August 12, 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: Staff is presenting for approval of the FDIC Board of Directors (FDIC Board) a request to adopt and publish the attached interagency final rule (final rule) that would provide banking organizations that implement the new accounting standard under U.S. generally accepted accounting principles (GAAP) known as the current expected credit losses methodology (CECL) during the 2020 calendar year 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. 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 CECL, which replaces the incurred loss methodology. The final rule would address these concerns and allow these banking organizations to better focus on supporting lending to creditworthy households and businesses. This final rule would be consistent with the interim final rule published in the *Federal Register* on March 31, 2020, with certain clarifications and minor adjustments related to the mechanics of the transition and the eligibility criteria for applying the transition.

Concur:

Nicholas J. Podsiadly
General Counsel

Recommendation: Staff requests that the FDIC Board approve this final rule and authorize its publication in the *Federal Register* with an effective date as of the date of *Federal Register* publication.

Discussion:

I. Background

In 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments—Credit Losses, Topic 326, Measurement of Credit Losses on Financial Instruments*.[1] The update resulted in significant changes to credit loss accounting under GAAP. The revisions to credit loss accounting under GAAP included the introduction of 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 the 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 Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), and the Federal Deposit Insurance Corporation (FDIC) (collectively, the agencies) issued a final rule that revised certain regulations to account for the aforementioned changes to credit loss accounting under GAAP, including CECL (2019 CECL rule).[2] The 2019 CECL rule revised the agencies' regulatory capital rule

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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).

(capital rule),[3] 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 for which the accounting principles are uniform and consistent with GAAP,[4] including banking organizations that are subject to the capital rule or stress testing requirements.

The 2019 CECL rule also includes a transition provision 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 intend for the transition provision 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. This increase in allowances is expected largely because CECL requires banking organizations to consider current and reasonable and supportable forecasts of future economic conditions to estimate credit loss allowances.

On March 31, 2020, as part of efforts to address the disruption of economic activity in the United States caused by the spread of COVID-19 and to implement section 4014 of the Coronavirus Aid, Relief, and Economic Security Act[5] (CARES Act), the agencies adopted a second CECL transition provision through an interim final rule.[6] This transition provision

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[3] 12 CFR part 3 (OCC); 12 CFR part 217 (FRB); 12 CFR part 324 (FDIC).

[4] *See* 12 U.S.C. 1831n.

[5] See Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, §4014, 134Stat. 281 (Mar. 27, 2020). The CARES Act provides banking organizations optional temporary relief from complying with CECL ending on the earlier of (1) the termination date of the current national emergency, declared by the President on March 13, 2020 under the National Emergencies Act (50 U.S.C. 1601 et seq.) concerning COVID-19, or (2) December 31, 2020.

[6] 85 FR 17723 (March 31, 2020).

provides banking organizations that were required to adopt CECL for purposes of GAAP (as in effect January 1, 2020), for a fiscal year that begins during the 2020 calendar year, the option to delay for up to two years an estimate of CECL's effect on regulatory capital, followed by a three-year transition period (i.e., a five-year transition period in total). The agencies provided this relief in response to the additional operational challenges and resource burden of implementing CECL amid the uncertainty caused by recent strains on the U.S. economy, so that adopting banking organizations may better focus on supporting lending to creditworthy households and businesses. Under the interim final rule, an eligible banking organization would make an election to use the 2020 CECL transition provision in its first Consolidated Reports of Condition and Income (Call Report) or Consolidated Financial Statements for Holding Companies (FR Y-9C) filed during the 2020 calendar year after it meets the eligibility requirements. The interim final rule provides electing banking organizations with a methodology for delaying the effect on regulatory capital of an estimated increase in the allowances for credit losses (ACL) that can be attributed to the adoption of CECL, relative to an estimated increase in the allowance for loan and lease losses (ALLL) that would occur for banking organizations operating under the incurred loss methodology. The interim final rule does not replace the three-year transition provision in the 2019 CECL rule, which remains available to any banking organization at the time that it adopts CECL. Banking organizations that were required to adopt CECL during the 2020 calendar year have the option to elect the three-year transition provision contained in the 2019 CECL rule or the 2020 CECL transition provision contained in the interim final rule, beginning with the March 31, 2020, Call Report or FR Y-9C (as applicable).

