U.S. DEPARTMENT OF THE TREASURY

The Current Expected Credit Loss Accounting Standard and Financial Institution Regulatory Capital

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Executive Summary

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The current expected credit loss (CECL) methodology is a new accounting standard for estimating allowances for credit losses. CECL currently applies—or will apply—to all entities whose financial statements conform to Generally Accepted Accounting Principles in the United States (GAAP), including all banks, credit unions, savings associations, and their holding companies (collectively, "financial institutions") that file regulatory reports that conform to GAAP. CECL requires financial institutions and other covered entities to recognize lifetime expected credit losses for a wide range of financial assets based not only on past events and current conditions, but also on reasonable and supportable forecasts.

Over the years, stakeholders have discussed and debated the potential effects that CECL may have on financial institutions and their regulatory capital and lending practices. These issues have included whether (1) CECL may have procyclical effects and reduce financial institutions' capacity to lend, particularly in economic downturns; (2) CECL's anticipated benefits justify its implementation costs and other burdens; (3) financial institution capital frameworks should be recalibrated in response to CECL; and (4) CECL may have disparate effects on certain types of lenders and lending.

The Consolidated Appropriations Act, 2020 directed the U.S. Department of the Treasury (Treasury), in consultation with the Board of Governors of the Federal Reserve System (Federal Reserve), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), and the National Credit Union Administration (NCUA) (collectively, the "prudential regulators"), to study the need, if any, for changes to regulatory capital requirements necessitated by CECL.[1]

Treasury has monitored the planning for the transition to CECL, including CECL's potential effects on regulatory capital and financial institutions' lending practices. Treasury has consulted with a wide range of stakeholders on this topic, including representatives from financial institutions and trade groups, representatives of the Financial Accounting Standards Board (FASB), staff of the U.S. Congress, staff of the prudential regulators, and staff of the U.S. Securities and Exchange Commission (SEC).

Treasury supports the goals of CECL—including to provide users of financial statements with more forward-looking information and to present assets on financial statements in a manner that reflects amounts expected to be collected. Treasury also recognizes the seriousness of the

[1] S. REP. NO. 116-111, at 11 (2019), https://www.congress.gov/116/crpt/srpt111/CRPT-116srpt111.pdf; Consolidated Appropriations Act, 2020, H.R. 1158, Pub. L. No. 116-93 [Legislative Text & Explanatory Statement], 116th Cong. (2020), https://www.govinfo.gov/content/pkg/CPRT-116HPRT38678/html/CPRT-116HPRT38678.htm.

concerns that have been raised regarding CECL's potential effects on and implications for regulatory capital, lenders, borrowers, and the U.S. economy.

A definitive assessment of the impact of CECL on regulatory capital is not currently feasible, in light of the state of CECL implementation across financial institutions and current market dynamics. Drawing conclusions right now regarding CECL's impact since its initial implementation in early 2020 is challenging because CECL has not been fully implemented by all entities, and numerous market factors relating to the COVID-19 global pandemic (including government responses) have affected the economy, financial institutions, and borrowing and lending dynamics. While some information has emerged indicating that credit availability declined and lending standards tightened in some financial product categories in early 2020, identifying a definitive linkage between any such trends and the introduction of CECL is difficult due to various factors related to the COVID-19 global pandemic.

Treasury will continue to actively monitor CECL implementation and consult with relevant stakeholders, including the prudential regulators, FASB, and the SEC. As described in more detail below, Treasury makes the following recommendations at this time:

1. The prudential regulators should continue to monitor the effects of CECL on regulatory capital and financial institution lending practices, and calibrate capital requirements, as necessary.

2. The prudential regulators should monitor the use and impact of transitional relief granted, and extend or amend the relief, as necessary.

3. FASB should further study CECL's anticipated benefits.

4. FASB should expand its efforts to consult and coordinate with the prudential regulators to understand—and take into account when considering any potential amendments to CECL—the regulatory effects of CECL on financial institutions.

5. FASB should, in consultation with relevant stakeholders, explore the costs and benefits of further aligning the timing of the accounting recognition of fee revenues associated with financial assets under GAAP with the earlier accounting recognition of potential credit losses under CECL.

6. FASB, together with the prudential regulators, should examine the application of CECL to smaller lenders.

I. Background

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A. Overview

The Consolidated Appropriations Act, 2020, directed Treasury, in consultation with the prudential regulators, to "conduct a study on the need, if any, for changes to regulatory capital requirements necessitated by CECL."[2]

CECL is a new accounting standard for estimating allowances for credit losses. As explained below, CECL requires covered entities to recognize lifetime expected credit losses for a wide range of financial assets and to incorporate reasonable and supportable forecasts in developing their estimates of expected credit losses, while also maintaining the existing accounting requirement to consider past events and current information. CECL currently applies—or will apply—to all financial institutions that file regulatory reports that conform to GAAP, regardless of the size of the financial institution.[3]

This discussion is organized as follows. Part I provides background information about CECL, including how it differs from the prior standard, and when it becomes effective for different types of financial institutions. Part II examines CECL's implications for financial institutions' regulatory capital. Part III discusses many of the key concerns and questions that stakeholders have raised regarding CECL's potential impacts on regulatory capital and lending activity. Finally, Part IV provides Treasury's recommendations.

B. CECL's Predecessor: The Incurred Loss Methodology

To understand CECL and its potential effects on financial institutions' regulatory capital, it is important to understand the previous standard, the incurred loss methodology (ILM), and the decision by FASB, which is the U.S. accounting standard-setting body,[4] to transition from ILM to CECL.

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[2] S. REP. NO. 116-111, at 11 (2019); Consolidated Appropriations Act, 2020, H.R. 1158, Pub. L. No. 116-93 [Legislative Text & Explanatory Statement], 116th Cong. (2020).

[3] *See* FEDERAL RESERVE, FDIC, NCUA & OCC, FREQUENTLY ASKED QUESTIONS ON THE NEW ACCOUNTING STANDARD ON FINANCIAL INSTRUMENTS – CREDIT LOSSES (2019), https://www.ncua.gov/files/letters-credit-unions/financial-instruments-credit-losses-faqs.pdf ("Prudential Regulators' FAQs").

