Banker Teleconference

Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rules and Conforming Amendments to Other Regulations (CECL Transition NPR)

Staff of the Federal Banking Agencies

May 15, 2018
Introduction

In April 2018, the Federal banking agencies jointly issued a proposed rule addressing certain regulatory capital issues relating to changes in U.S. generally accepted accounting principles (GAAP) concerning the current expected credit losses methodology (CECL) (CECL Transition NPR).

The comment period will close 60 days after publication of the CECL transition NPR in the Federal Register.

During today’s teleconference and webinar, staff from the Federal banking agencies will provide an overview of the proposed rule and answer questions.

This presentation is intended to help interested parties better understand the outstanding proposed rule. Thus, the Federal banking agencies welcome any questions today to help clarify the contents of the proposal. Comments relating to the substance of the proposal that are received by the Federal banking agencies during the call will be incorporated into the rulemaking record so that they can be properly considered and addressed as part of the rulemaking process. The Federal banking agencies encourage interested parties to also submit any comments on the proposal to the agencies’ respective public dockets.

Submit questions during the call to RAC@fdic.gov
Key Aspects of the Proposed Rulemaking

The proposed rule would:

• Revise the capital rule to identify which credit loss allowances under the new accounting standard would be eligible for inclusion in the regulatory capital of banking organizations

• Introduce the definition of a new regulatory capital term, allowance for credit losses (ACL)

• Revise the regulatory capital definition of carrying value for available-for-sale (AFS) debt securities and purchased credit-deteriorated (PCD) assets

• Provide banking organizations with the option to phase in, over a three-year period beginning from its CECL effective date, any “day-one” potential adverse effects on regulatory capital stemming from the accounting changes

• Revise affected disclosure requirements for certain banking organizations

A banking organization’s CECL effective date is determined according to U.S. GAAP (ASC 326) and not the CECL Transition NPR.
CECL Background

• In June 2016, the Financial Accounting Standards Board issued a new accounting standard for credit losses that includes the CECL methodology and replaces the existing incurred loss methodology for certain financial assets

• CECL requires the incorporation of reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses, and maintains the current requirement for banking organizations to consider past events and current conditions

• CECL also replaces multiple impairment approaches in existing GAAP and will cover a broader range of financial assets than the incurred loss methodology

• Upon adoption of the new accounting standard, banking organizations are likely to increase certain credit loss allowance levels, which could lower their common equity tier 1 (CET1) capital. This is because CECL will require earlier recognition of credit losses relative to the incurred loss methodology
New Regulatory Capital Definitions

• New regulatory capital definition of ACL would replace allowances for loan and lease losses (ALLL) for banking organizations that have adopted CECL includes:
  – Credit loss allowances established through a charge against earnings or retained earnings (for purposes of the day-one adjustment) for financial assets measured at amortized cost and net investments in leases as determined in accordance with GAAP, except allowances for PCD assets and AFS debt securities
  – Credit loss allowances on off-balance sheet credit exposures as determined with GAAP

• The amount of ACL eligible for inclusion in tier 2 capital would remain at 1.25% of the banking organization’s standardized risk-weighted assets

• Would revise the regulatory capital definition of carrying value
  – For all assets other than AFS debt securities and PCD assets, carrying value (i.e. the value of the asset on the balance sheet) would not reduce by any associated credit loss allowance
Treatment of AFS

• Banking organizations must apply the AFS debt securities impairment methodology and recognize an initial allowance for credit losses in current period earnings for any impairment that is determined to be credit related.

• Thereafter, credit losses must be reassessed each subsequent period with any changes in the allowance for credit losses recognized in earnings.

• The initial establishment of an allowance for credit losses on AFS debt securities reduces CET1 capital through a credit loss expense, and subsequent adjustments to the allowance for credit losses also affect CET1 capital.

• For AOCI opt-out banking organizations, the exposure amount of an AFS debt security for purposes of risk weighting is the carrying value (i.e., fair value) plus unrealized losses and less unrealized gains included in AOCI.

