Final Interagency Policy Statement – How Regulatory Agencies Will Respond to CECL

The final interagency policy statement was put out for comment on October 17, 2019 to address FASB ASC Topic 326. It was released by the Office of the Comptroller of the Currency (OCC), Treasury; Board of Governors of the Federal Reserve System (Board); Federal Deposit Insurance Corporation (FDIC); and National Credit Union Administration (NCUA). The scope of the policy statement is defined as follows:

> "This interagency policy statement describes the measurement of expected credit losses under the current expected credit losses (CECL) methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB ASC Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate ACLs; the responsibilities of boards of directors and management; and examiner reviews of ACLs."

Along with the release of the final policy statement, the comments received over the 60-day comment period and the agencies response; they also included the following statement which clarifies the agencies intent to align with the CECL standard.

"FASB ASC Topic 326 replaces the incurred loss methodology for financial assets measured at amortized cost, net investments in leases, and certain off-balance-sheet credit exposures, and modifies the accounting for impairment on available-for-sale debt securities. 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 GAAP. The agencies are maintaining conformance with GAAP and consistency with FASB ASC Topic 326 through the issuance of the final Interagency Policy Statement on Allowances for Credit Losses (final Policy Statement)."

Over the 60-day comment period, concluding on December 16, 2019, 23 comment letters were received. The agencies response to specific commenters included the following key takeaways:

1. "Many commenters expressed support for the proposed Policy Statement. These commenters noted that the proposal is generally consistent with FASB ASC Topic 326 and retains the flexibility and judgmental nature of GAAP. Commenters also stated that supervisory practices and principles were clearly communicated. Some commenters appreciated the agencies' statement that examiners generally should accept an

institution's ACL estimates and not seek adjustments to the ACLs when management has provided adequate support for the loss estimation process employed, and the ACL balances and the assumptions used in the ACL estimates are in accordance with GAAP and regulatory reporting requirements."

2. "A number of commenters requested that the agencies include information in the final Policy Statement to provide additional guidance around technical aspects of FASB ASC Topic 326 and reduce the amount of management judgment required to implement the accounting standard. For example, commenters requested additional clarity on segmentation, data availability, estimating expected losses for credit cards, and accounting for loans transferred between held-for-sale and held-for investment classifications. The agencies considered these requests and decided not to limit flexibility in implementing FASB ASC Topic 326 by narrowing options or defining terms that are not defined in GAAP. The final Policy Statement does not endorse a specific loss estimation method or provide more detail about specific implementation choices, including providing templates for certain methods. FASB ASC Topic 326 allows management to exercise judgment to best reflect its estimate of expected credit losses given the institution's own unique set of facts and circumstances. Specific assumptions and determinations appropriate for one institution may not be appropriate for all other institutions. The final Policy Statement recognizes that different approaches and assumptions may be used by management in estimating expected credit losses. Prescribing only one method for use in estimating expected credit losses or narrowly defining terms or concepts introduced in ASC Topic 326 in the final Policy Statement could narrow the flexibility and scalability provided in FASB ASC Topic 326."
3. "The final Policy Statement is one of many steps the agencies have undertaken in assisting institutions with implementing FASB ASC Topic 326. The agencies will continue to monitor implementation activities through routine supervisory activities and will determine if any additional materials or outreach may be needed. The agencies recognize that FASB ASC Topic 326 may present implementation challenges, particularly for small community institutions and credit unions. The agencies may individually issue additional information to provide clarification beyond what is presented in the final Policy Statement as deemed necessary."
4. "Commenters expressed concern about the level of documentation needed to support the assumptions and judgments included in an institution's estimate of expected credit losses. It is consistent with safe and sound banking practices to maintain documentation that is appropriate for an institution's size as well as the nature, scope, and risk of its activities and include clear explanations of the supporting analysis and rationale used in estimating expected credit losses under FASB ASC Topic 326. A third party that is

independent of the ACL processes, whether internal or external, should also be able to understand the methodology used to determine estimated credit losses through review of the institution's ACL documentation."

In addition to the clarification on topics listed above, the agencies included a number of revisions to the final policy statement in response to the comments received. Key revisions included the following:

1. For AFS debt securities the agencies stated: "Expected credit losses for available-for-sale debt securities are measured using a discounted cash flow method. When estimating expected cash flows, institutions should consider past events, current conditions, and reasonable and supportable forecasts. While the qualitative factors included in the proposed Policy Statement may affect the institution's cash flow expectations used in the discounted cash flow calculation, the agencies have no expectation for institutions to develop and apply a separate qualitative analysis outside of the discounted cash flow model."
2. The agencies stated that the accounting policy elections related to accrued interest receivable may be made by class of financing receivable or major security-type.
3. The agencies decided to remove any reference to the income statement category to be used for adjustments to the estimated credit losses for off-balance-sheet credit exposures when preparing regulatory reports.
4. The regulators commented that when estimating credit losses with limited loss history or limited losses the following would be consistent with the policies stated.
    a. "When an institution has a long history of data with limited credit losses, management is not expected to default to external or peer data to determine expected credit losses. Existing data should be evaluated to determine if adjustments are needed to reflect changes in items such as the nature of the assets or underwriting terms."
    b. "When an institution has loss data covering only recent periods, historical loss information should be supplemented with external or peer data, industry data, or qualitative factor adjustments to ensure that expected credit losses are appropriately captured."
5. The agencies discussed comparing actual credit losses to estimated credit losses under CECL and decided that, due to the limitations in making such a comparison, they will not be requiring institutions to compare actual credit losses to estimated credit losses. They also stated that "Management may also develop other methods, metrics, or tools not described in the final Policy Statement to assist in the evaluation and analysis of the institution's ACLs."

6. The agencies also commented on reliance on external auditor to perform management validation of ACLs. The final policy statement explains: "The final Policy Statement clearly allow institutions to rely on external audit firms to perform management's validation of ACLs to minimize additional expense. External auditors are subject to applicable auditor independence. The external auditor's performance of management's responsibilities may impair the external auditor's independence under those standards if the external auditor also performs an independent audit of the institution's financial statements. The final Policy Statement explains that a party independent of the ACL processes should validate the ACLs. An independent party may be from an internal audit function, a risk management unit of the institution, or a contracted third-party. The agencies added language to the final Policy Statement to clarify that external auditor independence may be impaired if the external auditor performs validation activities for management when the external auditor also conducts the institution's independent financial statement audit."

The agencies do not plan on putting out any special rules or regulations on the calculation of the allowance for credit loss under CECL despite the requests of several commenters. This decision is in keeping with previous feedback from the TRG stating that the variability across institutions calls for flexibility in estimation methods. However, they may release additional information on how this would affect capital and other calculations. The guidance provided by the final policy statement is intended to provide clarification on key topics as they relate to the CECL standard. It is not the intent of the agencies to fundamentally change the interpretations of the standard.