[4] FASB is a private-sector, not-for-profit organization. The SEC has recognized FASB as the designated accounting standard-setter for public companies for more than 45 years. FASB—which is not a regulator—establishes financial accounting and reporting standards for public and private companies and not-for-profit organizations that follow GAAP. *See generally* Commission Statement of Policy Reaffirming the Status of the FASB as a Designated Private-Sector Standard Setter, 68 Fed. Reg. 23333 (May 1, 2003), https://www.govinfo.gov/content/pkg/FR-2003-05-01/pdf/03-10716.pdf (discussing the role of, and SEC oversight over, FASB); FASB, *About the FASB*, https://www.fasb.org/facts/ (last updated July 1, 2020) (explaining FASB's history, structure, and mission).

For the 45 years prior to 2020, ILM was the standard for determining allowances for loan and lease losses (ALLL) under GAAP. Under ILM, a firm recognizes credit losses only when, based on information available upon preparing the financial statement, (1) it is "probable" that a loss will have been incurred at the date of the statement, and (2) the firm can reasonably estimate the amount of the loss.[5] In judging whether a loss is probable under ILM, a firm can use current and past information, but cannot consider potential future events that might cause a loss.

ILM was the subject of criticism over the years, including from preparers and users of financial statements, financial institutions, and other stakeholders.[6] The main concern was that determining the impairment of financial assets based on a "probable" threshold and an "incurred" notion delayed the recognition of credit losses on loans—and resulted in loan loss allowances that were "too little, too late."[7] In the minds of many market participants and other stakeholders, the 2008 financial crisis highlighted these perceived shortfalls. As FASB has explained:

> In the lead-up to the financial crisis, financial statement users were making estimates of expected credit losses using forward-looking information and devaluing financial institutions before accounting losses were recognized. This highlighted that the information needs of users differ from what GAAP has required.
>
> Similarly, preparers expressed frustration during this period because they could not record credit losses that they were expecting due to the fact that the probable threshold had not been met.[8]

A related shortcoming of ILM, according to some, is the potential information asymmetry that it creates. Under ILM, the relevant thresholds delay credit loss recognition until the credit losses are probable. The delayed recognition, some have argued, creates information asymmetry between financial statement users' knowledge concerning a firm's allowance for losses and the

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[5] *See* Hal Schroeder, *For The Investor: Benefits of the "CECL" Model and "Vintage" Disclosures*, FASB OUTLOOK (Q2 2015), https://www.fasb.org/jsp/FASB/Page/SectionPage&cid=1176165963082.

[6] *See*, *e.g.*, FASB, *Accounting Standards Update No. 2016-13, Financial Instruments—Credit Losses (Topic 326)*, FASB IN FOCUS (June 16, 2016), https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176168232790&d=&pagename=FASB%2FDocument_C%2FDocumentPage (reporting that financial statement users and preparers expressed frustration with ILM around the time of the 2008 financial crisis); John C. Dugan, Comptroller of the Currency, OCC, Remarks Before the Institute of International Bankers: Loan Loss Provisioning and Pro-cyclicality (Mar. 2, 2009), https://www.occ.gov/news-issuances/speeches/2009/pub-speech-2009-16.pdf; Letter from James Kendrick, Vice President, Acct. & Cap. Pol'y, Indep. Cmty. Bankers of Amer., to Technical Dir., FASB (May 30, 2013), https://www.icba.org/docs/default-source/icba/advocacy-documents/letters-to-regulators/2013/cl053013.pdf.

[7] *See*, *e.g.*, Basel Comm. on Banking Supervision, *Regulatory Treatment of Accounting Provisions* 1 (Bank for Int'l Settlements, Basel Comm. on Banking Supervision, Discussion Paper, Oct. 2016), https://www.bis.org/bcbs/publ/d385.pdf.

[8] FASB, *supra* note 6, at 1.

firm's management's expectations of future credit losses[9]:

> Many institutions, for example, use forward looking information in underwriting, collateral determinations, servicing, and asset-liability management practices, but in reporting incurred credit losses under [ILM] use only a subset of that information. In addition, management has a tremendous amount of information from its risk management systems, again, only a subset of which is currently used in financial reporting. [Before adoption of CECL], investors are on their own to develop an assessment of expected credit losses. After adoption of CECL, management will provide their estimate of expected credit losses, which reduces information asymmetry for investors.[10]

In October 2008, FASB and the International Accounting Standards Board (IASB) established a Financial Crisis Advisory Group (FCAG) to advise on potential improvements in financial reporting in response to the 2008 financial crisis.[11] The FCAG recommended exploring more forward-looking alternatives to the ILM. Through 2016, FASB representatives met with hundreds of stakeholders, held numerous public roundtables, received over 3,000 comment letters, and evaluated a variety of potential alternatives to the ILM.[12]

On June 16, 2016, FASB adopted CECL through the issuance of FASB Accounting Standards Update No. 2016-13 (ASU 2016-13).[13] FASB and other proponents of CECL have stated that CECL provides financial statement users with more forward-looking, decision-useful information about expected credit losses than ILM does.[14] According to FASB, CECL more closely aligns a firm's financial reporting with its management's estimates of expected credit losses.[15]

C. CECL and ILM Compared

To prepare financial statements that conform to CECL, a firm must recognize lifetime expected

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[9] *See*, *e.g.*, Wesley R. Bricker, Chief Accountant, SEC, Remarks Before the Financial Executives International 36th Annual Current Financial Reporting Issues Conference: Effective Financial Reporting in a Period of Change (Nov. 14, 2017), https://www.sec.gov/news/speech/speech-bricker-2017-11-14.

[10] *Id.*

[11] For further information concerning the adoption of CECL, see FASB, ACCOUNTING STANDARDS UPDATE NO. 2016-13: FINANCIAL INSTRUMENTS—CREDIT LOSSES (TOPIC 326) 241-284 (2016), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176168232528&acceptedDisclaimer=true ("FASB ACCOUNTING STANDARDS UPDATE NO. 2016-13").

[12] *See* FASB, *ASU: Credit Losses (Topic 326)*, FASB: UNDERSTANDING COSTS & BENEFITS (June 16, 2016), https://www.fasb.org/cs/ContentServer?c=Document_C&cid=1176168233403&d=&pagename=FASB%2FDocument_C%2FDocumentPage ("FASB Understanding Costs and Benefits 2016").

[13] FASB ACCOUNTING STANDARDS UPDATE NO. 2016-13, *supra* note 11.

[14] FASB Understanding Costs and Benefits 2016, *supra* note 12.

[15] *Id.*

credit losses for financial assets covered by CECL and incorporate reasonable and supportable forecasts in developing an estimate of lifetime expected credit losses. A firm must also, similar to the existing ILM requirement, consider past events and current conditions.

