

June 17, 2016

**Joint Statement on the New Accounting Standard on  
Financial Instruments - Credit Losses**

**Purpose**

The Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC) (hereafter, the agencies) are issuing this joint statement to provide initial information about the new accounting standard, Accounting Standards Update (ASU) No. 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.<sup>1</sup>

The Financial Accounting Standards Board (FASB) recently issued this new accounting standard, which introduces the current expected credit losses methodology (CECL) for estimating allowances for credit losses. The new accounting standard allows a financial institution to leverage its current internal credit risk systems as a framework for estimating expected credit losses.

This joint statement also provides initial supervisory views regarding the implementation of the new accounting standard. This important accounting change requires the attention of each financial institution's board of directors and senior management.

**Scope of the New Accounting Standard**

The new accounting standard applies to all banks, savings associations, credit unions, and financial institution holding companies (hereafter, institutions), regardless of asset size.

**Key Elements of the New Accounting Standard**

Under CECL, the allowance for credit losses is a valuation account, measured as the difference between the financial assets' amortized cost basis and the net amount expected to be collected on the financial assets (i.e., lifetime credit losses).<sup>2</sup>

To estimate expected credit losses under CECL, institutions will use a broader range of data than under existing U.S. generally accepted accounting principles (GAAP). These data include

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<sup>1</sup> The FASB issued ASU 2016-13 on June 16, 2016. A complete copy of the document is available [here](#).

<sup>2</sup> Paragraph 326-20-30-1 states, "The allowance for credit losses is a valuation account that is deducted from the **amortized cost basis** of the **financial asset(s)** to present the net amount expected to be collected on the financial asset."

information about past events, current conditions, and reasonable and supportable forecasts relevant to assessing the collectability of the cash flows of financial assets.

**Single measurement approach:** Impairment measurement under existing U.S. GAAP is often considered complex because it encompasses a number of impairment models for different financial assets.<sup>3</sup> In contrast, the new accounting standard introduces a single measurement objective to be applied to all financial assets carried at amortized cost, including loans held for investment and held-to-maturity securities.

**Scalability:** While there are differences between today's incurred loss methodology and CECL, the agencies expect the new accounting standard will be scalable to institutions of all sizes. Similar to today's incurred loss methodology, the new accounting standard does not prescribe the use of specific estimation methods. Rather, allowances for credit losses may be determined using various methods. Additionally, institutions may apply different estimation methods to different groups of financial assets. Thus, the new standard allows institutions to apply judgment in developing estimation methods that are appropriate and practical for their circumstances. The agencies do not expect smaller and less complex institutions will need to implement complex modeling techniques.

**Purchased credit-deteriorated assets:** Another change from existing U.S. GAAP involves the treatment of purchased credit-deteriorated assets. For such assets, the new accounting standard requires institutions to estimate and record an allowance for credit losses at the time of purchase, which is then added to the purchase price rather than being reported as a credit loss expense. In addition, the definition of purchased credit-deteriorated assets<sup>4</sup> is broader than the definition of purchased credit-impaired assets in current accounting standards.

**Accounting for available-for-sale debt securities:** The new accounting standard also updates the measurement of credit losses on available-for-sale debt securities. Under this standard, institutions will record credit losses on available-for-sale debt securities through an allowance for credit losses rather than the current practice of write-downs of individual securities for other-than-temporary impairment.

**Retained accounting concepts:** The new accounting standard does not change the existing write-off principle in U.S. GAAP or current nonaccrual practices, nor does it change the current accounting requirements for loans held for sale, which are measured at the lower of amortized cost or fair value.

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<sup>3</sup> Current U.S. GAAP includes five different credit impairment models for instruments within the scope of CECL: ASC Subtopic 310-10, *Receivables-Overall*; ASC Subtopic 450-20, *Contingencies-Loss Contingencies*; ASC Subtopic 310-30, *Receivables-Loans and Debt Securities Acquired With Deteriorated Credit Quality*; ASC Subtopic 320-10, *Investments-Debt and Equity Securities-Overall*; and ASC Subtopic 325-40, *Investments-Other-Beneficial Interest in Securitized Financial Assets*.

<sup>4</sup> The new accounting standard defines purchased financial assets with credit deterioration as acquired individual financial assets (or acquired groups of financial assets with similar risk characteristics at the date of acquisition) that have experienced a *more than insignificant* deterioration in credit quality since origination, based on the assessment of the acquirer.

**Effective dates:** The FASB has set the following effective dates for the new standard, which depend on an institution’s characteristics:

- Public business entities (PBE) that are U.S. Securities and Exchange Commission (SEC) filers<sup>5</sup> (SEC filers): Fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
- Other PBEs (non-SEC filers<sup>6</sup>): Fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.
- Non-PBEs (private companies): Fiscal years beginning after December 15, 2020, including interim periods beginning after December 15, 2021.

