodology as a new accounting standard to replace the "incurred loss" impairment approach. The advent of CECL methodology will mark a significant shift in the way credit losses on many financial assets—especially loans—are recorded. Currently, banks account for losses based on actual defaults or on specific events that foreshadow a loss. Under CECL methodology, however, accounting will be based on historical and current losses as well as losses that are expected to occur in the future over the lifetime of a loan. Further, CECL methodology requires evaluation of these potential losses at the time a loan is originated.

CECL methodology differs from the incurred loss methodology in several key respects. For assets valued at amortized cost, CECL methodology requires banking organizations to recognize lifetime expected credit losses rather than only those losses incurred as of the reporting date. CECL methodology also requires organizations to include reasonable and supportable forecasts in developing estimates of lifetime expected credit losses, in addition to maintaining the current requirement to consider past events and current conditions. ASU 2016-13 also removes the "probable" threshold for recognition of allowances in accordance with the incurred loss methodology. According to the Agencies, these features together will result in earlier recognition of credit losses by many banking organizations.

ASU 2016-13 also consolidates the current impairment approaches in U.S. GAAP by making the following technical changes:

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[3] Banking organizations subject to the Agencies' regulatory capital rule include national banks, state member banks, state nonmember banks, savings associations, and top-tier bank holding companies and savings and loan holding companies not subject to the Federal Reserve's Small Bank Holding Company Policy Statement, but do not include savings and loan holding companies substantially engaged in insurance underwriting or commercial activities, among other entities.

[4] https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168232528&acceptedDisclaimer=true.

- CECL methodology covers a broader range of financial assets than the allowance for loan and lease losses ("ALLL") under the incurred loss methodology. In addition to credit losses on loans held for investment, leasing receivables, and certain off-balance sheet credit exposures, CECL methodology also applies to credit losses on held-to-maturity debt securities.
- ASU 2016-13 replaces the term purchased credit-impaired ("PCI") assets with the term purchased credit deteriorated ("PCD") assets, which will cover a broader range of assets than the PCI definition for purposes of identifying assets subject to CECL. CECL methodology will require banking organizations to estimate and account for a credit loss allowance on each PCD asset at the time of purchase as an adjustment of the purchase price to determine the purchase date amortized cost of the asset, with post-acquisition changes in allowances established through earnings.
- CECL methodology requires banking organizations to recognize credit losses on individual available-for-sale debt securities through credit loss allowances, rather than through direct write-downs. Changes in value unrelated to credit losses will be recognized in other comprehensive income.

CORRESPONDING CHANGES TO REGULATORY CAPITAL RULES

The Final Rule implements ASU 2016-13 by making corresponding changes to the Agencies' regulatory capital rule to identify which credit loss allowances would be eligible for inclusion in a banking organization's regulatory capital. Specifically, the Final Rule:

- Adds the term adjusted allowances for credit losses ("AACL") in lieu of ALLL, which will apply to a banking organization that has adopted CECL. AACL covers a broader range of assets than ALLL, including held-to-maturity debt securities, lessors' net investments in leases, and off-balance sheet credit exposures not accounted for as insurance. AACL does not include credit loss allowances on PCD assets or AFS debt securities. AACL will be eligible for inclusion in a banking organization's tier 2 capital up to 1.25 percent of the banking organization's standardized total risk-weighted assets (excluding its standardized market risk-weighted assets, if applicable).
- Adopts a new definition of "carrying value," defined as the value of the asset on the balance sheet as determined in accordance with U.S. GAAP. For assets other than AFS debt securities and PCD assets, the

carrying value is not reduced by corresponding credit loss allowances. ASU 2016-13 revises the accounting for the impairment of AFS debt securities (carried at fair value) by requiring banking organizations to determine whether a decline in fair value below amortized cost has occurred as a result of a credit loss. ASU 2016-13 requires the recording of that impairment through earnings with a corresponding allowance. Credit loss allowances on AFS debt securities are not eligible for inclusion in a banking organization's tier 2 capital.