As applied to financial institutions—including based on rules and guidance issued by the Federal Reserve, the FDIC, and the OCC (together, the "banking regulators")—CECL differs from ILM in several key respects. For example, to prepare financial statements that conform to CECL, financial institutions must recognize lifetime expected credit losses for financial assets, not just credit losses that have been incurred as of the reporting date. Additionally, CECL allowances cover a broader range of financial assets than ALLL under the other-than-temporarily impaired concept, as CECL allowances cover all financial assets recorded at amortized cost, including held-to-maturity debt securities.[16] ASU 2016-13 also introduces new requirements for available-for-sale (AFS) debt securities.[17] A financial institution must "recognize credit losses on individual AFS debt securities through credit loss allowances, rather than through direct write-downs."[18] Taken together, these characteristics of CECL (and other aspects of ASU 2016-13) result in earlier accounting recognition of a broader range of potential credit losses. CECL does not change the cumulative amount of losses ultimately charged off from an asset, relative to ILM; it changes the timing of when those losses are recognized for accounting purposes.[19]

While CECL generally results in earlier accounting recognition of potential credit losses and expenses associated with financial assets, GAAP does not necessarily provide early accounting recognition of all revenues associated with those assets. For example, for loans "held for investment,"[20] the accounting recognition of net loan fees is deferred and amortized over the life of the loan.[21] Therefore, the earlier accounting recognition of potential credit losses under CECL

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[16] *See* Regulatory Capital Rule: Implementation and Transition of the Current Expected Credit Losses Methodology for Allowances and Related Adjustments to the Regulatory Capital Rule and Conforming Amendments to Other Regulations, 84 Fed. Reg. 4222 (Feb. 14, 2019), https://www.govinfo.gov/content/pkg/FR-2019-02-14/pdf/2018-28281.pdf ("Banking Regulators' 2019 Regulatory Capital Rule").

[17] *Id.* at 4223.

[18] *Id.* As the banking regulators explained in 2019, "[c]urrent accounting standards require a banking organization to make an individual assessment of each of its AFS debt securities and take a direct writedown for credit losses when such a security is other-than-temporarily impaired." *Id*. at 4226.

[19] Hal Schroeder, Member, FASB, Opening Remarks at the ThinkBig 2019 Conference: Roadmap to the Future: Fact vs. Fiction (on CECL and Other FASB Standards) (Sept. 26, 2019), https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176173503494&d=&pagename=FASB%2FFASBContent_C%2FGeneralContentDisplay ("Schroeder Remarks").

[20] A loan is generally classified as "held for investment" under GAAP when the reporting entity holds a loan for which it "has the intent and ability to hold for the foreseeable future or until maturity or payoff." FED. FIN. INSTS. EXAMINATION COUNCIL, INSTRUCTIONS FOR PREPARATION OF CONSOLIDATED REPORTS OF CONDITION AND INCOME: FFIEC 031 AND FFIEC 041 RI-8b (2018), https://www.ffiec.gov/pdf/FFIEC_forms/FFIEC031_FFIEC041_201812_i.pdf.

[21] *See* FASB, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 91: ACCOUNTING FOR NONREFUNDABLE FEES AND COSTS ASSOCIATED WITH ORIGINATING OR ACQUIRING LOANS AND INITIAL DIRECT COSTS OF LEASES (1986), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1218220128141&acceptedDisclaimer=true.

may result in a timing mismatch between the recognition of revenues and expenses for certain financial assets.[22]

D. Timing of CECL Effectiveness and Implementation: A Phased Approach

FASB has established a phased approach that subjects different types of financial institutions to different CECL compliance dates[23]:

- For national banks, state member banks, state nonmember banks, savings associations, and top-tier bank holding companies and savings and loan holding companies domiciled in the United States (collectively, "banking organizations") that are public business entities (PBEs) and SEC filers, excluding those that would qualify as Smaller Reporting Companies as defined by the SEC, CECL became effective for the first fiscal year beginning after December 15, 2019, including interim periods within that fiscal year.[24]

- For all other financial institutions that are required to file regulatory reports that conform to GAAP, CECL will become effective for the first fiscal year beginning after December 15, 2022, including interim periods within that fiscal year.[25]

A financial institution may choose to voluntarily adopt CECL early, in any fiscal year beginning after December 15, 2018, including interim periods within that fiscal year.[26]

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[22] A timing mismatch between loss and revenue recognition also exists under ILM, albeit generally to a lesser degree, as losses recognized under CECL include those expected to occur in the future. In their dissent against FASB's adoption of CECL in 2016, FASB Vice Chairman James Kroeker and board member Lawrence Smith stated their belief that "moving to an expected loss model for recognizing the expected credit losses on financial assets can be justified only if the interest income and the related impairment charge are considered together." *See* FASB ACCOUNTING STANDARDS UPDATE NO. 2016-13, *supra* note 11, at 239.

[23] *See* FASB, ACCOUNTING STANDARDS UPDATE NO. 2019-10: FINANCIAL INSTRUMENTS—CREDIT LOSSES (TOPIC 326), DERIVATIVES AND HEDGING (TOPIC 815), AND LEASES (TOPIC 842) 2-3 (2019), https://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176173775344&acceptedDisclaimer=true ("FASB ACCOUNTING STANDARDS UPDATE NO. 2019-10"). Implementation dates for CECL were changed by FASB in late 2019. FASB, *FASB Approves Effective Date Delays at October 16 meeting* (FASB, Media Advisory, Oct. 18, 2019), https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176173615325&d=&pagename=FASB%2FFASBContent_C%2FNewsPage. *See also* Banking Regulators' 2019 Regulatory Capital Rule, *supra* note 16, at 4224 (listing previous CECL compliance dates for financial institutions).

[24] *See* FASB ACCOUNTING STANDARDS UPDATE NO. 2019-10, *supra* note 23. *See also* FASB, ACCOUNTING STANDARDS UPDATE NO. 2013-12: DEFINITION OF A PUBLIC BUSINESS ENTITY (2013), https://www.fasb.org/resources/ccurl/757/419/ASU%202013-12.pdf (defining a PBE); Smaller Reporting Company Definition, 83 Fed. Reg. 31992 (July 10, 2018), https://www.govinfo.gov/content/pkg/FR-2018-07-10/pdf/2018-14306.pdf (defining Smaller Reporting Companies); PRUDENTIAL REGULATORS' FAQS, *supra* note 3 (discussing criteria used for determining whether a financial institution can be considered a PBE or an SEC filer).

[25] *See* FASB ACCOUNTING STANDARDS UPDATE NO. 2019-10, *supra* note 23.