For all institutions, early application of the new standard is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

The table summarizes the effective dates.

| <b>Effective Dates</b>                           |   |   |
|--|---|---|
|  | <b>U.S. GAAP<br/>Effective Date</b>   | <b>Regulatory<br/>Reporting<br/>Effective Date*</b> |
| <b>PBEs that are SEC filers<br/>(SEC filers)</b> | Fiscal years beginning after December 15, 2019, including interim periods within 2020   | March 31, 2020                                      |
| <b>Other PBEs<br/>(non-SEC filers)</b>           | Fiscal years beginning after December 15, 2020, including interim periods within 2021   | March 31, 2021                                      |
| <b>Non-PBEs<br/>(private companies)</b>          | Fiscal years beginning after December 15, 2020, including interim periods beginning after December 15, 2021                         | December 31, 2021                                   |
| <b>Early application for all<br/>entities</b>    | Early application permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years |   |

\*For institutions with calendar year ends

<sup>5</sup> An SEC filer, as defined in U.S. GAAP, is an entity that is required to file its financial statements with the SEC under the federal securities laws or, for an FDIC-insured depository institution, the appropriate federal banking agency under Section 12(i) of the Securities and Exchange Act of 1934.

<sup>6</sup> A PBE that is not an SEC filer would include (1) an entity that has issued securities that are traded, listed, or quoted on an over-the-counter market, and (2) an entity that has issued one or more securities that are not subject to contractual restrictions on transfer and is required by law, contract, or regulation to prepare U.S. GAAP financial statements (including footnotes) and make them publicly available periodically (e.g., pursuant to Section 36 of the Federal Deposit Insurance Act and Part 363 of the FDIC’s regulations). For further information on the definition of a PBE, refer to ASU 2013-12, *Definition of a Public Business Entity*, issued in December 2013.

**Transition:**<sup>7</sup> On the effective date, institutions will apply the new accounting standard based on the characteristics of financial assets as follows:

- **Financial assets carried at amortized cost** (e.g., loans held for investment and held-to-maturity debt securities): A cumulative-effect adjustment will be recognized on the balance sheet as of the beginning of the first reporting period in which the new standard is effective.
- **Purchased credit-deteriorated assets:** Financial assets classified as purchased credit-impaired assets prior to the effective date will be classified as purchased credit-deteriorated assets as of the effective date. For all purchased-credit deteriorated assets, institutions will be required to gross up the amount of the financial asset for its allowance for expected credit losses as of the effective date and should continue to recognize the noncredit discount or premium as interest income, if appropriate, based on the effective yield on such assets determined after the gross-up for the allowance.
- **Available-for-sale and held-to-maturity debt securities:** Debt securities on which other-than-temporary impairment had been recognized prior to the effective date will transition to the new guidance prospectively (i.e., with no change in the amortized cost basis of these securities).

## Initial Supervisory Views

### Measurement Methods

The new accounting standard does not specify a single method for measuring expected credit losses; rather, institutions should use judgment to develop estimation methods that are well documented, applied consistently over time, and faithfully estimate the collectability of financial assets by applying the principles in the new accounting standard.

The new accounting standard allows expected credit loss estimation approaches that build on existing credit risk management systems and processes, as well as existing methods for estimating credit losses (e.g., historical loss rate, roll-rate, discounted cash flow, and probability of default/loss given default methods).<sup>8</sup> However, certain inputs into these methods will need to change to achieve an estimate of lifetime credit losses. For example, the input to a loss rate method would need to represent remaining lifetime losses, rather than the annual loss rates commonly used under today's incurred loss methodology. In addition, institutions would need to consider how to adjust historical loss experience not only for current conditions as is required under the existing incurred loss methodology, but also for reasonable and supportable forecasts that affect the expected collectability of financial assets.

Nevertheless, taking these factors into account, the agencies expect that smaller and less complex institutions will be able to adjust their existing allowance methods to meet the requirements of the new accounting standard without the use of costly and complex models.

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<sup>7</sup> Refer to paragraph 326-10-65-1 for transition related to ASU 2016-13.

<sup>8</sup> For example, neither a vintage nor a discounted cash flow method is required for estimating expected credit losses.

## **Use of Vendors**

The agencies will not require institutions to engage third-party service providers to calculate their allowances for credit losses. If an institution chooses to use a third-party service provider to assist with this process, the institution should follow the agencies' guidance on third-party service providers.<sup>9</sup>

The agencies encourage institutions to discuss the availability of historical loss data with their core loan service providers. System changes related to the collection and retention of data may be warranted.