• Because the carrying value already incorporates any allowance for credit losses, the credit loss allowances would not also be eligible for inclusion in Tier 2 capital.
## Treatment of AFS

### Risk Weighting Example for AFS Debt Security for AOCI opt-out banking organizations

<table>
<thead>
<tr>
<th>Amortized Cost as Determined in Accordance with U.S. GAAP</th>
<th>Fair Value</th>
<th>Impairment Amounts</th>
<th>Amount to be Risk Weighted</th>
</tr>
</thead>
<tbody>
<tr>
<td>$1000</td>
<td>$900</td>
<td>$40</td>
<td>$940 ($900 Fair Value + $40 non-credit impairment)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Impairment that is determined to be non-credit related and recorded in AOCI</td>
<td>$60</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Impairment that is determined to be credit related and recorded as an allowance for credit losses</td>
<td>($900 Fair Value + $40 non-credit impairment)</td>
</tr>
</tbody>
</table>
Treatment of PCD

- Under U.S. GAAP, a banking organization must recognize a day-one allowance for credit losses for a PCD asset.

- Under U.S. GAAP, banking organizations must also recognize a corresponding adjustment of the purchase price. This way, the initial amortized cost basis is the purchase price grossed up by the credit loss allowance, the net amount of which represents the amount expected to be collected.

- The day-one allowance is not established through a charge to earnings and therefore the initial credit loss allowance for PCD assets would not be eligible for inclusion in tier 2 capital. Subsequent adjustments to the credit loss allowance for PCD assets are established through earnings.

- For simplicity purposes, the agencies propose that all allowances for PCD assets would not be eligible for inclusion in tier 2 capital. Consequently, for purposes of risk weighting, the carrying value of a PCD asset would be the amortized cost reduced by the credit loss allowance.
Transition Provision

• Upon adopting CECL, a banking organization will record an adjustment to its credit loss allowances equal to the difference between the amount of credit loss allowances required under the incurred loss methodology and the amount of credit loss allowances required under CECL

• Proposal would provide an optional three-year phase-in of the “day-one” effects of CECL on regulatory capital

• A banking organization that elects the CECL transition provision must do so as of the CECL adoption date or forfeit the ability to make the election in future periods
Transition Amounts

• CECL transitional amounts are based on the balance sheet amounts as follows:
  – **CECL transitional amount** = difference between banking organization’s pre- and post-CECL amounts of retained earnings
  – **DTA transitional amount** = difference between banking organization’s pre- and post-CECL amounts of temporary difference deferred tax assets (DTAs)
  – **ACL transitional amount** = difference between banking organization’s pre-CECL amount of ALLL and post-CECL amount of ACL

• Electing bank organization would
  – Phase-in the amount of the decrease to retained earnings (CECL transitional amount)
  – Phase-in the amount by which the ACL exceeds the ALLL (ACL transitional amount)
  – Phase-in the amount of the increase in temporary difference DTAs (DTA transitional amount)
  – Phase-in the CECL transitional amount into average assets

• Each amount would be phased in on a straight line basis beginning as of a banking organization’s CECL effective date—75% in year 1; 50% in year 2; 25% in year 3
Transition Provision Example

• Banking organization has a CECL effective date of January 1, 2020, and a 21 percent tax rate

• Pre-CECL (December 31, 2019), the banking organization has $10 million in retained earnings and $1 million of ALLL. Post-CECL (January 1, 2020), the organization has $1.2 million of ACL

• The banking organization would record an increase to ACL of $200,000, an offsetting increase in temporary difference DTAs of $42,000, and a reduction in retained earnings of $158,000.

