SULLIVAN & CROMWELL LLP

December 27, 2018

Bank Capital Requirements

Federal Banking Agencies Release Final Rule Regarding the Implementation of CECL, and Federal Reserve Provides Guidance on CECL and CCAR

On December 21, the Federal Reserve, the FDIC and the OCC released a joint final rule[1] to revise their regulatory capital rules to address the upcoming implementation of the current expected credit losses ("*CECL*") accounting standard under U.S. GAAP, provide an optional three-year phase-in period for the day-one adverse regulatory capital effects that banking organizations are expected to experience upon adopting CECL, and require the use of CECL in stress tests beginning with the 2020 capital planning and stress testing cycle for banking organizations (except for those non-SEC reporting companies that have not then adopted CECL).[2] The final rule is the same as the joint proposal[3] released by the agencies in April of this year, which is described in our earlier Memorandum to Clients, with one change in terminology. The final rule will become effective on April 1, 2019, though a banking organization may choose to adopt the final rule early starting with the first quarter of 2019. For SEC reporting companies with December 31 fiscal-year ends, CECL will become effective beginning with the first quarter of 2020. For other banking organizations, CECL will first become effective for the first fiscal year beginning after December 15, 2020 or 2021, depending on whether the organization is a public business entity under U.S. GAAP.

The final rule preserves the optional three-year phase-in period that was proposed. The agencies declined to extend the transition period to five years or longer, or to neutralize the effects of CECL on regulatory capital pending further study of CECL, as some commenters had recommended.[4] The agencies stated that they continued to view the four years between the release of the final CECL standard and the earliest effective date, in combination with the optional 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."[5]

The agencies also note that many commenters requested that the agencies take action to neutralize the effects of CECL on regulatory capital on a more permanent basis. Although the agencies declined to do so, they stated that they "recognize commenters' concerns about CECL's effects on regulatory capital" and added that they "are committed to closely monitoring the effects of CECL on regulatory capital and bank lending practices."[6]

On December 21, concurrent with the release of the final rule, the Federal Reserve issued a statement[7] explaining how it intends to address the incorporation of CECL into its supervisory stress tests and its assessment of firms' company-run stress tests, including for purposes of CCAR.[8]

- **Supervisory Stress Tests.** In its supervisory stress tests, the Federal Reserve generally estimates a firm's allowance for loan and lease losses ("*ALLL*") as the amount needed to cover projected loan losses over the next four quarters. The Federal Reserve spreads out the difference between the actual historical level of a firm's ALLL and the assumed ALLL under the stress scenario at the start of the stress testing horizon over the nine quarters of the horizon to smooth the effect of the difference on capital—that is, to avoid reducing capital by the full amount of the difference at the start of the horizon. In order to "reduce uncertainty, allow for better capital planning at affected firms, and gather additional information on the impact of CECL," the Federal Reserve states that it "plans to maintain the current framework for calculating allowances on loans in the supervisory stress test until the impact of CECL on banking organizations' financial reporting is better known and understood."[9] The Federal Reserve adds that it "intends to maintain this framework for the 2020 and 2021 supervisory stress test cycles and to evaluate appropriate future enhancements to this framework as best practices for implementing CECL are developed." The expectation, according to the Federal Reserve, is "that maintaining the current framework . . . will largely offset any impact in the supervisory stress test that may result from the expected increase in the allowances under the CECL standard."
- **Company-Run Stress Tests.** With respect to firms' company-run stress tests, the Federal Reserve states that it "plans to collect information necessary to determine the range of practice used by firms to incorporate [CECL] into stress testing and capital planning and share its observations with firms." The Federal Reserve notes, however, that it "would not issue supervisory findings on firms' stressed estimation of the allowance under CECL in CCAR's qualitative assessment any earlier than 2022."

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ENDNOTES

[1] Board of Governors of the Federal Reserve System, Office of the Comptroller of the Currency and Federal Deposit Insurance Corporation, *Regulatory Capital Rule: 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/bcreg20181221a1.pdf (December 21, 2018) (hereinafter, the "*Final Rule*").

[2] The Final Rule amends the stress testing rules for the Federal Reserve and the FDIC. In the preamble, the OCC explained that it would address these matters in its stress test instructions, consistent with its current practice.

[3] Board of Governors of the 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*, 83 Fed. Reg. 22312 (May 14, 2018), *available at* https://www.govinfo.gov/content/pkg/FR-2018-05-14/pdf/2018-08999.pdf.

[4] Final Rule, at 13 and 18-19.

[5] *Id.*, at 20.

[6] *Id*., at 36.

[7] Board of Governors of the Federal Reserve System, *Statement on the Current Expected Credit Loss Methodology (CECL) and Stress Testing, available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181221b1.pdf.

[8] "*CCAR*" refers to the Federal Reserve's Comprehensive Capital Analysis and Review of capital plans filed annually under the Federal Reserve's capital plan rule, Section 225.8 of Regulation Y, and supervisory and company-run stress tests under its Dodd-Frank Act Stress Test ("*DFAST*") rules, Subparts E and F of Regulation YY, 12 C.F.R. Part 252.

[9] The Federal Reserve specifies that it plans to maintain the current assumption that a firm's ALLL covers losses over the next four quarters and to spread out differences between actual and stressed ALLL over nine quarters. The Federal Reserve also notes that its projection of expected credit losses on securities will be incorporated into its credit loss estimates, reflecting that CECL will modify the treatment of available-for-sale debt securities by requiring firms to recognize credit losses on individual AFS debt securities through credit loss allowances, instead of through direct write-downs, as is currently the case under U.S. GAAP.

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