## **Portfolio Segmentation**

The new accounting standard requires institutions to measure expected credit losses on a collective or pool basis when similar risk characteristics exist. Although the new accounting standard provides examples of such characteristics, smaller and less complex institutions may continue to follow the practices they have used for appropriately segmenting the portfolio under an incurred loss methodology or they may refine those practices.

Further, if a financial asset does not share risk characteristics with other financial assets, the new accounting standard requires expected credit losses to be measured on an individual asset basis. As with practices applied under the incurred loss methodology, financial assets on which expected credit losses are measured on an individual basis should not also be included in a collective assessment of expected credit losses.

## **Data**

To implement the new accounting standard, institutions should collect data to support estimates of expected credit losses in a way that aligns with the method or methods that will be used to estimate their allowances for credit losses. Depending on the method selected, institutions may need to capture additional data. Institutions also may need to retain data longer than they have in the past on loans that have been paid off or charged off.

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<sup>9</sup> For the agencies' guidance on third-party service providers, refer to the following:

- FRB, [Supervision and Regulation Letter 13-19/Consumer Affairs Letter 13-21, "Guidance on Managing Outsourcing Risk"](#)
- FDIC, [Financial Institution Letter 44-2008, "Guidance for Managing Third-Party Risk"](#)
- OCC, [Bulletin 2013-29, "Third-Party Relationships: Risk Management Guidance"](#)
- NCUA, [Supervisory Letter No. 07-01, "Evaluating Third Party Relationships"](#)

## Qualitative Adjustments and Systematic Allowance Processes

Similar to the agencies' expectations under an incurred loss methodology, institutions should develop and document their allowance methodology and apply it in a thorough, disciplined, and consistent manner.<sup>10</sup> Estimating allowance levels, including assessments of qualitative adjustments to historical lifetime loss experience, involves a high degree of management judgment, is inevitably imprecise, and results in a range of estimated expected credit losses. For these reasons, institutions are encouraged to build strong processes and controls over their allowance methodology.

## Future Supervisory Guidance

The agencies are determining the nature and extent of supervisory guidance institutions will need during the implementation period, with a particular focus on the needs of smaller and less complex institutions. If institutions have issues or concerns about implementing the new accounting standard, they should discuss their questions with their primary federal supervisor.

## Successful Transition

Until institutions implement the new accounting standard, they must continue to calculate their allowances for loan and lease losses using the existing incurred loss methodology. Institutions should not begin increasing their allowance levels beyond those appropriate under existing U.S. GAAP in advance of the new standard's effective date. However, institutions are encouraged to take steps to assess the potential impact on capital.

Although the agencies recognize the impact of CECL will vary from institution to institution, the agencies encourage institutions to start planning and preparing for their transition to the new accounting standard by:

- Becoming familiar with the [new accounting standard](#).
- Discussing with the board of directors, industry peers, external auditors,<sup>11</sup> and supervisory agencies how best to implement the new accounting standard in a manner appropriate to the institutions' size and the nature, scope, and risk of their lending and debt securities investment activities.
- Reviewing existing allowance and credit risk management practices to identify processes that can be leveraged when applying the new accounting standard.
- Identifying data needs and necessary system changes to implement the new accounting standard consistent with its requirements, the allowance estimation method or methods to be used, and supervisory expectations.
- Determining how and when to begin collecting the additional data that may be needed for implementation.

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<sup>10</sup> For the agencies' expectations under the incurred loss methodology, refer to the "Interagency Policy Statement on the Allowance for Loan and Lease Losses" issued in December 2006.

<sup>11</sup> When discussing the new accounting standard and its implementation with their external auditors, institutions and their audit committees should be mindful of applicable auditor independence requirements.

- Planning for the potential impact of the new accounting standard on capital.

Senior management, under the oversight of the board of directors, should work closely with staff in their accounting, lending, credit risk management, internal audit, and information technology functions during the transition period leading up to the effective date of the new accounting standard as well as after its adoption.

### **Interagency Coordination**

The agencies' goal is to ensure consistent and timely communication, delivery of examiner training, and issuance of supervisory guidance pertaining to the new accounting standard. The agencies will be especially mindful of the needs of smaller and less complex institutions when developing supervisory guidance describing the expectations for an appropriate and comprehensive implementation of this standard. The guidance will not prescribe a single approved method for estimating expected credit losses. Furthermore, because appropriate allowance levels are institution-specific amounts, the guidance will not establish benchmark targets or ranges for the change in institutions' allowance levels upon adoption of CECL or for allowance levels going forward.

### **Conclusion**

The move to an expected credit loss methodology represents a change to current allowance practices for the agencies and institutions. The agencies support an implementation of the FASB's new accounting standard that is both reasonable and practical, taking into consideration the size, complexity, and risk profile of each institution.