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Bank Capital Requirements

Federal Reserve, OCC and FDIC Release Joint Proposal Regarding the Implementation of CECL and Their Regulatory Capital Rules

SUMMARY

On April 13 and 17, 2018, the Federal Reserve, the OCC and the FDIC released a joint proposal[1] to revise their regulatory capital rules to address U.S. generally accepted accounting principles' ("*GAAP*") upcoming change to the Current Expected Credit Losses ("*CECL*") treatment of credit expense and allowances and provide an optional three-year phase-in period for the day-one adverse regulatory capital effects upon adopting CECL. Additionally, the proposal would address which credit loss allowances under CECL would be eligible for inclusion in tier 2 regulatory capital. The proposal would not, however, recalibrate the limits on the inclusion of credit loss allowances in tier 2 capital.

In June 2016, the Financial Accounting Standards Board issued Accounting Standards Update No. 2016-13,[2] which introduced CECL as the methodology to replace the current "incurred loss" methodology for financial assets measured at amortized cost and changed the approaches for recognizing and recording credit losses on available-for-sale ("*AFS*") debt securities and purchased credit impaired ("*PCI*") financial assets. Under the incurred loss methodology, credit losses are recognized only when the losses are probable or have been incurred; under CECL, companies are required to recognize the full amount of expected credit losses for the lifetime of the financial assets, based on "historical experience, current conditions and reasonable and supportable forecasts."[3] This change, which will result in earlier recognition of credit losses, was intended to address concerns that the incurred loss methodology prevented the recognition of losses that were expected, but not yet probable.[4] CECL also revises the approach to recognizing credit losses on AFS debt securities by requiring allowances to be established instead of direct write-downs; as a consequence, companies can record reversals in net income. In addition, CECL provides that the initial allowance for credit losses on PCI financial assets will be recorded

as an increase to the purchase price, with subsequent changes to the allowance recorded as a credit loss expense.

For SEC reporting companies with December 31 fiscal-year ends, CECL will become effective beginning with the first quarter of 2020. For other companies, CECL will first become effective for the fiscal year beginning after December 15, 2020 (with differences in when it becomes effective for interim period reporting depending on whether the company is a public business entity).[5]

Upon adopting CECL, a company will record a one-time adjustment to its credit loss allowances as of the beginning of its fiscal year of adoption equal to the difference between the amounts of its credit loss allowances under the incurred loss methodology and CECL.[6] The adjustment will be recognized with offsetting entries to deferred tax assets ("*DTAs*"), if appropriate, and to the new fiscal year's beginning retained earnings. Because retained earnings form a major component of a banking organization's common equity tier 1 ("*CET1*") capital, the adoption of CECL and the corresponding one-time adjustment is expected to negatively affect most banking organizations' regulatory capital ratios.

The current regulatory capital treatment of credit loss allowances dates back to the 1988 Basel I capital standard in the case of standardized approach ratios and the 2006 Basel II capital standard in the case of advanced approaches ratios.[7] In light of the close relationship between regulatory capital and credit loss allowances, as well as the adoption of CECL under GAAP and similar forward-looking standards under International Financial Reporting Standards, in October 2016 the Basel Committee published a discussion paper on the regulatory capital treatment of credit loss allowances.[8] It remains to be seen whether the Basel Committee will propose further revisions to its capital standards to reflect the implementation of forward-looking methodologies and, if it does, whether and how the U.S. banking agencies would reconcile the Basel Committee's approach with the proposal or any other revisions implemented in the United States.

