December 18, 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 2016-13, Topic 326, Financial Instruments—Credit Losses ("ASU 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 incurred loss methodology. The new accounting standard for credit losses will apply to all banking organizations ("institutions") that file regulatory reports that must conform to U.S. GAAP, and may increase institutions' credit loss allowances, thereby reducing their earnings and common equity tier 1 ("CET1") capital. To address this change in U.S. GAAP and the potential day-one impact of this new accounting standard on the regulatory capital of institutions, staff seeks the approval of the FDIC Board of Directors ("FDIC Board") to publish the attached interagency final rule ("final rule") that revises the regulatory capital rules ("capital rule") of the Office of the Comptroller of the Currency ("OCC"), the Board of

Concur:

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General Counsel

Governors of the Federal Reserve System ("Board"), and the Federal Deposit Insurance Corporation ("FDIC") (collectively, the "agencies"). The final rule would (1) reflect the new accounting standard, and (2) provide an optional three-year transition period for institutions to phase in the day-one impact on regulatory capital that may result from the adoption of CECL. The final rule also amends certain disclosure requirements to reflect changes to U.S. GAAP and makes conforming amendments to other regulations of the agencies.

Recommendation: Staff recommends that the FDIC Board approve the final rule and authorize its publication in the *Federal Register*, with an effective date of April 1, 2019, and an option for institutions to early adopt this final rule prior to that date.

Discussion:

I. New CECL Methodology and Related GAAP Changes

ASU 2016-13 revises the accounting for credit losses under U.S. GAAP and introduces CECL 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 incurred loss methodology in several key respects. First, CECL requires institutions to estimate losses expected over a longer time horizon (lifetime) when assessing the collectability of financial assets. As part of this methodology, CECL requires the incorporation of reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses, while maintaining the current requirement for institutions to consider past events and current conditions. This change in U.S. GAAP should result in the earlier recognition of credit losses under CECL than under the incurred loss methodology.

Second, CECL applies to a broader range of assets, including assets covered by the allowances for loan and lease losses ("ALLL"), 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 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. Instead, 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 ALLL required under the incurred loss methodology and the amount of adjusted allowances for credit losses ("AACL") required under CECL.

In addition, under ASU 2016-13, an institution will begin to recognize credit losses on individual available-for-sale ("AFS") debt securities through credit loss allowances, 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. 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.

The effective date of ASU 2016-13 varies for different categories of institutions. For institutions that are U.S. Securities and Exchange Commission ("SEC") filers,[1] ASU 2016-13 will become effective for the first fiscal year beginning after December 15, 2019. For institutions that are public business entities ("PBEs"),[2] but not SEC filers, ASU 2016-13 will become effective for the first fiscal year beginning after December 15, 2020. For institutions that are not PBEs, ASU 2016-13 will become effective for the first fiscal year beginning after December 15, 2021. An institution may choose to adopt ASU 2016-13 early in the first fiscal year beginning after December 15, 2018.

II. Summary of the Proposed Rule

On May 14, 2018, the agencies issued and invited comment on a proposed rule that would amend their capital rule to address changes made in U.S. GAAP following the FASB's issuance of ASU 2016-13.[3] The proposed rule would have applied to all institutions that are subject to the agencies' capital rule and that file regulatory reports, which must be uniform and consistent with U.S. GAAP.

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[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 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.

[2] A 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 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).

[3] 83 Fed. Reg. 22,312 (May 14, 2018).

A. Revisions to the Capital Rule to Reflect CECL

The agencies proposed to add allowances for credit losses ("ACL") as a new term in the agencies' capital rule. ACL would have included nearly all allowances for credit losses related to financial assets measured at amortized cost.[4] 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 would have revised the definition of carrying value in the capital rule 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.

B. Optional Transition Provision

To address capital planning and the uncertainty regarding the impact stemming from CECL implementation, the agencies proposed an elective CECL transition provision that would have given institutions the option to phase in the day-one effects of CECL adoption into regulatory capital over a three-year period, such that in the first reporting period after the transition, an electing institution would have fully phased-in the day-one effects. Under the proposal, 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.

[4] The agencies also proposed to revise the capital rule applicable to an advanced approaches institution 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 the proposal.

C. Disclosure Requirements and Other Conforming Amendments

The proposal would have revised particular disclosure requirements that apply to certain institutions to reflect those institutions' adoption of CECL. In addition, the proposal required advanced approaches institutions that elect the transition provision under this proposal to disclose two sets of regulatory capital ratios. One set reflecting the proposed CECL transition provision and the other set reflecting the institution's capital ratios on a fully phased in basis. The proposal sought to make conforming amendments to the FDIC's regulations to reflect the implementation of ASU 2016-13. The proposal also required the inclusion of CECL provisions in an institution's stress testing projections beginning with the 2020 stress test cycle.

III. Summary of Comments

The agencies received 25 comment letters from institutions, trade associations, public interest groups, and individuals. Most commenters supported the agencies' proposal to provide elective, temporary regulatory capital relief as institutions adopt CECL. Many commenters, however, requested further additional measures for addressing CECL's impact. Many commenters supported the agencies' proposal to provide a three-year transition provision to phase in CECL's day-one effect on an institution's regulatory capital ratios; however, most commenters favored a longer, five-year transition period. Some commenters offered targeted recommendations regarding implementation of a transition provision that would phase-in CECL's impact for periods after CECL's day-one implementation.

Several commenters requested that, instead of a transition provision, the agencies should provide a temporary neutralization adjustment of CET1 capital while further consideration of the impact of CECL is undertaken. According to these commenters, any transitional provision would be inadequate; they preferred neutralizing the effect of CECL on regulatory capital ratios by either adjusting the CET1 capital calculation or revising the overall capital requirements. Some commenters requested that the agencies increase or remove the current limit on allowances includable in tier 2 capital. One commenter requested that the scope of credit loss allowances eligible for inclusion in an institution's tier 2 capital be expanded to include certain PCD assets.

Several commenters raised concerns with the proposed schedule for the incorporation of CECL provisions into the agencies' stress testing requirements. One commenter requested that CECL's implementation in the stress testing cycle align with the proposal's three-year transition provision to allow time for industry practices to converge. Other commenters raised concerns and requested guidance in connection with how CECL interacts with regulatory capital and stress testing.

Many of these commenters requested that the agencies undertake additional formal cost-benefit studies to assess CECL's impact on the regulatory capital of institutions of various sizes and under varying economic conditions over time. Numerous commenters urged the agencies to delay CECL's implementation until the completion of additional impact studies, and to intervene on commenters' behalf with the FASB to alter the accounting treatment for credit losses.

IV. Final Rule

The FDIC staff believes it is appropriate to adopt as final the proposed rule, with one non-substantive change. The final rule includes a new term, AACL, which replaces the term ACL, as used in the proposal. For purposes of regulatory capital, the term AACL would minimize potential confusion because it has a different meaning than the term ACL, which is used in applicable accounting standards. Other than this change in nomenclature, the definition of AACL would be the same as proposed for the term ACL.

Conclusion:

FDIC staff recommends that the FDIC Board approve the attached final rule and authorize its publication in the *Federal Register*, with an effective date of April 1, 2019, and an option for institutions to early adopt this final rule prior to that date.

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