• For each quarterly reporting period in year 1 of the transition period (2020), the banking organization would increase retained earnings and average total consolidated assets by $118,500, decrease temporary difference DTAs by $31,500, and decrease ACL by $150,000
  – These increases and decreases are shown only in the regulatory capital schedule of the banking organizations’ regulatory reports
  – These increases and decreases are not shown on the banking organizations’ balance sheets
## CECL Transition Provision Example

<table>
<thead>
<tr>
<th>In thousands</th>
<th>Transitional Amounts</th>
<th>Transitional Amounts Applicable during Each Year of the Transition Period</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Column A</td>
<td>Column B</td>
</tr>
<tr>
<td>Increase retained earnings and average total consolidated assets by the CECL transitional amount</td>
<td>$158</td>
<td>$118.50</td>
</tr>
<tr>
<td>Decrease temporary difference DTAs by the DTA transitional amount</td>
<td>$42</td>
<td>$31.50</td>
</tr>
<tr>
<td>Decrease ACL by the ACL transitional amount</td>
<td>$200</td>
<td>$150</td>
</tr>
</tbody>
</table>

*Because non-public business entities (Non-PBEs), with a calendar fiscal year that do not early adopt CECL, will initially report their adoption of CECL as of December 31, 2021, they may only use the 75% phase-in for one quarter (i.e., December 31, 2021), not for an entire year after they first report under CECL. Such non-PBEs may use the 50% and 25% phase-in for all four quarters of Years 2 and 3 respectively.

- Day-one ACL Transitional Amount: $200,000  ($1.2 million ACL - $1.0 million ALLL)
- Day-one temporary difference DTAs Transitional Amount: $42,000  ($200,000 * 21% tax rate)
- Day-one retained earnings Transitional Amount: $158,000 ($200,000 - $42,000)
Supervisory Oversight for Electing Banking Organizations

- For regulatory capital requirements, such as capital buffers and Prompt Corrective Action, the agencies would use an electing banking organization’s regulatory capital ratios as adjusted by the CECL transition provision.

- Electing banking organizations should ensure that they have adequate capital throughout the CECL transition provision period and also when the period ends.
Regulatory Disclosures

• After adopting CECL, banking organizations subject to regulatory disclosure requirements under Section 63 of the agencies’ capital rules would disclose ACL instead of ALLL
  – Such banking organizations generally include those banking organizations with $50 billion or more in total consolidated assets that are not (i) advanced approaches banking organizations or (ii) a consolidated subsidiary of an organization subject to comparable disclosure requirements

• Banking organizations subject to advanced approaches disclosure requirements under Section 173 of the agencies’ capital rules that elect to use the CECL transition provision would be required to disclose regulatory capital ratios both including and excluding the CECL transition provision
Comments on CECL Transitions NPR

• The agencies seek comment on the modifications to the capital rule proposed in the CECL Transition NPR as well as the transition provision

• Comments should be submitted to any or all of the agencies using the methods described in the NPR

• The NPR and other materials are available at the following website: https://www.fdic.gov/regulations/capital/capital/index.html.

Thank You
Additional Contacts

• Questions directed to the FDIC can be emailed to regulatorycapital@fdic.gov

• Questions directed to the OCC can be emailed to CapitalPolicy@occ.treas.gov

• Questions directed to the Federal Reserve Board can be emailed to questions@askthefed.org
Questions?

Leading up to this teleconference and webinar the agencies received a number of questions relating to availability of resources to assist smaller banking organizations with the implementation of CECL and the development of estimated expected credit losses under the new accounting standard. Questions of this nature are beyond the intended scope of this presentation today.

For additional help concerning CECL implementation, the agencies would direct participants to the following other resources:

FDIC:
- https://www.fdic.gov/regulations/accounting/cecl.html (Link to FAQs and Joint Statement)
- CECL@fdic.gov (Accounting inbox)

OCC:
- https://www.banknet.gov/home/banker-resources/bank-operations/cecl/ (CECL banker webpage)
- CECL@occ.treas.gov (Accounting inbox)

Fed:

Submit CECL Transition NPR questions during today’s call to RAC@FDIC.gov