Comments are due within 60 days of the publication of the proposal in the *Federal Register*.[9]

DISCUSSION

- ***CECL Transition Period.*** The proposal would allow banking organizations to elect to phase-in the impact of adopting CECL on regulatory capital over a three-year transition period. The agencies explained that they proposed this transition period to address concerns about the difficulty in capital planning resulting from uncertainty about economic conditions at the time of adoption, and consequently how large the impact on CET1 capital will be.[10] The agencies note that they "view a period of four years to plan for CECL, combined with the proposed three-year transition period, as a sufficient amount of time for a banking organization to adjust and adapt to any immediate adverse effects on regulatory capital ratios resulting from CECL adoption."[11]
    - ***One-Time Election.*** A banking organization applying the transitional arrangement would be required to report its election to do so beginning in the first quarter it reports its credit loss allowances under CECL (*e.g.,* in its March 31, 2020 FR Y-9C submission in the case of an SEC reporting bank holding company).[12] A banking organization that does not elect to use the transitional arrangement in its first period reporting under CECL would not be permitted to do so

later.[13] Holding companies and their insured depository institution subsidiaries may make independent and different elections.[14]

- ***Ratable Three-Year Adjustment.*** The transition period would allow a banking organization to phase-in the day-one adverse impact of implementing CECL, for purposes of regulatory capital, on its retained earnings, temporary difference DTAs and credit loss allowances eligible for inclusion in tier 2 capital.[15] The transitional amount that would be phased-in for each of those items would be the difference between the closing balance sheet amount as of the fiscal year-end immediately prior to the adoption of CECL (*e.g.,* December 31, 2019 for an SEC reporting company with a December 31 year-end) and the balance sheet amount as of the beginning of the fiscal year in which CECL is adopted (*e.g.*, January 1, 2020 for an SEC reporting company with a December 31 year-end)."[16] The transitional adjustment for retained earnings would also be added back to average total consolidated assets for purposes of the tier 1 leverage ratio.

  The phase-in would adjust the affected items on a straight-line basis over three years, by 75% of the transitional amount in the first year, by 50% in the second year, and by 25% in the third year.[17] As discussed below, the methodology is different for advanced approaches capital ratios if the banking organization has a shortfall in eligible credit reserves.

- ***Business Combinations.*** In the case of business combinations, if a banking organization applying the transitional arrangement were to acquire another banking organization during the CECL transition period, the acquiring banking organization would continue to use the transitional amount it calculated when it adopted CECL.[18] Transitional amounts of acquired banking organizations would not flow through to any resulting banking organization, reflecting that "assets of an acquired banking organization are generally measured at fair value at the time of the business combination."[19]

- ***Introduction of New Term "Allowance for Credit Losses."*** Because credit loss allowances under CECL will cover a broader range of financial assets than the allowance for loan and lease losses ("*ALLL*") under current GAAP, the proposal would also introduce a new term "Allowance for Credit Losses" ("*ACL*"). ACL would replace ALLL for banking organizations that have adopted CECL and would be eligible for inclusion in tier 2 capital for purposes of standardized approach ratios, subject to the current limit of 1.25 percent of credit risk-weighted assets.[20] ACL would include allowances for expected credit losses on assets currently covered by the ALLL (such as loans and other extensions of credit), as well as held-to-maturity debt securities, lessors' net investments in leases, and off-balance sheet credit exposures not accounted for as insurance.[21]

  The definition of ACL would exclude credit loss allowances related to AFS debt securities and purchased credit-deteriorated ("*PCD*") assets. Accordingly, credit loss allowances related to AFS debt securities and PCD assets could not be added back to tier 2 capital. Excluding allowances related to AFS debt securities and PCD assets is intended to reflect that allowances may be added back to tier 2 capital only if (i) the allowances have reduced retained earnings (and, therefore CET1) and (ii) the allowances do not reduce the carrying value of the related asset.

