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Update: CECL & Covid-19

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Abstract

In response to the unprecedented situation presented by the Covid-19 pandemic, the legislature as well as agencies have announced relief measures for financial institutions to temporarily relieve CECL requirements keeping in mind the current economic environment. This update provides an overview of these measures.

Covid-19

In terms of economic impact, the situation presented by Covid-19 is probably the worst we have faced since World War II. With the economy crippling, the economic impact is expected to be staggering and far-reaching. The US Government has undertaken significant measures through the CARES act and the agencies – OCC, Fed and FDIC – have also responded to the situation. This update summarizes the announcements made recently as it relates to CECL.

Section 4014 - CARES Act

On 27th March, the President signed into law the Coronavirus Aid, Relief and Economic Security Act (CARES Act). Section 4014 of the CARES Act provides optional temporary relief to financial institutions from CECL. Specifically, this section provides that no insured depository institution, bank holding company, or any affiliate thereof is required to comply with the Financial Accounting Standards Board Accounting Standards Update No. 2016–13 (“Measurement of Credit Losses on Financial Instruments”), including the current expected credit losses methodology for estimating allowances for credit losses, during the period beginning on the date of enactment of this Act and ending on the earlier of the date on which the national emergency concerning Covid-19 is terminated or December 31, 2020. Institutions that utilize this option would continue to rely on incurred loss methodology.

Some of the large institutions that have spent significant resources on their CECL process, might go ahead without using the option provided by CARES Act. However, some of the smaller institutions might leverage this option because of following reasons:

- i) To learn from the experience of larger institutions as they comply with CECL in these uncertain times.
- ii) To study how larger institutions incorporate immediate impact of Covid-19 (through models or qualitative adjustments).
- iii) To study the economic forecasts that different institutions use and the expected impact of Covid-19 pandemic.

However, it should be noted that the adoption date for institutions that are going to comply in 2023, is not changed. These institutions are expected to continue with their preparations.

Capital Relief - Guidance Issued by the Agencies

On 27th March 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 that adopt CECL during the 2020 calendar year to delay for two years the estimated impact of CECL on regulatory capital, followed by a three-year transition period to phase out the capital benefit provided during the initial two-year delay (i.e., a five-year transition, in total).

The interim final rule does not replace the current three-year transition option provided by the February 2019 regulation. Banking organizations that have already adopted CECL have the option to elect the three-year transition option or the five-year transition provided by the interim final rule.

To estimate the impact of CECL on capital, the interim final rule introduces a 25 percent scaling factor that approximates the average after-tax provision for credit losses attributable to CECL, relative to the incurred loss methodology. The 25 percent scaling factor is an approximation of the impact of differences in credit loss allowances reflected under CECL versus the incurred loss methodology. Because of this approach, the organizations availing the option provided by interim final rule don't need to run the CECL as well as incurred loss-based models in parallel. Calculating the credit loss allowance as per CECL would be enough.

If a banking organization chooses to revert to the incurred loss methodology pursuant to the CARES Act, it would be allowed to use the five-year transition when it returns to the use of CECL. However, an institution that has elected the transition, but does not apply it in any quarter, does not receive any extension of the transition period.

Mechanics of the Five-Year Transition Provision

An electing banking organization should calculate the following:

i) The CECL transitional amount: It is equal to the difference between an electing banking organization's pre-CECL and post-CECL amounts of retained earnings at adoption.

ii) The AACL (adjusted allowance for credit losses) transitional amount: It is equal to the difference between an electing banking organization's pre-CECL amount of ALLL and its post-CECL amount of AACL at adoption.

iii) The DTA (deferred tax assets) transitional amount: It is the difference between an electing banking organization's pre-CECL amount and post-CECL amount of DTAs at adoption due to temporary differences.

iv) Modified CECL transitional amount: It is similar to CECL transitional amount but is adjusted to reflect changes in retained earnings due to CECL that occur during the first two years of the five-year transition period. The change in retained earnings due to CECL is calculated by taking the change in reported AACL relative to the day CECL was adopted and applying a scaling multiplier of .25 during the first two years of the transition period.

v) Modified AACL transitional amount: It is similar to the AACL transitional amount but reflects the change in AACL due to CECL that occurs during the first two years of the five-year transition period. The change in AACL due to CECL is calculated with the same method used for the modified CECL transitional amount.

Inputs to regulatory capital need to be adjusted as follows:

i) Increase retained earnings and average total consolidated assets by modified CECL transitional amount

ii) Decrease AACL by modified AACL transitional amount

iii) Decrease temporary difference DTAs by DTA transitional amount.

An electing banking organization will reflect the modified transitional amount which includes 100 percent of the day one impact of CECL plus the quarterly changes that result from CECL in transition amounts applied to regulatory capital calculations. After two years, the cumulative amount of quarterly modified transitional amounts become fixed and are phased out of regulatory capital along with the transitional amounts that were calculated to reflect the day one impact of CECL. The transitional phase out occurs over the subsequent three-year period as per the following table*:

TABLE 1—CECL TRANSITIONAL AMOUNTS TO APPLY TO REGULATORY CAPITAL COMPONENTS DURING THE FINAL THREE YEARS OF THE FIVE-YEAR TRANSITION

	Year 3	Year 4	Year 5
Increase retained earnings and average total consolidated assets by the following percentages of the modified CECL transitional amount. *Decrease* temporary difference DTAs by the following percentages of the DTA transitional amount ... *Decrease* AACL by the following percentages of the modified AACL transitional amount.	75%	50%	25%

The interim final rule doesn't change the CECL implementation dates, its scope is limited to providing capital relief as explained above.

*https://www.govinfo.gov/content/pkg/FR-2020-03-31/pdf/2020-06770.pdf

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