II. Summary of Comments to the Interim Final Rule

The agencies received six public comments on the interim final rule from banking organizations and interest groups. Commenters supported the objectives of the interim final rule because it provides banking organizations additional flexibility to lend to creditworthy borrowers in the current economic environment, without imposing undue regulatory burden. However, several commenters suggested that the regulatory capital relief provided in the interim final rule is insufficient, especially given the current economic downturn. Some of these commenters asserted either that banking organizations should be permitted to add back a larger proportion of the ACL (temporarily or permanently) to common equity tier 1 capital or that the methodology for calculating the add-back should address certain commenters' concerns regarding pro-cyclicality and differences in credit portfolios. One commenter asked the FASB and the agencies to allow banking organizations of all sizes the option to defer the implementation of CECL until 2025, given current economic uncertainties. This commenter asserted that without a longer delay, community banking organizations may need to maintain loan portfolios with a certain credit profile that minimizes the regulatory capital volatility caused by CECL, rather than loan portfolios that meet the credit needs of the community. One commenter suggested that the agencies reevaluate whether to increase the amount of ACL includable in tier 2 capital on a permanent basis to address the commenter's concerns regarding pro-cyclicality and CECL.

III. The Final Rule

The final rule would be consistent with the interim final rule with some clarifications and adjustments related to the calculation of the transitions and the eligibility criteria for using the 2020 CECL transition provision, as discussed below.

A. Approximating the Impact of CECL

In the interim final rule, the agencies considered different ways for determining the portion of credit loss allowances attributable to CECL that is eligible for transitional regulatory capital relief. To best capture the effects of CECL on regulatory capital, it would be necessary for a banking organization to calculate the effect on retained earnings of measuring credit loss allowances using both the incurred loss methodology and CECL . This approach, however, would require a banking organization to maintain the equivalent of two separate loss-provisioning processes. For many banking organizations that have adopted CECL, it would be burdensome to track credit loss allowances under both CECL and the incurred loss methodology, due to significant CECL-related changes already incorporated in internal systems or third-party vendor systems in place of elements of the previous incurred loss methodology.

To address concerns regarding burden and to promote a consistent approach across electing banking organizations, the interim final rule provides a uniform approach for estimating the effect of CECL during the first two years of the five-year transition period. Specifically, the interim final rule introduced a 25 percent 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.

After considering comments received on this aspect of the interim final rule, the final rule would retain the 25 percent scaling factor. In developing an approach for adding back an amount of ACL measured under CECL to regulatory capital, the agencies have provided a measure of relief for banking organizations while not creating undue burden. As noted in the Supplemental Information to the interim final rule, the agencies believe that the 25 percent scaling factor provides a reasonable estimate of the portion of the increase in allowances related to CECL relative to the incurred loss methodology.[7] In addition, staff believes that the uniform calibration promotes competitive equity in the current economic environment between electing banking organizations and those banking organizations that have not yet adopted CECL.

B. Mechanics of the 2020 CECL Transition Provision

Under the interim final rule, an electing banking organization must calculate transitional amounts for the following items: retained earnings, temporary difference deferred tax assets (DTAs), and credit loss allowances eligible for inclusion in regulatory capital. The agencies received several comments from banking organizations requesting clarification about how the day-one changes to the CECL transitional amount, DTA transitional amount, and AACL transitional amount should be calculated, when an electing banking organization experiences a day-one increase in retained earnings. To the extent there is a day-one change for these items, an electing banking organization would calculate each transitional amount as a positive or negative number. For example, an electing banking organization with an increase in retained earnings