  - ***AFS Debt Securities.*** The agencies explain that credit loss allowances related to AFS debt securities would not be included in ACL because the carrying value of an AFS debt security is its fair value, which already reflects credit impairment and the corresponding allowance under CECL.[22]

  - ***PCD Assets.*** Under CECL, the term PCD assets will replace PCI assets under current GAAP. PCD assets are acquired financial assets that, based on the acquirer's assessment, have experienced a more-than-insignificant deterioration between origination and the time of the acquisition.[23] Under CECL, acquirers will be required to estimate expected credit losses "embedded in the purchase price of a PCD asset" and recognize these amounts as an allowance as of the date of acquisition.[24] The initial credit loss allowance is thus not established through a charge against earnings and, accordingly, would be excluded from the definition of ACL and not eligible to be added back to tier 2 capital. The agencies explained that "[i]ncluding in tier 2 capital allowances that have not been charged against earnings would diminish the quality of regulatory capital."[25]

Although post-acquisition increases in allowances on PCD assets would be established through a charge against earnings, those allowances would not be included in ACL or eligible to be added back to tier 2 capital under the proposal. The agencies note that they considered proposing a bifurcated approach for PCD assets, under which post-acquisition allowances for PCD assets would have been included in ACL, and only the initial allowances would have been excluded, but were concerned that such an approach would create "undue complexity and burden."[26]

- ***No Adjustments to Tier 2 Add-Backs.*** Although the implementation of CECL will result in earlier recognition of credit losses and, accordingly, higher credit loss allowances that correspondingly reduce CET1 capital, the agencies did not propose to increase the current 1.25 percent limit on including credit loss allowances in tier 2 capital for purposes of standardized capital ratios.[27] The agencies note that they "intend to monitor the effects of this limit on regulatory capital and bank lending practices," and that such monitoring would help the agencies decide whether further changes may be warranted.[28] As discussed below, the agencies also did not propose to adjust the 0.6 percent limit on tier 2 add-backs for purposes of advanced approaches capital ratios.
- ***Revisions to the Definition of "Carrying Value."*** The agencies propose to revise the regulatory definition of carrying value under capital rules to clarify that the carrying value of an asset would not be reduced by any associated credit loss allowance, except for AFS debt securities and PCD assets.[29] Under the proposal, all credit losses recognized on AFS debt securities and all credit loss allowances associated with PCD assets would reduce the carrying value of those assets for purposes of determining risk-weighted assets.[30]
- ***Advanced Approaches Capital Ratios.*** Currently, for purposes of advanced approaches ratios, a banking organization includes in its tier 2 capital eligible credit reserves that exceed its regulatory expected credit losses, up to 0.6 percent of its credit risk-weighted assets.[31] A banking organization must also deduct from CET1 any shortfall in eligible credit reserves, *i.e.*, the amount by which its regulatory expected losses exceed its eligible credit reserves. As for the limit on the inclusion of ACL in tier 2 capital for purposes of standardized approach ratios, the agencies did not propose to change the limit for advanced approaches ratios.[32]

  The proposal would, however, revise the definition of eligible credit reserves for banking organizations that have adopted CECL. As revised, eligible credit reserves would generally include allowances charged against earnings or retained earnings but exclude, among other things, allowances relating to AFS debt securities and PCD assets.[33]

  - ***Transitional Arrangement.*** For advanced approaches capital ratios, there would be transitional adjustments for retained earnings, temporary difference DTAs, and eligible credit reserves. The respective transitional amounts would be calculated in the same manner as the standardized approach transitional amounts and likewise phase-in ratably over three years.[34]

    Additionally, the proposal would require a banking organization to decrease its CECL transitional amount by its DTA transitional amount if it had an eligible credit reserves shortfall before adopting CECL and would have an increase in CET1 capital as a result of adopting CECL.[35] The agencies proposed the deduction of the DTA transitional amount to address the possibility the transitional arrangement might provide an "undue benefit" for a banking organization that may experience an increase in CET1 capital from adopting CECL, instead of the CET1 capital reductions the transition arrangement is intended to help alleviate.[36] The agencies explain that a banking organization could have such an increase in CET1 capital because of the interplay between allowance levels, CET1 and eligible credit reserve shortfalls: higher CECL allowances would cause not only a reduction in retained earnings (partially offset by DTAs), but also a concurrent reduction in eligible credit reserves shortfall deductions, both of which impact CET1.[37] The agencies considered requiring banking organizations to reduce their CECL transitional amount by the amount necessary to cause its CET1 capital to not rise upon adoption of CECL and sought comment on this alternative.[38]

    Similar to the adjustment for the tier 1 leverage ratio, the transitional adjustment for retained earnings would also be added back to total leverage exposure for purposes of the supplementary leverage ratio. This would apply to all "advanced approaches" banking organizations, irrespective of whether they are required to calculate risk-based capital ratios using the advanced approaches capital rules.

