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Legal Update
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Credit Loss Accounting: US Bank Regulators' Proposal Addresses Concerns About GAAP Update on CECL (Current Expected Credit Loss)

On April 17, 2018—responding to significant industry concerns regarding the negative consequences of the required adoption of Accounting Standards Update 2016-13 (Topic 326), Financial Instruments – Credit Losses (ASU 2016-13)—the US prudential banking agencies[1] proposed an option to phase-in over three years the day-one adverse effects that this new accounting standard may have on a banking organization's regulatory capital[2] and to amend related regulatory disclosure and stress-testing (and related provisioning) requirements.

Overview of ASU 2016-13

In June 2016, the Financial Accounting Standards Board (FASB) issued ASU 2016-13,[3] which revises the accounting for credit losses under US generally accepted accounting principles (US GAAP). ASU No. 2016-13 introduces the current expected credit losses methodology (CECL), which replaces the incurred loss methodology for financial assets measured at amortized cost; introduces the term "purchased credit-deteriorated" (PCD) assets, which replaces the term "purchased credit-impaired" (PCI) assets; and modifies the treatment of credit losses on available-for-sale (AFS) debt securities.

The new accounting standard for credit losses will apply to all banking organizations[4] that are subject to the regulatory capital rules[5] (capital rules) of the agencies and that file regulatory reports for which the reporting requirements are required to conform to US GAAP.

Changes Introduced by ASU 2016-13

EARLIER RECOGNITION OF CREDIT LOSSES

CECL differs from the current incurred loss methodology in three key respects that will, taken together, result in earlier recognition of credit losses. First, CECL requires banking organizations to recognize lifetime expected credit losses for financial assets measured at amortized cost, not just those credit losses that have been incurred as of the reporting date. Second, CECL requires the incorporation of reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses while maintaining the current requirement for banking organizations to consider past events and current conditions. Third, CECL removes the probable threshold for recognition of allowances in accordance with the incurred loss methodology.

ALLOWANCES COVERING A BROADER RANGE OF ASSETS

CECL replaces multiple impairment approaches. CECL allowances will cover a broader range of financial assets than the allowance for loan and lease losses (ALLL) under the current incurred loss methodology. In general, ALLL covers credit losses on loans held for investment and lease financing receivables, with additional allowances for certain other extensions of credit and for credit losses on certain off-balance sheet credit exposures (with the latter allowances presented as a liability).[6] These exposures will be within the scope of CECL.

PCD ASSETS REPLACING PCI ASSETS

CECL covers credit losses on held-to-maturity (HTM) debt securities, and as mentioned above, ASU No. 2016-13 also introduces PCD assets as a replacement for PCI assets. The PCD asset definition covers a broader range of assets than the PCI asset definition. CECL requires banking organizations to estimate and record credit loss allowances for a PCD asset at the time of purchase. The credit loss allowance is then added to the purchase price to determine the amortized cost basis of the asset for financial reporting purposes. Post-acquisition increases in credit loss allowances on PCD assets will be established through a charge to earnings. This differs from the current treatment of PCI assets, for which banking organizations are not permitted to estimate and recognize credit loss allowances at the time of purchase. Rather, in general, credit loss allowances for PCI assets are estimated subsequent to the purchase only if there is deterioration in the expected cash flows from the assets.

NEW REQUIREMENTS FOR AFS DEBT SECURITIES

ASU No. 2016-13 also introduces new requirements for AFS debt securities. The new accounting standard requires that a banking organization recognize credit losses on individual AFS debt securities through credit loss allowances rather than through direct write-downs, as is currently required under US GAAP. AFS debt securities will continue to be measured at fair value, with changes in fair value not related to credit losses recognized in other comprehensive income. Credit loss allowances on an AFS debt security are limited to the amount by which the security's fair value is less than its amortized cost.

ONE-TIME ADJUSTMENT TO CREDIT LOSS ALLOWANCES

Upon adoption of CECL, a banking organization will record a one-time adjustment to its credit loss allowances as of the beginning of its fiscal year of adoption equal to the difference, if any, between the amount of credit loss allowances required under the incurred loss methodology and the amount of credit loss allowances required under CECL. Except for PCD assets, the adjustment to credit loss allowances would be recognized with offsetting entries to deferred tax assets (DTAs), if appropriate, and to the fiscal year's beginning retained earnings.

REGULATORY CAPITAL

CECL's changes to a banking organization's retained earnings, DTAs and allowances will affect its regulatory capital ratios. Specifically, retained earnings are a key component of a banking organization's common equity tier 1 (CET1) capital. An increase in a banking organization's allowances, including those estimated under CECL, generally will reduce the banking organization's earnings or retained earnings and, therefore, its CET1 capital. DTAs arising from temporary differences (temporary difference DTAs) must be included in a banking organization's risk-weighted assets or deducted from CET1 capital if they exceed certain thresholds. Increases in allowances generally give rise to increases in temporary difference DTAs that will partially offset the reduction in earnings or retained earnings.

Under the standardized approach of the capital rules, ALLL is included in a banking organization's tier 2 capital up to 1.25 percent of its standardized total risk-weighted assets (excluding its standardized market risk-weighted assets, if applicable). An advanced approaches banking organization that has completed the parallel run process includes in its advanced-approaches-adjusted total capital any eligible credit reserves that exceed the banking organization's total expected credit losses, as defined in the capital rules, to the extent that the excess reserve amount does not exceed 0.6 percent of the banking organization's credit risk-weighted assets.

