Regulatory Alert

Financial Services Regulatory Insight Center

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Agencies propose amendments to regulatory capital rules in response to CECL accounting standard

Key highlights

- All banking organizations that experience a reduction in retained earnings as a result of adopting CECL would have the option to elect a three-year phase-in of the "day 1" adverse impact to regulatory capital.
- Banking organizations must elect to use the phase-in approach by the end of their first reporting period after adopting CECL or they forfeit the option.
- Certain large banking organizations would be required to report two sets of regulatory capital ratios, one with the phase-in transition amounts and one without (fully phased-in); stress tests would not reflect the adoption of CECL until the 2020 stress test cycle even if CECL is adopted earlier.

Summary

The federal banking agencies (Federal Reserve Board, Office of the Comptroller of the Currency, Federal Deposit Insurance Corporation) have jointly published proposed rules that would amend their regulatory capital rules to respond to banking organizations' implementation of the new Current Expected Credit Losses (CECL) methodology under U.S. Generally Accepted Accounting Principles (GAAP). Adoption of the CECL accounting standard will necessitate one-time adjustments to retained earnings, temporary difference DTAs (deferred tax assets), and credit loss allowances eligible for inclusion in regulatory capital, which will impact a banking organization's regulatory capital ratios.

Key features of the agencies' proposed rules follow.

Phase-in Option. All banking organizations would have the option to elect a three-year phase-in of the "day 1" regulatory capital effects from adopting CECL (referred to as the CECL Transition Provision) if they experience a reduction in retained earnings as a result of adopting the new accounting standard. Further:

- The CECL Transition Provision would be comprised of the separate impacts to retained earnings and temporary difference DTAs, and the difference between the pre-CECL allowance for loan and lease losses (ALLL) and the newly defined post-CECL allowance for credit losses (ACL), discussed below.
- Phase-in of the CECL Transition Provision would be calculated on a straight-line basis over the three-year period.
- The election to use the phase-in approach would be required to be made by the end of the first regulatory reporting period in which the banking organization applies CECL, otherwise it is forfeited.
- A depository institution holding company and its subsidiary depository institutions would be eligible to make the phase-in election independent of one another.

Definitions. A new term, "allowance for credit losses" or ACL, would take the place of ALLL for banking organizations that have adopted CECL. ACL would include credit loss allowances related to financial assets measured at amortized cost, except for allowances for PCD assets (purchased credit-deteriorated assets). It would also exclude allowances for AFS (available-for-sale) debt securities. ACL would be eligible for inclusion in Tier 2 capital subject to the current limit for ALLL. PCD assets and AFS debt securities would be treated separately.

The agencies are also proposing to revise the regulatory definition of "carrying value" under the capital rules to provide that, for all assets other than PCD assets and AFS debt securities, the carrying value is not reduced by any associated credit loss allowance.

AA Banks. Advanced Approaches Banking Organizations (AA Banks) that adopt CECL would be subject to certain additional provisions, including:

— The definition of eligible credit reserves would be revised to align with the definition of ACL.

— AA Banks that have completed the parallel run process and have elected the phase-in approach would be required to calculate an additional transition amount – a pre-CECL and post-CECL eligible credit reserves difference – to phase-into eligible credit reserves, subject to certain limitations. The current limit for including eligible credit reserves in Tier 2 capital would be retained.

Disclosures. Banking organizations would be required to update certain regulatory disclosures to reflect the adoption of CECL. AA Banks that have elected the phase-in option would be required to disclose two sets of regulatory capital ratios: one with the CECL Transition Provision and one on a fully phased-in basis.

Stress Tests. For purposes of the stress testing rules, banking organizations that adopt CECL would be required to begin using the provision for credit losses in the 2020 stress test cycle even if they adopted CECL in 2019. For the 2018 and 2019 stress test cycle, a banking organization would continue to use its provision for loan and lease losses calculated under the incurred loss methodology. Banking organizations that adopt CECL in 2021 would begin to use the provision for credit losses in the 2021 stress test cycle.

Applicability. All banking organizations that are subject to the agencies' regulatory capital rules and file regulatory reports that are required to conform to U.S. GAAP are covered by the proposed rule. The agencies intend to use regulatory capital ratios adjusted by the CECL Transition Provision when determining whether a banking organization that has elected the phase-in approach is in compliance with its regulatory capital requirements.

CECL Accounting Standard. The CECL accounting guidance was issued in 2016 as part of Accounting Standards Update No. 2016-13. The effective date varies for different banking organizations based on certain characteristics; it becomes effective for the first group of banking organizations in their first fiscal year beginning after December 15, 2019, including interim periods within that fiscal year (e.g., quarterly reports). Early adoption is permitted for all banking organizations for fiscal years beginning after December 15, 2018.

For additional information on CECL and related regulatory capital rules, please contact Michael Ohlweiler, Mark Northan, or Reza Van Roosmalen.

Amy Matsuo
Principal and National Lead
Regulatory Insights
T: 919-664-7302
E: amatsuo@kpmg.com

Contributing authors:
Amy Matsuo, Principal and National Lead, Regulatory Insights

Karen Staines, Director, Financial Services Regulatory Insight Center

Phil MacFarlane, Associate Director, Financial Services Regulatory Insight Center

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