- ***Additional Changes Proposed.*** Additionally, the proposal addresses Pillar 3 disclosure requirements, the incorporation of CECL into Dodd-Frank Act Stress Testing ("*DFAST*"), and conforming changes to other agencies regulations.

  - ***Pillar 3 Disclosures and Regulatory Reports.*** Advanced approaches banking organizations that have completed the parallel run would be required to disclose whether they have elected to phase-in the impact of adopting CECL and to disclose their risk-based capital ratios on a transitional and fully phased-in basis.[39] The agencies note that they would issue a separate proposal addressing revisions to regulatory reporting forms.[40]

  - ***DFAST and CCAR.*** The Federal Reserve and FDIC[41] proposed amending their DFAST rules to require banking organizations not to use CECL in DFAST until the later of the 2020 stress test cycle and the cycle that coincides with the year in which CECL is adopted, even if the stress test cycle covers periods during which CECL will be in effect (*e.g.*, during the 2019 stress test cycle, more than half of the stress testing horizon will be after 2020 and, for SEC reporting companies, during periods in which CECL will be effective).[42] The Federal Reserve also proposed to revise its rules for the supervisory stress tests used in DFAST and CCAR[43] to similarly provide that CECL would not be reflected until the 2020 stress test cycle.

    Deferring CECL until the 2020 stress test cycle is consistent with the Federal Reserve's instructions for CCAR 2018. In those instructions, the Federal Reserve noted that firms subject to CCAR "should exclude the potential effect of CECL for CCAR 2018 and 2019, even if a firm chooses to early adopt CECL for financial reporting purposes in 2019" and that the Federal Reserve would "provide further guidance on reflecting CECL in CCAR 2020."[44] On April 10, 2018, the Federal Reserve proposed substantial revisions to CCAR and its capital rules, including the introduction of stress buffer requirements. It remains to be seen how the Federal Reserve will address the interaction of CECL, CCAR and the new stress buffer requirements.[45] Notably, the Federal Reserve sought comment in the CECL-related proposal on whether additional changes should be made to its stress testing rules to address the implementation of CECL.[46]

  - ***Conforming Changes to Other Agency Regulations.*** The agencies also propose to make a number of conforming changes to their regulations, such as replacing references to ALLL with references to ACL for banking organizations that have adopted CECL.[47]

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[1] Federal Reserve System, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, *Regulatory Capital Rules: 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, available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180417a1.pdf (April 17, 2018) (hereinafter, the "Proposal").

[2] Financial Accounting Standards Board, *Financial Instruments – Credit Losses: Measurement of Credit Losses on Financial Instruments*, *available at* https://asc.fasb.org/imageRoot/39/84156639.pdf (June 2016) (hereinafter, "ASU 2016-13"). For additional information on ASU 2016-13 and CECL, see our Memorandum to Clients entitled *FASB Expected Credit Loss Methodology* (June 23, 2016), *available at* https://www.sullcrom.com/client-alert-fasb-expected-credit-loss-methodology.

[3] Financial Accounting Standards Board, *FASB In Focus: Accounting Standards Update No. 2016-13, Financial Instruments – Credit Losses (Topic 326)*, *available at* http://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176168232790&d=&pagename=FASB%2FDocument_C%2FDocumentPage (June 2016).

[4] ASU 2016-13, at 1.