- Requires banking organizations to estimate expected credit losses embedded in the purchase price of PCD assets and to recognize those amounts as an allowance as of the date of acquisition. As with AFS debt securities, PCD allowances are not eligible for inclusion in a banking organization's tier 2 capital.

Given these changes, a banking organization's implementation of ASU 2016-13 and CECL will affect its retained earnings, DTAs, and allowances. Because retained earnings are a key component of a banking organization's CET1 capital, implementation also will affect a banking organization's regulatory capital ratios. In general, an increase in a banking organization's allowances, including those estimated under CECL, will reduce the banking organization's earnings or retained earnings, and therefore its CET1 capital. Increases in allowances generally give rise to increases in DTAs arising from temporary differences that will partially offset the reduction in earnings or retained earnings. However, the net effect of implementation will generally be a decrease in regulatory capital ratios.

TRANSITION PERIOD

Upon adopting CECL, a banking organization will record a one-time adjustment to its allowance for credit losses as of the beginning of its fiscal year of adoption. The adjustment will be equal to the difference between the amount of credit loss allowances calculated under the incurred loss methodology and the amount of credit loss allowances calculated under the CECL methodology. In recognition of the difficulty of incorporating future expected economic conditions in estimating allowances, the potential for unexpected economic conditions at the time of CECL adoption, and the likely one-time negative adjustment to regulatory capital ratios, the Agencies have provided for a three-year transition period for phasing in CECL. A banking organization must indicate on its Call Report or FR Y-9C, as applicable, that it is electing to use the transition period.

A banking organization that does not elect to use the transition period in the quarter in which it first reports credit loss allowances calculated under CECL

will not be permitted to make the election in subsequent periods. A banking organization that has elected to use the transition period for a portion of the three-year phase-in may elect to opt out at any point, but may not return to using the transition period.

Under the Final Rule, banking organizations electing to use the transition period will calculate transitional amounts of retained earnings, temporary difference DTAs, and AACL using the organization's balance sheet amounts for the fiscal year-end immediately prior to the organization's adoption of CECL as a baseline. The transitional amounts may then be phased-in in 25 percent increments over the three-year period (with affected amounts reflecting 75 percent of the transition amounts in Year 1, 50 percent in Year 2, and 25 percent in Year 3, with fully transitioned amounts appearing in Year 4 reports).

FASB has set a series of effective dates by which banking organizations must adopt ASU 2016-13 and elect the transition period, if it will be used. SEC filers are required to adopt no later than the fiscal year beginning after December 15, 2019 (with a corresponding bank regulatory report effective date of March 31, 2020). Other "public business entities" that are not SEC filers (including a banking organization that has its equity securities traded, listed or quoted on an over-the-counter (OTC) market) are required to adopt no later than the fiscal year beginning after December 15, 2020 (with a corresponding bank regulatory report effective date of March 31, 2021). All other banking organizations subject to the Final Rule must adopt no later than the fiscal year beginning after December 15, 2021 (with a corresponding bank regulatory report effective date of March 31, 2022). Early adoption is permitted for fiscal years beginning after December 15, 2018.

The above transition period is only applicable to bank regulatory reporting. Neither the FASB nor the SEC have adopted the transition period, which will exacerbate existing differences in the calculation of regulatory capital and the calculation of stockholder's equity, and related ratios.

CHANGES TO STRESS TESTS AND REGULATORY REPORTING

In addition to the regulatory capital changes described above, the Final Rule also amends the supervisory and company-run stress testing rules in Regulation YY to address the issuance of ASU 2016-13. Under amended Regulation YY, banking organizations will be required to incorporate CECL in stress testing processes the same year they adopt it for financial reporting. To promote comparability of stress test results across banking organizations, however, stress tests for the 2018 and 2019 cycles will continue to use ALLL as calculated under the incurred loss methodology even for banking organizations that adopt CECL in 2019.

By separate rulemaking, the Agencies have proposed revisions to certain regulatory reporting forms to reflect the changes to U.S. GAAP required by ASU 2016-13.[5] These changes have not yet been finalized.

