April 17, 2018

MEMORANDUM TO: Board of Directors

FROM: Doreen R. Eberley, Director
Division of Risk Management Supervision

SUBJECT: Regulatory Capital Rule: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rule and Conforming Amendments to Other Regulations

Summary: In June 2016, the Financial Accounting Standards Board ("FASB") issued Accounting Standards Update No. 2016-13, Topic 326, Financial Instruments—Credit Losses ("ASU No. 2016-13"), which revises the accounting for credit losses under U.S. generally accepted accounting principles ("U.S. GAAP") and introduces the current expected credit losses methodology ("CECL") to replace the currently in place incurred loss methodology. The new accounting standard for credit losses will apply to all banking organizations ("institutions"), which file regulatory reports that must conform to U.S. GAAP, and this may increase institutions' allowances thereby reducing their earnings and common equity tier 1 capital. To address this change in U.S. GAAP and the potential day-one regulatory capital impact on institutions of this new accounting standard, staff is seeking the approval of the FDIC Board of Directors ("FDIC Board") to publish the attached interagency notice of proposed rulemaking ("interagency NPR") that would revise the regulatory capital rules of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the

Concur:

[redacted]

Charles Yi
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Federal Deposit Insurance Corporation (collectively, the "agencies") to (1) reflect the new accounting standard, and (2) provide an optional transition arrangement to phase in the day-one impact on institutions' regulatory capital that may result from the adoption of CECL by institutions. The proposal in the interagency NPR also would amend certain disclosure requirements to reflect changes to U.S. GAAP and make conforming amendments to the agencies' regulations.

Recommendation: Staff recommends that the FDIC Board approve the interagency NPR and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

Discussion:

I. New CECL Methodology and Related GAAP Changes

ASU No. 2016-13 revises the accounting for credit losses under U.S. GAAP and introduces the CECL methodology that replaces the incurred loss methodology for financial assets held at amortized cost and off-balance sheet credit exposures. CECL will apply to all institutions that file Call Reports for which the reporting requirements must conform to U.S. GAAP.

CECL differs from the existing incurred loss methodology in several key respects. CECL requires institutions to estimate losses expected over a longer time horizon (lifetime) when assessing the collectability of financial assets. As part of this assessment, 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. This change in U.S. GAAP would result in earlier recognition of credit losses under CECL than under the existing incurred loss methodology.

Second, CECL applies to a broader range of assets, including the assets covered by the allowances for loan and lease losses ("ALLL") and held-to-maturity debt securities, net investments in leases, and purchased credit-deteriorated ("PCD") assets (which replaces purchased credit-impaired ("PCI") assets for purposes of U.S. GAAP). As the PCD asset definition is broader than the PCI asset definition, it is expected that more purchased assets will be considered PCD assets relative to those considered as PCI assets prior to the issuance of ASU No. 2016-13. For PCD assets, CECL requires institutions to estimate and record an allowance for credit losses at the time of purchase, which is then added to the purchase price to determine the amortized cost basis of the asset for financial reporting purposes. This is different from the current treatment of PCI assets, for which institutions are not required to estimate a credit loss allowance at the time of purchase. Rather, a credit loss allowance for PCI assets is estimated subsequent to the purchase only if there is deterioration in the expected cash flow of the assets.

Upon its adoption of CECL, an institution will record a one-time adjustment to its allowances for credit losses as of the beginning of its fiscal year of adoption equal to the difference, if any, between the amount of allowances for loan and lease losses ("ALLL") required under the incurred loss methodology and the amount of allowances for credit losses ("ACL") required under CECL.

In addition, under ASU No. 2016-13, an institution will begin to recognize credit losses on individual available-for-sale ("AFS") debt securities through allowances for credit losses, rather than through direct write-downs, as is currently required by U.S. 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. The allowance for credit losses on an

AFS debt security is limited to the amount by which the security's fair value is less than amortized cost.

The effective date of ASU No. 2016-13 varies for different categories of institutions. For institutions that are U.S. Securities and Exchange Commission ("SEC") filers,[1] ASU No. 2016-13 will become effective for the first fiscal year beginning after December 15, 2019. For institutions that are public business entities[2] but not SEC filers, ASU No. 2016-13 will become effective for the first fiscal year beginning after December 15, 2020. For institutions that are not public business entities, ASU No. 2016-13 will become effective for the first fiscal year beginning after December 15, 2020. An institution may choose to early adopt ASU No. 2016-13 in the first fiscal year beginning after December 15, 2018.

II. Proposed Revisions to the Capital Rules to Reflect the CECL Methodology

To address changes made in U.S. GAAP following the FASB's issuance of ASU No. 2106-13, the agencies propose to amend their respective capital rules. In particular, the agencies are proposing to add ACL as a new term in the agencies' capital rules. ACL would include

[1] An SEC filer is an entity (like 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 Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation.

[2] A public business entity 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 U.S. 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).

nearly all allowances for credit losses related to financial assets measured at amortized cost.[3] Consistent with ALLL under the current capital rule's standardized approach, amounts of ACL would be eligible for inclusion in an institution'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).

To reflect the new accounting treatment for AFS debt securities and PCD assets, the proposal also would revise the definition of carrying value in the capital rules to provide that, for all assets other than AFS debt securities or PCD assets, the carrying value is gross of the accompanying credit loss allowance.

III. Optional Transition Provision

Some institutions have expressed concerns about the difficulty in capital planning due to the uncertainty about the economic environment at their CECL adoption date. It is possible that the initial adjustment to an institution's allowance for credit losses upon adoption of CECL will be material and that the amount of this potential adjustment may not be known until much closer to each institution's CECL adoption date. This is primarily because CECL requires institutions to consider current and future expected economic conditions to estimate allowances and these conditions will be better understood closer to an institution's CECL adoption date. Increases in an institution's allowances for credit losses will reduce its earnings, and therefore, may reduce its common equity tier 1 capital.

To address capital planning and the uncertainty regarding the impact stemming from CECL implementation, the agencies are proposing an elective CECL transition provision that

[3] The agencies are also proposing to revise the capital rules to amend the definition of eligible credit reserves under the capital rule's advanced approaches to align with the definition of ACL in this proposal.

would give institutions the option to phase in the day-one effects of CECL adoption into regulatory capital over a three-year period (i.e., 75 percent in year one, 50 percent in year two, and 25 percent in year three) such that in the first reporting period after the transition, an electing institution would have fully phased-in the day-one effects. An institution making this election would be required to begin applying the CECL transition provision as of the institution's CECL adoption date or forfeit the ability to make the election in future periods.

IV. Disclosure Requirements and Other Conforming Amendments

The proposed rule would revise particular disclosure requirements that apply to certain institutions to reflect those institutions' adoption of CECL. In addition, the agencies are proposing to require advanced approaches institutions that elect the transition provision under this proposal to disclose two sets of regulatory capital ratios. One set would reflect the CECL transition provision under this proposal and the other set would reflect the institution's capital ratios on a fully phased in basis. Corresponding revisions to the agencies' regulatory reports would be proposed in a separate notice issued after this proposal. Finally, the proposed rule would also make conforming amendments to the agencies' regulations to reflect the implementation of ASU No. 2016-13.

Conclusion:

FDIC staff recommends that the FDIC Board approve the attached interagency NPR and authorize its publication in the *Federal Register* with a public comment period that closes 60 days after publication.

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