[26] PRUDENTIAL REGULATORS' FAQS, *supra* note 3.

E. Transition Relief

As described below in Part II, CECL implementation may be operationally complex for financial institutions and can have important implications for financial institutions' regulatory capital and lending activities. Given these and other factors—including the onset of the COVID-19 global pandemic—FASB, Congress, and the prudential regulators have taken certain steps designed to facilitate the transition to CECL.

1. <u>February 2019 Relief for Banking Organizations</u>

On February 14, 2019, the banking regulators published a final regulatory capital rule (the "Banking Regulators' 2019 Regulatory Capital Rule") to provide a transition option that allows banking organizations to phase-in over a three-year period certain "day-1" effects from the transition to CECL on their regulatory capital ratios.[27] The banking regulators intended for the transition option to address concerns that, despite adequate capital planning, unexpected economic conditions at the time of CECL adoption could result in higher-than-anticipated increases in day-1 allowances. Part II below provides additional details on the day-1 effects of CECL and related regulatory relief.

2. <u>October 2019 FASB CECL Implementation Delay for Smaller Institutions</u>

As reflected by the current CECL implementation timeline above, several months after the prudential regulators issued the Banking Regulators' 2019 Regulatory Capital Rule, FASB delayed the CECL implementation deadline to the first fiscal year beginning after December 15, 2022, including interim periods within that fiscal year, for all PBEs that met the Smaller Reporting Companies definition or entities that were not SEC filers.[28] According to one FASB official, this change resulted in the CECL implementation deadline being moved from January 2021 to January 2023 for over 90 percent of financial services companies.[29]

3. <u>CARES Act Relief</u>

On March 27, 2020, President Donald J. Trump signed the Coronavirus Aid, Relief, and Economic Security Act (CARES Act) into law.[30] Among other things, the CARES Act provides banking organizations optional temporary relief from complying with CECL ending on the

[27] *See* Banking Regulators' 2019 Regulatory Capital Rule, *supra* note 16.
[28] *See* FASB ACCOUNTING STANDARDS UPDATE NO. 2019-10, *supra* note 23.
[29] Schroeder Remarks, *supra* note 19.
[30] Coronavirus Aid, Relief, and Economic Security Act, Pub. L. No. 116-136, 116th Cong. (2020), https://www.congress.gov/bill/116th-congress/house-bill/748/text.

earlier of (1) the termination date of the COVID-19 national emergency declared by President Trump on March 13, 2020, under the National Emergencies Act, or (2) December 31, 2020.[31]

4. March and August 2020 Relief for Banking Organizations

Also on March 27, 2020, in recognition of the disruptions in economic conditions caused by the COVID-19 global pandemic and related operational challenges faced by banking organizations, the banking regulators issued an interim final rule (IFR) that delays the estimated impact on regulatory capital stemming from CECL for a transition period of up to five years.[32] On August 26, 2020, the banking regulators issued a final rule that, with a few exceptions, generally aligns with the IFR.[33] As explained below in Part II, the final rule provides banking organizations that adopt CECL during 2020 the option to mitigate an estimate of CECL's impact on their regulatory capital for two years, followed by a three-year transition period.[34]

5. July 2020 NCUA Rulemaking Proposal

On July 30, 2020, the NCUA approved a proposed rule that—consistent with the banking regulators' rules delaying the estimated impact on regulatory capital stemming from CECL—would phase-in the day-1 effects of CECL on federally insured credit unions' net worth ratio over a three-year period, as discussed further below.[35] Additionally, the NCUA proposed to exempt credit unions with less than $10 million in assets from determining their charges for loan losses in accordance with GAAP, including CECL.[36]

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[31] 15 U.S.C. § 9052 (2020).
[32] *See* Regulatory Capital Rule: Revised Transition of the Current Expected Credit Losses Methodology for Allowances, 85 Fed. Reg. 17723 (Mar. 31, 2020), https://www.govinfo.gov/content/pkg/FR-2020-03-31/pdf/2020-06770.pdf ("Banking Regulators' 2020 IFR"). The Banking Regulators' 2020 IFR was announced on March 27, 2020. OCC, *Current Expected Credit Losses: Interim Final Rule* (OCC, Bulletin 2020-27, Mar. 27, 2020), https://www.occ.treas.gov/news-issuances/bulletins/2020/bulletin-2020-27.html.
[33] *See* OCC, Federal Reserve & FDIC, Regulatory Capital Rule: Revised Transition of the Current Expected Credit Losses Methodology for Allowances (Aug. 26, 2020), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20200826a2.pdf ("Banking Regulators' 2020 Final Rule").
[34] Alternatively, banking organizations may use the regulatory capital CECL transition provided in the Banking Regulators' 2019 Regulatory Capital Rule. *See* FEDERAL RESERVE, FDIC & OCC, JOINT STATEMENT ON THE INTERACTION OF REGULATORY CAPITAL RULE: REVISED TRANSITION OF THE CECL METHODOLOGY FOR ALLOWANCES WITH SECTION 4014 OF THE CORONAVIRUS AID, RELIEF, AND ECONOMIC SECURITY ACT (2020), https://www.occ.treas.gov/news-issuances/bulletins/2020/bulletin-2020-30a.pdf.
[35] Transition to the Current Expected Credit Loss Methodology, 85 Fed. Reg. 50963 (proposed July 30, 2020), https://www.govinfo.gov/content/pkg/FR-2020-08-19/pdf/2020-16987.pdf ("NCUA 2020 Proposed Rule").
[36] *Id.*

II. CECL's Implications for Financial Institution Regulatory Capital

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A. Effects of CECL on Financial Institutions' Capital Requirements

1. Overview

Financial institutions subject to risk-based capital requirements in the United States are required to maintain specified levels of regulatory capital based on the type of financial institution and the riskiness of the particular assets that the institution holds. The functions of regulatory capital are to support the financial institutions' operations, absorb unanticipated losses and declines in asset values that could otherwise cause an institution to fail, and provide protection to uninsured depositors and debt holders in the event of a liquidation.[37]

CECL will affect financial institutions in different ways, depending on a given institution's business model (e.g., nature and mix of lending activities), as well as its credit modeling, risk management, and related accounting practices (e.g., how it estimates the allowance for credit losses), among other factors. A financial institution's implementation of CECL will also likely impact its regulatory capital ratios.[38]

