

COVID-19 Update: Banking Agencies Delay CECL Capital Impacts

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On March 27, 2020, the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation (collectively, the “Agencies”) issued an interim final rule that allows banking organizations to mitigate the effects of the “current expected credit loss” (“CECL”) accounting standard in their regulatory capital.¹ Banking organizations that are required under U.S. accounting standards to adopt CECL in 2020 can mitigate the estimated cumulative regulatory capital effects for up to two years. Alternatively, banking organizations can follow the capital transition schedule issued by the banking agencies in February 2019.

Background of the CECL

Under the incurred-loss methodology, banking organizations and other creditors used models to recognize credit losses when a particular loan had reached a probable threshold of loss. Accounting principles did not provide a forward-looking methodology to estimate if a performing loan might result in a loss. Thus, until an event occurs affecting that particular loan, no reserve creation is required. The CECL methodology, created by FAS 2016-13, eliminates the current accounting restrictions on using forward-looking information to calculate loan losses. Under FAS 2016-13, creditors must look to the foreseeable future, assess current conditions, take historical experience into account and come up with a reasonable calculation of expected losses over the life of the particular loan and recognize the expected loss at origination. This means that every loan generates at least some loan loss reserve as soon as it is originated.

Capital Implications

The CECL is expected to create higher loan loss reserves generally, which in turn erode GAAP net income. While the amount of loan loss reserves counts as capital, loan loss reserves do not count as the most versatile and important form of capital, Common Equity Tier 1 capital, or even as Additional Tier 1 capital. Instead, loan loss reserves count toward the less desirable Tier 2 capital, and even then are subject to a cap (*i.e.*, 1.25% of total risk-weighted assets). The anticipated impact of CECL is that it will shift amounts from a banking organization’s retained income to loan loss reserves, which then diminishes the banking organization’s overall capital ratios.

Capital Implications Delayed

The original plan, adopted by regulation in February 2019,² was for the CECL requirements to become applicable in three steps over the next two years, with the largest banking organizations becoming subject to CECL requirements for the period ending March 31, 2020, and all other banking organizations subject to CECL requirements by March 31, 2022. Alternatively, the 2019 rule included a transition option that allows any banking organizations to phase in over a three-year period the day-one adverse effects of CECL on their regulatory capital ratios, with the three-year transition beginning that banking organization's otherwise applicable implementation year (*i.e.*, 2020, 2021, 2022).

Due to the effects of the coronavirus 2019 ("COVID-19") pandemic, the Agencies have opted to delay the capital effects of the CECL for banking organizations subject to the 2020 implementation year. As the Agencies explained:

To address these [COVID-19-related] concerns and allow banking organizations to better focus on supporting lending to creditworthy households and businesses, the agencies are providing banking organizations that adopt in the current environment an alternate option to temporarily delay a measure of CECL's effect on regulatory capital, relative to the incurred loss methodology. The transitional relief provided in the interim final rule is intended to be simple to implement without imposing undue operational burden, while reducing the potential for competitive inequities across banking organizations during this time of economic uncertainty and maintaining the quality of regulatory capital.³

Under the interim final rule, with respect to banking organizations previously required to adopt the CECL in 2020, the Agencies are providing the option to disregard for a two-year period (*i.e.*, 2020 and 2021) the estimated impact of CECL on the banking organization's regulatory capital, followed by a three-year transition period to phase into full compliance with respect to any capital benefit provided during the initial two-year delay. Thus, for 2020 and 2021, banking organizations originally subject to 2020 implementation may continue to calculate capital as if the prior "incurred loss" methodology were still in effect. So that banking organizations are not required to maintain two methodologies over this time period (incurred loss and CECL), the interim final rule allows banking organizations to estimate the impact on capital using a "25% scaling factor," as applied to CECL-calculated amounts. Capital amounts adjusted during 2020 and 2021 would then be restored over a three-year period, from 2022 through 2024.

1 85 Fed. Reg. 17723 (Mar. 31, 2020) ("Interim Final Rule"), available [here](#).

2 84 Fed. Reg. 4222 (Feb. 14, 2019).

3 Interim Final Rule at 17725.