DATE: August 15, 2019

MEMORANDUM TO: The Board of Directors

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

SUBJECT: Proposed Interagency Policy Statement on Allowances for Credit Losses

RECOMMENDATION AND SUMMARY

Staff recommends that the Federal Deposit Insurance Corporation (FDIC) Board of Directors (the Board) authorize publication in the *Federal Register* of the attached notice requesting comment for 60 days on a proposed *Interagency Policy Statement on Allowances for Credit Losses* The staffs of the FDIC, the Board of Governors of the Federal Reserve System (Board), the Office of the Comptroller of the Currency (OCC) (collectively, the banking agencies), and the National Credit Union Administration (NCUA) (collectively, the agencies) have prepared this proposed interagency policy statement in response to changes in the accounting for credit losses under U.S. generally accepted accounting principles (U.S. GAAP) as promulgated by the Financial Accounting Standards Board (FASB). These accounting changes are set forth in FASB Accounting Standards Update No. 2016-13 (FASB ASU 2016-13), as amended in subsequent updates, which are codified in Accounting Standards Codification Topic 326, Financial Instruments – Credit Losses (FASB ASC Topic 326). FASB ASU 2016-13 introduces the current expected credit losses (CECL) methodology, which replaces the existing incurred loss methodology in U.S. GAAP.

Section 37(a) of the Federal Deposit Insurance Act (FDI Act) (12 U.S.C. 1831n(a)) states that, in general, the accounting principles applicable to the Consolidated Reports of Condition and Income (Call Reports) required to be filed with the banking agencies "shall be uniform and consistent with generally accepted accounting principles." The agencies have previously issued supervisory guidance that addresses the allowance for loan and lease losses (ALLL) as determined under the incurred loss methodology. The proposed policy statement describes the accounting for credit losses in accordance with FASB ASC Topic 326; supervisory expectations for designing, documenting, and validating expected credit loss estimation processes; the maintenance of appropriate allowances for credit losses (ACLs); the responsibilities of boards of directors and management with respect to ACLs; and examiner reviews of ACLs. The agencies would be maintaining conformance with U.S. GAAP and consistency with FASB ASC Topic 326 through their issuance of the proposed policy statement.

Concur:

Nicholas J. Podsiadly
General Counsel

DISCUSSION

Background

In June 2016, the FASB issued FASB ASU 2016-13, which revises the accounting for credit losses under U.S. GAAP. FASB ASU 2016-13 replaces the incurred loss methodology for financial assets measured at amortized cost and off-balance sheet credit exposures with the CECL methodology. FASB ASU 2016-13 also modifies the accounting for impairment on available-for-sale (AFS) debt securities. FASB ASU 2016-13, along with subsequent amendments issued since June 2016 (collectively, FASB ASC Topic 326), applies to all banks, savings associations, credit unions, and financial institution holding companies (collectively, institutions), regardless of size, that file regulatory reports for which the reporting requirements conform to U.S. GAAP.

FASB ASC Topic 326 provides flexibility to institutions in the selection of credit loss estimation methods, which allows institutions to use judgment in determining the relevant information and estimation methods that are appropriate in their circumstances. Thus, the CECL methodology is scalable to institutions of all sizes. Smaller and less complex institutions are not expected to need to adopt complex modeling techniques to implement FASB ASC Topic 326. Institutions are not required to engage third-party service providers to assist management in estimating credit loss allowances under this new accounting standard. The agencies have stated that they expect institutions to make good faith efforts to implement FASB ASC Topic 326 in a sound and reasonable manner.[1]

The effective dates of FASB ASC Topic 326 vary for different institutions. At present, FASB ASC Topic 326 is effective for institutions that are public business entities (PBEs) and also are U.S. Securities and Exchange Commission (SEC) filers, as both terms are defined in U.S. GAAP, for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For institutions that are PBEs but not SEC filers, FASB ASC Topic 326 is effective for fiscal years beginning after December 15, 2020, including interim periods within those fiscal years. For institutions that are not PBEs, FASB ASC Topic 326 is effective for fiscal years beginning after December 15, 2021, including interim periods within those fiscal years.[2] Early application of FASB ASC Topic 326 is permitted for all institutions for fiscal years beginning after December 15, 2018, including interim periods within that fiscal year.