As described above, to prepare financial statements that conform to CECL, financial institutions must recognize lifetime expected credit losses for financial assets—not only, as is the case under ILM, credit losses that are probable and estimable as of the reporting date.[39] In addition, CECL applies to a wider range of financial assets than ILM.[40] As a result, CECL will generally[41] require financial institutions to establish greater credit loss allowances than under ILM. That is, CECL will generally increase a financial institution's allowance for credit losses relative to its ALLL.[42] All else equal, an increase in credit loss allowances will reduce the institution's GAAP net income—and thus its retained earnings.[43] This may be significant for bank capital purposes

[37] Federal Reserve, *Supervisory Policy and Guidance Topics: Capital Adequacy*, https://www.federalreserve.gov/supervisionreg/topics/capital.htm (last updated Aug. 4, 2020).
[38] *See* Banking Regulators' 2020 Final Rule, *supra* note 33, at 5.
[39] CECL does not specify a single method for measuring expected credit loss, and instead allows any reasonable approach as long as it achieves the new GAAP objectives for credit loss estimates. *See* FASB Understanding Costs and Benefits 2016, *supra* note 12.
[40] *See* PRUDENTIAL REGULATORS' FAQS, *supra* note 3.
[41] Certain financial institutions' allowances under CECL could be lower than under ILM, depending on factors such as their portfolio mix and internal risk modeling estimates (including of recovery rates).
[42] *See* Bert Loudis & Ben Ranish, *CECL and the Credit Cycle* (Federal Reserve, Fin. & Econ. Discussion Series 2019-061, May 30, 2019), https://www.federalreserve.gov/econres/feds/files/2019061pap.pdf; Francisco Covas & William Nelson, *Current Expected Credit Loss: Lessons from 2007-2009* (Bank Pol'y Inst., Staff Working Paper 2018-1, July 12, 2018), https://bpi.com/wp-content/uploads/2018/07/CECL-Lessons-2007-2009-WP-July-12-2018.pdf.
[43] In general, greater CECL credit loss allowances will primarily impact regulatory capital through changes in retained earnings, but will likely also impact regulatory capital through changes in deferred tax assets and allowance levels. For example, changes in allowance levels may impact the amount of a firm's tier 2 regulatory capital. *See* Banking Regulators' 2019 Regulatory Capital Rule, *supra* note 16, at 4226.

because retained earnings are a major component of a banking organization's common equity tier 1 (CET1) capital. A reduction in CET1 capital lowers the banking organization's CET1 capital ratio, since CET1 capital is the numerator in this capital ratio. CET1 capital is also a key input to various other financial institution regulatory capital measures.[44]

Credit unions may also be affected by an increase in loss allowances under the transition to CECL. In general, the vast majority of a credit union's net worth (which is the numerator in the credit union capital ratio) is the accumulation of retained earnings, since credit unions are generally not allowed to raise capital from other sources.[45] Credit unions are subject to net worth requirements, and some will soon also be subject to a risk-based capital requirement.[46] Net worth requirements can be met with retained earnings, while the NCUA's risk-based capital requirement, which is scheduled to become effective in 2022, can be met with both retained earnings and the allowance balance.[47] All else equal, credit unions—like banking organizations—that increase credit loss allowances will have reduced GAAP net income and thus reduced retained earnings, which will likely lower their capital adequacy ratio, the "net worth ratio."

2. Day-1 and Ongoing Effects

Financial institutions are impacted by CECL through a potentially significant "day-1" impact, as well as through their ongoing quarterly adjustments to their allowances for credit losses over the lives of loans and other financial assets. Upon its adoption of CECL, a financial institution must record a one-time adjustment to its allowances to reflect the difference, if any, between allowances required under ILM and CECL. Additionally, thereafter, on a quarterly basis, a financial institution must revisit and, as necessary, update its estimate of credit losses to account for management's current expectation of credit losses based on economic conditions and other factors.[48]

Some have raised concerns that the day-1 and ongoing effects on financial institutions' regulatory capital may ultimately reduce financial institutions' capacity to lend, particularly in an economic downturn when loss estimates may be higher, as explained below in Part III.

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[44] For example, CET1 capital is required to calculate a banking organization's other regulatory capital ratios, including the tier 1, total risk-based capital, tier 1 leverage, and supplementary leverage ratios.
[45] 12 C.F.R. § 702.2 (2020). By contrast, banking organizations' regulatory capital can include common stock and subordinated debt, in addition to retained earnings.
[46] Starting in 2022, credit unions with more than $500 million in assets will be subject to the NCUA's risk-based net worth requirements. 12 C.F.R. §§ 700, 701, 702, 703, 713, 723 & 747 (2020).
[47] PRUDENTIAL REGULATORS' FAQS, *supra* note 3, at 19.
[48] *See, e.g.*, Thomas W. Killian & Weison Ding, *CECL – Ready or Not Here it Comes* (Piper Sandler, Report, Jan. 28, 2020), http://www.pipersandler.com/private/pdf/CECL_ready_or_not.pdf; Lauren Sullivan, *Banks Begin to Provide 'Day 2' CECL Guidance*, S&P GLOBAL MKT. INTELLIGENCE (Jan. 31, 2020), https://www.spglobal.com/marketintelligence/en/news-insights/trending/fypj5vewog838ovl6z3mug2.

B. Key Regulatory Responses Related to Regulatory Capital

The prudential regulators have acknowledged many of the potential challenges and effects of financial institutions' implementation of CECL and have taken various actions in response, described below.

1. 2018 Federal Reserve Stress Test Statement

On December 21, 2018, the Federal Reserve announced that it planned to maintain the current modeling framework for loan allowances in its supervisory stress test process through 2021 to provide more time for it to analyze the potential impacts of CECL.[49] The Federal Reserve chose to maintain the current framework in supervisory stress tests in order to reduce uncertainty and allow for better capital planning at affected banking organizations, among other reasons.[50] In addition, as part of the Banking Regulators' 2019 Regulatory Capital Rule, the Federal Reserve amended its stress testing rules to require a covered banking organization that has adopted CECL to incorporate CECL in its company-run stress testing methodologies, data, and disclosure beginning in the 2020 stress testing cycle.[51] The Federal Reserve also announced on December 21, 2018, that it would not issue supervisory findings on a firm's stressed estimation of its allowances under CECL any earlier than 2022.[52]

2. 2019 Banking Regulators' Transitions Final Rule

On February 14, 2019, the banking regulators published revisions to their capital rules to clarify expectations for credit loss accounting under CECL.[53] Among other things, the banking regulators adopted revisions to their capital rules to identify which credit loss allowances under CECL are eligible for inclusion in a banking organization's regulatory capital. For example, the agencies added a newly defined term "adjusted allowances for credit losses" (AACL) to replace ALLL and identify which credit loss allowances would have certain regulatory capital implications.[54] AACL applies to a wider range of assets than ALLL.[55] Additionally, in an effort to help address some of the potential challenges of managing the day-1 effects on a banking organization's regulatory capital ratios associated with CECL implementation, the banking regulators provided banking organizations with the option to phase-in the day-1 effects of CECL

