March 26, 2020

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director

SUBJECT: Regulatory Capital Rule: Revised Transition of the Current Expected Credit Losses Methodology for Allowances

SUMMARY: The recent disruptions in economic conditions caused by the coronavirus disease 2019 ("COVID-19") and the uncertainty of its overall effects on the economy have presented significant operational challenges to banking organizations at the same time they have been required to direct significant resources to implement the new accounting standard for credit losses under U.S. GAAP known as the current expected credit losses methodology (CECL), which replaces the incurred loss methodology. To address these concerns and allow banking organizations to better focus on supporting lending to creditworthy households and businesses, staff is presenting for approval of the FDIC Board of Directors ("FDIC Board") a request to adopt and publish the attached interagency interim final rule ("interim final rule") that would provide banking organizations that implement CECL before the end of 2020 the option to delay for two years an estimate of CECL's effect on regulatory capital, relative to the incurred loss methodology's effect on regulatory capital, followed by a three-year transition period.

Recommendation: FDIC staff requests that the FDIC Board approve this interim final rule and authorize its publication in the *Federal Register* with an effective date as of the date of *Federal Register* publication and with a comment period deadline of 45 days after the date of *Federal Register* publication.

Concur:

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Nicholas J. Podsiadly
General Counsel

Discussion:

I. Background

In 2016, the Financial Accounting Standards Board issued Accounting Standards Update No. 2016-13.[1] The update resulted in significant changes to credit loss accounting under U.S. generally accepted accounting principles ("U.S. GAAP"). The revisions to credit loss accounting under U.S. GAAP included the introduction of the current expected credit losses methodology ("CECL"), which replaces the incurred loss methodology for financial assets measured at amortized cost. For these assets, CECL requires banking organizations to recognize lifetime expected credit losses and to incorporate reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses, while also maintaining the current requirement that banking organizations consider past events and current conditions.

On February 14, 2019, the FDIC, the Office of the Comptroller of the Currency, and the Board of Governors of the Federal Reserve System (together, the "agencies") issued a final rule that revised certain regulations to account for the aforementioned changes to credit loss accounting under U.S. GAAP, including CECL (the "2019 CECL rule").[2] The 2019 CECL rule revised the agencies' regulatory capital rule ("capital rule"), stress testing rules, and regulatory disclosure requirements to reflect CECL, and made conforming amendments to other regulations that reference credit loss allowances. The 2019 CECL rule applies to banking organizations that file regulatory reports that are uniform and consistent with U.S. GAAP, including banking

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[1] ASU 2016-13 covers measurement of credit losses on financial instruments and includes three subtopics within Topic 326: (i) Subtopic 326-10 Financial Instruments—Credit Losses—Overall; (ii) Subtopic 326-20: Financial Instruments—Credit Losses—Measured at Amortized Cost; and (iii) Subtopic 326-30: Financial Instruments—Credit Losses—Available-for-Sale Debt Securities.

[2] 84 FR 4222 (February 14, 2019).

organizations that are subject to the capital rule and those that are subject to stress testing requirements.

The 2019 CECL rule also included a transition option that allows banking organizations to phase in over a three-year period the day-one adverse effects of CECL on their regulatory capital ratios. The agencies intended for the transition option to address concerns that despite adequate capital planning, unexpected economic conditions at the time of CECL adoption could result in higher-than-anticipated increases in allowances. The difficulty in anticipating the increase in allowances results from the requirement in CECL that banking organizations must consider current and future expected economic conditions to estimate credit loss allowances.

The spread of coronavirus disease 2019 ("COVID-19") has disrupted economic activity in many countries, including the United States. While the U.S. government is taking significant steps to mitigate the magnitude and persistence of the overall effects of COVID-19, the magnitude and persistence of the overall effects on the economy remain highly uncertain. This uncertainty has presented significant operational challenges to banking organizations at the same time they have been required to direct significant resources to implement CECL. In addition, due to the nature of CECL and the uncertainty of future economic forecasts, banking organizations that have adopted CECL are likely to experience significantly higher increases in credit loss allowances than expected.

To address these concerns and allow banking organizations to better focus on supporting lending to creditworthy households and businesses, the agencies are providing banking organizations that adopt CECL in the current environment with the an additional option to temporarily delay a measure of CECL's effect on regulatory capital, relative to the incurred loss

methodology. The transitional relief provided in the interim final rule is intended to be simple without imposing undue operational burden, while reducing the potential for competitive inequities across banking organizations during this time of economic uncertainty and maintaining the quality of regulatory capital.

II. The Interim Final Rule

The interim final rule would provide banking organizations that adopt CECL during the 2020 calendar year with the option to delay for two years a measure of the estimated impact of CECL on regulatory capital, relative to the incurred loss methodology, followed by a three-year transition period to phase out the aggregate amount of capital benefit provided during the first two-year delay (i.e., a five-year transition, in total). The interim final rule does not replace the current three-year transition option in the 2019 CECL rule, which remains available to any banking organization at the time that it adopts CECL. Banking organizations that have already adopted CECL have the option to elect the three-year transition option contained in the 2019 CECL rule or the five-year transition contained in the interim final rule, beginning with the March 31, 2020, Call Report or FR Y-9C.

A banking organization is eligible to use the interim final rule's five-year transition if it adopts CECL by December 31, 2020 and elects to use the transition option in its first Call Report or FR Y-9C filed for a reporting period within the 2020 calendar year ("electing banking organization") that reflects the institution's adoption of CECL. If the Coronavirus Aid, Relief, and Economic Security Act ("CARES Act") becomes law and a banking organization chooses to revert to the incurred loss methodology pursuant to the CARES Act in any quarter in 2020, the banking organization would not apply any transition amounts in that quarter but would be allowed to apply the transition in subsequent quarters when the banking organization returns to

the use of CECL. However, an institution that has elected the transition, but does not apply it in any quarter, would not receive any extension of the transition period.

To promote a consistent approach across electing banking organizations, the interim final rule would provide a uniform approach for delaying the recognition of certain provisions for credit losses during the five-year transition period. Specifically, the interim final rule introduces a scaling factor that approximates the average after-tax provision for credit losses attributable to CECL, relative to the incurred loss methodology, in a given reporting quarter. The interim final rule would use a 25 percent scaling factor as an approximation of the impact of differences in provision for loan and lease losses ("provision") reflected under CECL versus the incurred loss methodology. The calibration of the scaling factor is also designed to promote competitive equity in the current economic environment between electing banking organizations and those banking organizations that have not yet adopted CECL. Although staff of the agencies expect losses under either method to be higher in the current environment, losses under CECL may be significantly larger based on a longer loss horizon period for most assets.

Conclusion:

Staff requests that the FDIC Board approve this interim final rule and authorize its publication in the *Federal Register* with an effective date as of the date of *Federal Register* publication and with a comment period deadline of 45 days after the date of *Federal Register* publication.

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