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[7] See Loudis, Bert and Ben Ranish. (2019) "CECL and the Credit Cycle." Finance and Economics Discussion Series Working Paper 061. Available at: https://www.federalreserve.gov/econres/feds/files/2019061pap.pdf and Covas, Francisco and William Nelson. "Current Expected Credit Loss: Lessons from 2007-2009." (2018) Banking Policy Institute Working Paper. Available at: https://bpi.com/wpcontent/uploads/2018/07/CECL_WP-2.pdf; the agencies reviewed data from public securities filings of various large banking organizations. These organizations reported allowances and provisions under CECL, on a weighted-average basis, approximately 30 percent higher on a pre-tax basis and 25 percent higher on an after-tax basis. The agencies chose a scalar closer to the after-tax median to avoid additional burden involved with making quarterly tax adjustments throughout the transition period.

upon adopting CECL would treat this amount as a negative value when calculating its modified CECL transitional amount for purposes of the 2020 CECL transition provision.[8]

The agencies adopted the 2020 CECL transition provision in the interim final rule to mitigate the adverse effect of CECL on regulatory capital based on an estimated difference between allowances under the incurred loss methodology and CECL amid the uncertainty caused by recent strains on the U.S. economy. To help achieve this goal, the final rule would revise the capital rule to clarify that an electing banking organization would not be required to apply the transitional amounts in any quarter in which it would not reflect a positive modified CECL transitional amount *(i.e.*, when applying the transition would result in a decrease to retained earnings for regulatory capital).[9] During quarters in which a banking organization does not calculate a positive modified CECL transition amount, the electing banking organization would not reflect any of the transitional amounts in its regulatory capital calculations. However, the banking organization subsequently could resume applying the transitional amounts in the remaining quarters of the transition period if the banking organization calculates a positive modified CECL transitional amount during any of those quarters. This clarification would be incorporated in this final rule. The final rule also would adopt as final all other aspects of the interim final rule related to the calculation of the transitional amounts.

Finally, if a banking organization chooses to revert to the incurred loss methodology in any quarter in 2020, the banking organization would not apply any transitional amounts in that quarter but would be allowed to apply the transitional amounts in subsequent quarters when the

[8] *See* 85 FR 29839 (May 19, 2020).

[9] *See* 12 CFR 3.100(d) (OCC); 12 CFR 217.100(d) (Board); 12 CFR 324.100(d) (FDIC).

banking organization resumes use of CECL. However, a banking organization that has elected the transition, but subsequently elects to not apply the transitional amounts, in any quarter, would not receive extension of the 2020 CECL transition provision.

C. 2020 CECL Adopters

Consistent with the interim final rule, under the final rule, banking organizations that are required to adopt CECL under GAAP (as in effect January 1, 2020) in the 2020 calendar year would be eligible for the 2020 CECL transition provision. A banking organization that is required to adopt CECL under GAAP in the 2020 calendar year, but chooses to delay use of CECL for regulatory reporting in accordance with section 4014 of the CARES Act, would also be eligible for the 2020 CECL transition provision.[10]

Many depository institution holding companies that are Securities and Exchange Commission filers are required to adopt CECL for financial statement purposes under GAAP in the 2020 calendar year (in which case they are eligible for the 2020 CECL transition provision). Additionally, since issuing the interim final rule, supervisory experience has shown that depository institution subsidiaries of holding companies generally adopt CECL based on when their holding companies are required to adopt CECL. Furthermore, a banking organization that is not required to adopt CECL under GAAP in the 2020 calendar year would not have been eligible to use the 2020 CECL transition provision under the interim final rule.

The final rule would permit use of the 2020 CECL transition provision by any banking organization that adopts CECL during the 2020 calendar year, including those not required to

[10] The option to delay the use of CECL in accordance with section 4014 of the CARES Act also is available for other GAAP-based reporting.

adopt CECL under GAAP in the 2020 calendar year and those that adopt CECL in an interim period in the 2020 calendar year. A banking organization that initially elected the three-year transition provision under the 2019 CECL rule in the first or second quarter of 2020 because it was not eligible to elect the 2020 CECL transition provision under the interim final rule at that time may change its election to the 2020 CECL transition provision in its Call Report or Y-9C (as applicable) filed later in the 2020 calendar year. In all cases, an electing banking organization would be required to follow the calculations for determining the transitional amounts as described in the capital rule.

Conclusion:

Staff requests that the FDIC Board approve this final rule and authorize its publication in the *Federal Register* with an effective date as of the date of *Federal Register* publication.

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