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[49] *See* FEDERAL RESERVE, STATEMENT ON THE CURRENT EXPECTED CREDIT LOSS METHODOLOGY (CECL) AND STRESS TESTING (2018), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20181221b1.pdf.
[50] *Id.*
[51] *Id.*
[52] *Id.*
[53] Banking Regulators' 2019 Regulatory Capital Rule, *supra* note 16.
[54] The banking regulators introduced AACL to identify which credit loss allowances have been charged against net income or retained earnings and would therefore be eligible to be included in regulatory capital. Like ALLL, the amount of AACL that may count as tier 2 capital is limited to 1.25 percent of a banking organization's standardized total risk-weighted assets (excluding its standardized market risk-weighted assets, if applicable). *See id.* at 4224-25.
[55] *See id*. at 4225-26.

over a three-year period.[56]

3. March 2020 FDIC Chairman McWilliams Request for CECL Relief

On March 19, 2020, FDIC Chairman Jelena McWilliams sent a letter to FASB that, among other things, urged FASB to allow banks that are currently subject to CECL to have the option of postponing CECL implementation.[57] Chairman McWilliams' letter also urged FASB to impose a moratorium on the CECL effective date for those institutions that are not currently required to implement CECL in order to allow those institutions "to focus on immediate business challenges relating to the impacts of the current pandemic and its effect on the financial system."[58] Chairman McWilliams' letter noted that transitioning to CECL "for smaller institutions is a significant effort in both financial and staffing commitment" and that institutions "under current conditions need to apply their full efforts, focus, and resources toward working to ensure the safety of their staff, customers, and local communities."[59]

4. March and August 2020 Banking Regulators' Relief

As noted above, on March 27, 2020, in response to the COVID-19 global pandemic, the banking regulators issued an IFR that delays the estimated impact on regulatory capital stemming from CECL for a transition period of up to five years for banking organizations required to adopt CECL in 2020. The banking regulators recognized that the COVID-19 global pandemic presents "significant operational challenges to banking organizations at the same time they have been required to direct significant resources to implement CECL."[60] The agencies also recognized that "due to the nature of CECL and the uncertainty of future economic forecasts, banking organizations that have adopted CECL may continue to experience higher-than-anticipated increases in credit loss allowances."[61]

On August 26, 2020, the banking regulators issued a final rule that generally aligns with the IFR, except for clarifications regarding the transition calculation and an expansion in the scope of the rule to apply to any firm adopting CECL in 2020 that chooses to use the transition.[62] The relief under the final rule provides banking organizations that adopt CECL during 2020 the option to delay an estimate of CECL's impact on regulatory capital for two years, followed by a three-year transition period to phase out the capital benefit provided during the initial two-year

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[56] *Id.* at 4227. The agencies also made other amendments to address CECL changes. *See id.* at 4229-30.
[57] Letter from Jelena McWilliams, Chairman, FDIC, to Shayne Kuhaneck, Acting Technical Dir., FASB (Mar. 19, 2020), https://www.fdic.gov/news/press-releases/2020/pr20036a.pdf.
[58] *Id*. at 2.
[59] *Id*.
[60] Banking Regulators' 2020 IFR, *supra* note 32, at 17725.
[61] *Id.*
[62] While the IFR limited relief only to banking organizations required to adopt CECL during 2020, the final rule permits any banking organization that elects CECL in 2020 to use the five-year transition relief. *See* Banking Regulators' 2020 Final Rule, *supra* note 33.

delay. Taken together, these measures offer electing banking organizations a transition period of up to five years. The agencies endeavored to calibrate the capital relief—by providing a capital offset—to approximate the difference in allowances under CECL relative to ILM during the first two years of the transition period.[63] During the initial two-year period following implementation, electing banking organizations are permitted to add back to CET1 capital the day-1 after-tax change in retained earnings resulting from adopting CECL plus 25 percent of the ongoing difference between AACL reported in the firm's most recent regulatory filings and the day-1 AACL.[64] The banking regulators calibrated the standardized 25 percent scaling factor to approximate the effect of using CECL rather than ILM. The cumulative difference at the end of the second year of the transition period is then phased out of regulatory capital over a three-year transition period. In this way, this final rule gradually phases in the day-1 and ongoing effects on regulatory capital over a five-year transition period.

Banking organizations adopting CECL alternatively have the option of using the banking regulators' three-year implementation approach, in which they phase-in the day-1 effects of CECL over a three-year period.

5. <u>April 2020 NCUA Chairman Hood Request for Credit Union Exemption</u>

On April 30, 2020, NCUA Chairman Rodney E. Hood sent a letter to FASB requesting that FASB permanently exempt credit unions from complying with CECL.[65] In his letter, Chairman Hood stated that in the context of credit unions "the compliance costs associated with implementing CECL overwhelmingly exceed the benefits" and that "the continued challenges of resource constraints and data system challenges [associated with CECL implementation for credit unions] seem to outweigh the anticipated benefits of financial statement comparability between credit unions and the rest of the financial sector."

6. <u>July 2020 NCUA Proposed Rule</u>

On July 30, 2020, the NCUA approved a proposed rule that—consistent with the banking regulators' rules delaying the estimated impact on regulatory capital stemming from CECL—would phase-in the day-1 effects of CECL on federally insured credit unions' net worth ratio over a three-year period.[66] The phase-in would only be applied to those federally insured credit unions that adopt CECL for fiscal years beginning on or after December 15, 2022 (the deadline established by FASB for credit union implementation). Credit unions that decide to adopt CECL

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[63] *Id*. at 14.
[64] *Id.*
[65] Letter from Rodney E. Hood, Chairman, NCUA, to Russell G. Golden, Chairman, FASB (Apr. 30, 2020), https://www.ncua.gov/about-ncua/leadership/honorable-rodney-e-hood/publications-chairman-rodney-e-hood/letter-fasb-urging-cecl-exemption-credit-unions ("Chairman Hood Letter").
[66] NCUA 2020 Proposed Rule, *supra* note 35.

for fiscal years beginning before then would be ineligible for the proposed phase-in. Additionally, the NCUA proposed to exempt credit unions with less than $10 million in assets from determining their charges for loan losses in accordance with GAAP, including CECL.[67] The NCUA proposed that these institutions may "instead use any reasonable reserve methodology (incurred loss), provided that it adequately covers known and probable loan losses."[68]

[67] *Id.*
[68] *Id.* at 50963.