Until FASB ASC Topic 326 becomes effective for an institution, it must continue to follow current U.S. GAAP on impairment and the ALLL. The institution also should continue to refer to the agencies' December 2006 Interagency Policy Statement on the Allowance for Loan and

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[1] See the agencies' Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses, issued April 3, 2019, at https://www.fdic.gov/news/news/financial/2019/fil19020a.pdf.

[2] On July 17, 2019, the FASB tentatively decided to amend the effective dates of certain major accounting standards, including FASB ASC Topic 326. The FASB tentatively decided that FASB ASC Topic 326 will be effective for SEC filers, excluding smaller reporting companies as currently defined by the SEC, for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years. For all other entities, the FASB tentatively decided that FASB ASC Topic 326 will be effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years.

Lease Losses and the policy statements on allowance methodologies and documentation[3] (collectively, the ALLL policy statements) until the applicable effective date of FASB ASC Topic 326.

Proposed Interagency Policy Statement

The agencies' staffs have developed the proposed *Interagency Policy Statement on Allowances for Credit Losses* in response to the changes in accounting for credit losses under U.S. GAAP as set forth in FASB ASC Topic 326. The proposed policy statement describes the CECL methodology for determining ACLs applicable to financial assets measured at amortized cost (including loans held for investment and held-to-maturity debt securities), net investments in leases, and certain off-balance-sheet credit exposures in accordance with FASB ASC Subtopic 326-20. It also describes the estimation of an ACL for an impaired AFS debt security in accordance with FASB ASC Subtopic 326-30.

In addition, the proposed interagency policy statement includes and updates concepts and practices detailed in the existing ALLL policy statements that remain relevant under FASB ASC Topic 326. These concepts and practices relate to management's responsibilities for the allowance estimation process, including the need to appropriately support and document the institution's allowance estimates; the board of directors' responsibilities for overseeing management's processes; and the role of examiners in reviewing the appropriateness of an institution's ACLs as part of their supervisory activities.

The principles described in the proposed policy statement are consistent with U.S. GAAP, applicable regulatory reporting requirements,[4] safe and sound banking practices, and the agencies' codified guidelines establishing standards for safety and soundness.[5] The operational and managerial standards included in those guidelines address such matters as internal controls and information systems, an internal audit system, loan documentation, credit underwriting, asset quality, and earnings, and should be appropriate for an institution's size and the nature, scope, and risk of its activities.

The proposed interagency policy statement would be effective at the time of each institution's adoption of FASB ASC Topic 326. Upon adoption, the ALLL policy statements would no longer be effective for the institution. After FASB ASC Topic 326 is effective for all institutions, the agencies would rescind the ALLL policy statements.

An attachment to the agencies' December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* addresses concepts and practices related to loan review systems.

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[3] The *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* issued by the FDIC, the Board, and the OCC in July 2001 and the Interpretative Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions*, issued by the NCUA in May 2002, as applicable.
[4] See Section 37(a) of the FDI Act (12 U.SC. 1831n(a)).
[5] For FDIC-supervised institutions, see the *Interagency Guidelines for Establishing Standards for Safety and Soundness* in 12 CFR Part 364, Appendix A, which were adopted pursuant to Section 39 of the FDI Act (12 U.S.C. 1831p-1).

Rather than updating the agencies' guidance on loan review systems as part of the proposed interagency policy statement on ACLs, the agencies are currently developing separate standalone guidance on supervisory expectations for effective credit risk review.

Conclusion

FDIC staff recommends that the Board authorize publication in the *Federal Register* of the attached notice requesting comment for 60 days on the proposed *Interagency Policy Statement on Allowances for Credit Losses.*

<u>Attachments:</u>

Resolution

Federal Register Notice

<u>Staff Contacts</u>:

RMS

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