Effective Date of ASU 2016-13

The effective date of ASU No. 2016-13 depends on the type of banking organization:

- Banking organizations that are US Securities and Exchange Commission (SEC) filers:[7] Effective for the first fiscal year beginning after December 15, 2019, including interim periods within that fiscal year.
- Banking organizations that are public business entities (PBE)[8] but not SEC filers (as defined in US GAAP): Effective for the first fiscal year beginning after December 15, 2020, including interim periods within that fiscal year.
- Banking organizations that are not PBEs (as defined in US GAAP): Effective for the first fiscal year beginning after December 15, 2020. However, these banking organizations will not be required to adopt ASU No. 2016-13 for interim period reporting until the first fiscal year that begins after December 15, 2021.

A banking organization that chooses to apply ASU No. 2016-13 early may do so in the first fiscal year beginning after December 15, 2018, including interim periods.

The Banking Agencies' Proposal

CAPITAL RULES

To address the forthcoming implementation of changes of ASU No. 2016-13 and to improve consistency between the capital rules and US GAAP, the agencies propose to amend their capital rules to identify which credit loss allowances under the new accounting standard are eligible for inclusion in a banking organization's regulatory capital.

In particular, the agencies are proposing to add "allowance for credit losses" (ACL) as a newly defined term in the capital rules. ACL would include credit loss allowances related to financial assets measured at amortized cost, except for allowances for PCD assets. ACL would be eligible for inclusion in a banking organization's tier 2 capital subject to the current limit for including ALLL in tier 2 capital under the capital rules.

Further, the agencies are proposing to revise the capital rules, as applicable to an advanced approaches banking organization that has adopted CECL, and that has completed the parallel run process, to align the definition of eligible credit reserves with the definition of ACL in this proposal. For such a banking organization, the proposal would retain the current limit for including eligible credit reserves in tier 2 capital.

ALLOWANCES

The proposal also would provide a separate capital treatment for allowances associated with AFS debt securities and PCD assets that would apply to all banking organizations upon adoption of ASU 2016-13.

PHASE-IN DAY-ONE ADVERSE EFFECTS

In addition, the agencies are proposing to provide banking organizations the option to phase in the day-one adverse regulatory capital effects of CECL adoption over a three-year period (CECL transition provision). The CECL transition provision is intended to address banking organizations' challenges in capital planning for CECL implementation, including the uncertainty of economic conditions at the time a banking organization adopts CECL.

REGULATORY DISCLOSURE REQUIREMENTS

The proposed rule also would revise regulatory disclosure requirements that would apply to certain banking organizations following their adoption of CECL. Revisions to the agencies' regulatory reports will be proposed in a separate notice.

CONFORMING AMENDMENTS

Finally, the proposed rule would make conforming amendments to the agencies' other regulations that refer to credit loss allowances in order to reflect the implementation of ASU No. 2016-13.

Comments

Comments on the proposal are due within 60 days of the publication of the notice of proposed rulemaking in the Federal Register.

For more information about this topic, please contact the author listed below.

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Endnotes

1 Namely, the Department of the Treasury, Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (Board) and the Federal Deposit Insurance Corporation (FDIC).

2 See, for example, "*Current Expected Credit Loss (CECL) Threatens Total Risk-Based Capital (TRBC) Levels,*" December 18, 2017 (available at: https://stonecastle.com/industry-insights/current-expected-credit-loss-cecl-threatens-bank-total-risk-based-capital-trbc-levels/).

3 ASU No. 2016-13 introduces ASC Topic 326, which covers measurement of credit losses on financial instruments and includes three subtopics: (i) Subtopic 10 Financial Instruments—Credit Losses—Overall; (ii) Subtopic 20: Financial Instruments—Credit Losses—Measured at Amortized Cost; and (iii) Subtopic 30: Financial Instruments—Credit Losses—Available-for-Sale Debt Securities.

4 Banking organizations subject to the capital rules include national banks, state member banks, state nonmember banks, savings associations and top-tier bank holding companies and savings and loan holding companies domiciled in the United States not subject to the Board's Small Bank Holding Company Policy Statement (12 CFR part 225, appendix C). Excluded are (a) certain savings and loan holding companies that are substantially engaged in insurance underwriting or commercial activities or that are estate trusts and (b) bank holding companies and savings and loan holding companies that are employee stock ownership plans.

5 12 CFR part 3 (OCC); 12 CFR part 217 (Board); 12 CFR part 324 (FDIC).

6 "Other extensions of credit" include trade and reinsurance receivables and receivables that relate to repurchase agreements and securities lending agreements. "Off-balance sheet credit exposures" includes off-balance sheet credit exposures not accounted for as insurance, such as loan commitments, standby letters of credit, and financial guarantees. The agencies note that credit losses for off-balance sheet credit exposures that are unconditionally cancellable by the issuer are not recognized under CECL.

7 An SEC filer is an entity (e.g., a bank holding company or savings and loan holding company) that is required to file its financial statements with the SEC under the federal securities laws or, for an insured depository institution, the appropriate federal banking agency under section 12(i) of the Securities Exchange Act of 1934. The banking agencies named under section 12(i) of the Securities Exchange Act of 1934 are the OCC, the Board and the FDIC.

8 A public business entity (PBE) that is not an SEC filer would include: (1) an entity that has issued securities that are traded, listed or quoted on an over-the-counter market or (2) an entity that has issued one or more securities that are not subject to contractual restrictions on transfer and is required by law, contract or regulation to prepare US GAAP financial statements (including footnotes) and make them publicly available periodically (e.g., pursuant to Section 36 of the Federal Deposit Insurance Act and Part 363 of the FDIC's rules). For further information on the definition of a PBE, refer to ASU No. 2013-12, Definition of a Public Business Entity, issued in December 2013.