III. Key Areas of Debate

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In the time since CECL was first considered in concept, financial institution representatives, accountants, public officials, academics, and others have discussed and debated various benefits, concerns, and potential effects of CECL's application to financial institutions and their regulatory capital and lending. While the issues raised have been wide-ranging, what follows is a high-level summary of some of the main themes.

- ***Potential Procyclical Effects***. Some, including FASB officials,[69] anticipate that CECL will have less procyclical effects[70] than ILM because a greater level of allowances would be accumulated before an economic downturn due to the fact that allowances will be made for expected lifetime credit losses (as opposed to only for probable credit losses). On the other hand, some financial institution representatives and researchers argue that CECL will be more procyclical than ILM.[71] They argue that CECL will result in a larger increase in loss allowances at the start of an economic downturn (in part because of the challenges in accurately predicting turning points in economic cycles), which will cause financial institutions to deleverage and reduce their lending at the onset of an economic downturn—particularly for longer-tenored products like mortgages and student loans—thus potentially exacerbating the downturn. The divergence in views about the procyclicality of CECL appears to be due, in part, to variations in the assumptions and modeling underlying different research on the topic.[72]

- ***Disagreement Regarding Whether Benefits Justify Costs***. Some industry representatives, regulators, and members of Congress have questioned whether the potential costs associated with CECL—for instance, operational implementation costs, including employee and management resources; training; software development; and accounting, consulting, and legal fees—are worth the perceived benefits of CECL, such

[69] Schroeder Remarks, *supra* note 19. *See also* Sarah Chae et al., *The Impact of the Current Expected Credit Loss Standard (CECL) on the Timing and Comparability of Reserves* (Federal Reserve, Fin. & Econ. Discussion Series 2018-020, Mar. 6, 2018), https://www.federalreserve.gov/econres/feds/files/2018020pap.pdf.

[70] "Procyclical" refers to when a given policy has the effect of magnifying or amplifying fluctuations in an economic cycle; the term "countercyclical" means the opposite—i.e., a given policy has the effect of dampening or reducing fluctuations. *See* Larry D. Wall, *Procyclicality: CECL Versus Incurred Loss Model*, FED. RESERVE BANK OF ATLANTA CTR. FOR FIN. INNOVATION & STABILITY: NOTES FROM THE VAULT (Oct. 2019), https://www.frbatlanta.org/cenfis/publications/notesfromthevault/10-procyclicality-cecl-versus-incurred-loss-model-2019-10-31.

[71] Bank Pol'y Inst. Staff, *The current expected loss (CECL) accounting standard will make the next recession worse*, UNDERWRITINGS: THE BPI BLOG (July 16, 2018), https://bpi.com/analysis-demonstrates-that-the-current-expected-credit-loss-cecl-accounting-standard-would-be-procyclical-if-used-for-regulatory-capital-purposes/; Amer. Bankers Ass'n, *ABA Snapshot of Banks' CECL Estimates – May 2019* (Amer. Bankers Ass'n, Data, May 1, 2019), https://www.aba.com/-/media/documents/data/cecl-loss-rate-expectations-may-2019.pdf.

[72] Wall, *supra* note 70; Joseph L. Breeden, *CECL Procyclicality: It Depends on the Model* (Working Paper, Sept. 14, 2018), https://www.prescientmodels.com/articles/CECL-Procyclicality.pdf.

as the potentially more forward-looking information for users of financial statements.[73] Some credit unions and community banks note that they have less resources to devote to CECL implementation than larger financial institutions do.[74] As explained above, NCUA Chairman Hood has noted in the context of credit unions that "the compliance costs associated with implementing CECL overwhelmingly exceed the benefits" and that "the continued challenges of resource constraints and data system challenges [associated with CECL implementation for credit unions] seem to outweigh the anticipated benefits of financial statement comparability between credit unions and the rest of the financial sector."[75] When adopting CECL, FASB recognized that organizations are likely to incur costs associated with implementing the new standard. However, FASB expected that organizations would be able to leverage many of their existing financial reporting processes and concluded that the ongoing costs for most organizations of preparing the allowance for credit losses under CECL should not be significantly above the costs of complying with the accounting model under the ILM approach.[76]

- ***Evaluating the Need to Recalibrate Capital Requirements in Light of CECL***. Some industry representatives have argued that financial institution capital frameworks should be reviewed and potentially recalibrated in response to CECL.[77] Many of these arguments note that the existing capital requirements were designed and calibrated under the ILM framework, and therefore, the capital framework should be revisited to ensure that CECL implementation does not effectively increase capital requirements. For example, comments submitted in response to the Banking Regulators' 2019 Regulatory Capital Rule suggest that some support changing the regulatory capital treatment of credit

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[73] *See, e.g.*, Amer. Bankers Ass'n, Statement for the Record Before the Investor Protection, Entrepreneurship, and Capital Markets Subcommittee of the Committee on Financial Services, U.S. House of Representatives (Jan. 15, 2020), https://www.aba.com/advocacy/policy-analysis/statement-overseeing-standard-setters-fasb-pcaob-examination.

[74] *See, e.g.*, *id*. *See also* Letter from Ronald McLean, President/CEO, Coop. Credit Union Ass'n, Inc., to Technical Dir., FASB (Sept. 16, 2019), https://www.ccua.org/images/uploads/CCUA_FASB_CECL_Delay_Exposure_Draft_ASU_2019.750.pdf; Letter from Christopher L. Williston, President & CEO, Indep. Bankers Ass'n of Tex., to Legis. & Reg. Activities Div., OCC (July 11, 2018), https://www.regulations.gov/document?D=OCC-2018-0009-0006.

[75] Chairman Hood Letter, *supra* note 65.

[76] *See* FASB Understanding Costs and Benefits 2016, *supra* note 12.