OUTLOOK

The transition to a life-of-asset concept under CECL methodology will challenge banks to adopt a deeper level of modeling, analysis and reporting of loss reserves than previously required and will likely result in initial, substantial additions to the allowance for loan losses and reductions in retained earnings by many banks upon adoption. The transition period offered under the Final Rule for regulatory capital ratio calculations will soften the initial capital impact and allow financial institutions significant additional time for capital planning, and potential capital raising as needed.

In addition to preparing for implementation of CECL at the end of 2019, SEC reporting companies should focus current 10-K and 10-Q disclosures regarding CECL methodology on, not only the impact of adoption of recent accounting pronouncements, but also on Risk Factor disclosure regarding the potential impact of CECL on the company and the regulatory relief afforded by Agencies under the Final Rule. The largest U.S. domestic banking organizations have begun to disclose estimates of the financial impact of implementation of CECL in their most recent 10-Ks.

Banking organizations are expected to incur both transition costs and ongoing costs in developing and implementing the CECL methodology,[6] and the methodology will result in increased capital costs upon initial adoption as well as over time. According to one estimate, the transition to CECL will likely result in an increase in loan loss reserves of between $50 billion and $100 billion in the aggregate across the banking industry, which will result in some banks having to significantly increase their credit reserves.[7]

FASB derives its authority to establish accounting standards from the Securities Exchange Commission, a federal government agency subject to U.S. congressional oversight, but FASB, as an independent, private-sector, not-for-

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[5] *Proposed Agency Information Collection Activities; Comment Request*, 83 Fed. Reg. 49160 (Sept. 28, 2018).

[6] Such additional costs include potential costs related to additional data retention requirements due to the probable need to retain data longer than banks might have in the past to determine loss reserves.

[7] Raj Gnanarajah, Congressional Research Service, Banking: Current Expected Credit Loss (CECL), pg. 3 (Oct. 9, 2018).

profit organization, is not subject to similar oversight. This has not prevented U.S. Congress members from weighing in on CECL, and the potential adverse impact the methodology will have on the capital reserves of banking organizations.[8] Certain members of Congress on the House Financial Services Committee have commented on the redundancy of CECL methodology for banking organizations, given that the Agencies have designed the risk-based capital requirements to address similar concerns that CECL proposes to address, and noted that the credit loss calculations under CECL methodology will likely result in banks reducing credit availability for borrowers.[9] Whether CECL implementation actually reduces credit availability is speculative and it may be difficult to discern a causal connection, even with the passage of time. With the largest banks seemingly prepared for implementation and the regulatory agencies offering additional guidance through the issuance of Frequently Asked Questions as recently as early April,[10] all banking organizations need to prepare for their applicable effective date and all publicly traded banking organizations need to prepare for the investor and analyst questions that will increase throughout 2019.

In 2018, FASB indicated a willingness to work with Congress and stakeholders to make changes to the final standard to appropriately take into consideration existing bank capital regimes, which already require institutions to hold capital against expected losses. FASB held a credit losses roundtable in January 2019 to gather additional views on the credit losses standard, and to discuss certain transition issues for banks related to the implementation of CECL.[11] Even if changes are forthcoming, such changes may not occur prior to the CECL implementation dates or the effective dates under the Agencies' Final Rule. As a result, banking organizations should make appropriate plans to comply with the requirements under the Final Rule as presently written, as well as continuing with preparation for CECL implementation.

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[8] *See e.g.*, Press Release, U.S. Congressman Blaine Luetkemeyer: Luetkemeyer Urges Reconsideration of CECL Rule (Dec. 11, 2018).

[9] Assessing the Impact of FASB's Current Expected Credit Loss (CECL) Accounting Standard on Financial Institutions and the Economy: Hearings before the Subcommittee on Financial Institutions and Consumer Credit, 115th Cong. (Dec. 11, 2018)(testimonies of Reps. Gregory Meeks and Brad Sherman).

[10] Frequently Asked Questions on the New Accounting Standard on Financial Instruments — Credit Losses, April 3, 2019, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, National Credit Union Administration, and Office of the Comptroller of the Currency.

[11] Press Release, U.S. Congressman Blaine Luetkemeyer: Luetkemeyer Urges Reconsideration of CECL Rule (Dec. 11, 2018).