[5] Proposal, at 11-12; ASU 2016-13, at 5. Specifically, for SEC reporting companies, CECL is effective for fiscal years beginning after December 15, 2019, including interim periods within those years. For public business entities that are not SEC reporting companies, CECL is effective for fiscal years beginning after December 15, 2020, including interim periods within those years. For other entities, CECL is also effective for fiscal years beginning after December 15, 2020 and for interim periods within fiscal years beginning after December 15, 2021. Early adoption is permitted for all entities as of fiscal years beginning after December 15, 2018.

[6] Proposal, at 11.

[7] Banking organizations that must calculate their risk-based capital ratios using the advanced approaches are generally those with $250 billion or more in total consolidated assets or $10 billion or more in foreign exposures (including subsidiary depository institutions of bank holding companies that meet one of these thresholds). Intermediate holding companies of foreign banking organizations that meet the advanced approaches definition are not required to determine their risk-based capital ratios using the advanced approaches.

[8] Basel Committee, *Discussion Paper – Regulatory Treatment of Accounting Provisions* (October 2016), *available at* https://www.bis.org/bcbs/publ/d385.pdf.

[9] As of the publication of this Memorandum, the proposal has not been published in the *Federal Register*.

[10] Proposal, at 15-16.

[11] Proposal, at 27. Although not discussed in the proposal, in March 2017, the Basel Committee had adopted a standard that would allow jurisdictions to implement a transition period of up to five years to address the day-one impact of the implementation of forward-looking credit loss methodologies (such as CECL) on retained earnings and, therefore, CET1. Basel Committee, *Standards – Regulatory Treatment of Accounting Provisions – Interim Approach and Transitional Arrangements* (March 2017), *available at* https://www.bis.org/bcbs/publ/d401.pdf.

[12] Proposal, at 21.

[13] *Id*.

[14] Proposal, at 22.

[15] Proposal, at 22-23.

[16] Proposal, at 22.

[17] Proposal, at 23-24.

[18] Proposal, at 27.

[19] *Id*.

[20] Proposal, at 16.

[21] Proposal, at 17.

[22] Proposal, at 18.

[23] *Id*.

[24] *Id*.

[25] Proposal, at 19.

[26] Proposal, at 20.

[27] Proposal, at 21.

[28] *Id*.

[29] Proposal, at 17.

[30] Proposal, at 19.

[31] Proposal, at 28.

[32] Proposal, at 28-32.

[33] Proposal, at 29.

[34] Proposal, at 29-30.

[35] Proposal, at 31.

[36] *Id*.

[37] Proposal, at 30-31.

[38] Proposal, at 31-32.

[39] Proposal, at 32-33.

[40] Proposal, at 33.

[41] The Proposal does not explain why the OCC did not propose corresponding amendments to its DFAST rules.

[42] Proposal, at 35.

[43] "*CCAR*" refers to the Federal Reserve's Comprehensive Capital Analysis and Review of capital plans filed annually by bank holding companies with $50 billion or more in total consolidated assets and U.S. intermediate holding companies of foreign banking organizations under the Federal Reserve's capital plan rule, Section 225.8 of Regulation Y, and supervisory and company-run stress tests under its DFAST rules, Subparts E and F of Regulation YY, 12 C.F.R. Part 252.

[44] Federal Reserve, *Comprehensive Capital Analysis and Review 2018 Summary Instructions* (February 2018), at 3, *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20180201a2.pdf.

[45] For additional information on this proposal, see our Memorandum to Clients entitled *Bank Capital Requirements, Capital Plans and Stress Tests: Federal Reserve Proposes Substantial Changes to CCAR and Its Capital Rules, Including New Stress Captial Buffer and Stress Leverage Buffer*

Requirements and the Elimination of CCAR Quantitative Objection (April 19, 2018), *available at* https://www.sullcrom.com/siteFiles/Publications/SC_Publication_Bank_Capital_Requirements_Capital_Plans_and_Stress_Tests.pdf.

[46] Proposal, at 36.

[47] Proposal, at 33-37.

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