[77] *See, e.g.*, Letter from David Wagner, Senior Vice President, Head of Fin., Risk & Audit Affairs & Dep'y Gen. Counsel, Bank Pol'y Inst., to Legis. & Reg. Activities Div., OCC, Ann E. Misback, Sec'y, Federal Reserve, and Robert E. Feldman, Exec. Sec'y, FDIC (July 13, 2018), https://bpi.com/wp-content/uploads/2018/07/BPI-CECL-Comment-Letter-Final.pdf.

loss allowances.[78] Conversely, some point out that banking regulators' efforts to smooth CECL implementation's impact on regulatory capital are sufficient.[79]

- ***Potentially Disparate Effects on Certain Types of Lending***. Some industry representatives have argued that CECL will affect the availability and cost of certain lending products, for example, longer-tenor loans.[80] Under CECL, longer-tenor loans generally have higher expected lifetime loss rates than shorter-tenor loans. As a result, these longer-tenor assets may require greater upfront allowances. Because CECL requires lifetime expected credit losses on loans to be recognized immediately, but the revenues from those loans are not recognized up-front under GAAP, under CECL originating a new loan could decrease the lender's GAAP earnings. These accounting results, according to this argument, could potentially change how a financial institution offers, prices, and structures certain lending products.[81]

- ***Potentially Disparate Effects on Certain Types of Lenders***. Some industry representatives have argued that CECL will disproportionately affect lenders that have large loan portfolios in, or specialize in, consumer loans. Additionally, as stated above, CECL may have disproportionate operational and implementation effects on smaller institutions, which do not have the same level of resources as larger financial institutions to devote to the operational, accounting, strategy, and other work relating to a transition to CECL. However, in 2016, the prudential regulators stated that they expected that smaller and less complex institutions would be able to adjust their existing allowance methods to meet the requirements of CECL without the use of costly and complex models.[82]

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[78] *See id.*; Letter from Michael L. Gullette, Senior Vice President, Tax & Acct., Amer. Bankers Ass'n, to Legis. & Reg. Activities Div., OCC, Ann E. Misback, Sec'y, Federal Reserve & Robert E. Feldman, Exec. Sec'y, FDIC (July 13, 2018), https://www.regulations.gov/document?D=OCC-2018-0009-0013. *See also* Banking Regulators' 2019 Regulatory Capital Rule, *supra* note 16, at 4231.

[79] *See, e.g.*, Michael Rapoport, *Banks Got Accounting Relief. Investors May Suffer.*, INSTITUTIONAL INVESTOR (Apr. 3, 2020), https://www.institutionalinvestor.com/article/b1l5q4vzrxs18n/Banks-Got-Accounting-Relief-Investors-May-Suffer.

[80] *See, e.g.*, David Wagner, *Two Fixes for CECL's Problematic Capital Impact*, UNDERWRITINGS: THE BPI BLOG (May 22, 2019), https://bpi.com/two-fixes-for-cecls-problematic-capital-impact/ ("Wagner 2019"); Amer. Bankers Ass'n, *supra* note 73.

[81] *See* Killian & Ding, *supra* note 48 (stating that "[l]onger duration and higher risk loans will attract much higher CECL reserves" and "[a]s such, student loans, longer term consumer credit and higher risk loans may face limits on availability or repricing of credit").

[82] FEDERAL RESERVE, FDIC, NCUA & OCC, JOINT STATEMENT ON THE NEW ACCOUNTING STANDARD ON FINANCIAL INSTRUMENTS – CREDIT LOSSES 4 (2016), https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20160617b1.pdf.

IV. Recommendations

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Treasury has monitored the planning for the transition to CECL, including CECL's potential effects on regulatory capital and financial institutions' lending practices. For example, in its June 2017 Executive Order report "A Financial System that Creates Economic Opportunities: Banks and Credit Unions," Treasury recommended that the prudential regulators carefully review the potential impact of CECL on banks' capital levels "with a view towards harmonizing the application of the standard with regulators' supervisory efforts."[83] The Financial Stability Oversight Council (FSOC), chaired by the Secretary of the Treasury, has also considered the CECL transition, including through discussions at FSOC meetings with presentations by representatives from the financial regulatory agencies.[84]

Treasury supports the goals of CECL—including providing users of financial statements with more forward-looking information and carrying assets on financial statements in a manner that reflects amounts expected to be collected. Treasury also recognizes the seriousness of the concerns that have been raised concerning CECL's potential effects on and implications for regulatory capital, lenders, borrowers, and the economy.

A definitive assessment of the impact of CECL on financial institutions' regulatory capital is not feasible at this time, in light of the state of CECL implementation across financial institutions and current market dynamics. As discussed above, FASB has taken a phased approach to CECL implementation, and the CARES Act and the banking regulators have provided various forms of CECL accounting and regulatory capital relief. Further, the first phase of the transition to CECL in early 2020 coincided with the onset of the COVID-19 global pandemic and its innumerable direct and indirect effects on borrowers, lenders, the financial system, and the economy, including the unprecedented government response efforts in the United States and globally. While some information has emerged indicating that credit availability declined and lending standards tightened in some financial product categories in early 2020,[85] identifying a definitive

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[83] *A Financial System that Creates Economic Opportunities: Banks and Credit Unions* 13 (Treasury, Report to President Donald J. Trump, June 2017), https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

[84] For example, at the December 19, 2018, FSOC meeting, then-Comptroller of the Currency Joseph Otting presented on CECL's potential implications on bank capital and lending, followed by a discussion. *See* FSOC, Minutes of the Financial Stability Oversight Council (Dec. 19, 2018), https://home.treasury.gov/system/files/261/December192018_minutes.pdf. At the November 7, 2019, FSOC meeting, following an interagency staff presentation, FSOC discussed the potential impact CECL may have on the allowances held at various financial institutions, among other things. *See* FSOC, Minutes of the Financial Stability Oversight Council (Nov. 7, 2019), https://home.treasury.gov/system/files/261/November072019-minutes.pdf.

[85] *See, e.g.*, Federal Reserve, Div. of Monetary Affairs, *The July 2020 Senior Loan Officer Opinion Survey on Bank Lending Practices* (Federal Reserve, Div. of Monetary Affairs, Report, Aug. 3, 2020), https://www.federalreserve.gov/data/documents/sloos-202007-fullreport.pdf; Mortgage Bankers Ass'n, *Mortgage Credit Availability Decreased in June* (Mortgage Bankers Ass'n, Press Release, July 9, 2020), https://www.mba.org/2020-press-releases/july/mortgage-credit-availability-decreased-in-june; Matt Schulz, *About 70 Million Cardholders Had Credit Limits Cut, Card Accounts Closed Involuntarily in Past 60 Days*,

linkage between any such trends and the introduction of the CECL standard is challenging, given the presence of numerous economic factors and other market externalities related to the COVID-19 global pandemic.

Together, the state of CECL implementation and the economic effects of, and government responses to, the COVID-19 global pandemic result in an incomplete and unclear dataset from which it is challenging to draw definitive conclusions regarding CECL. More information is needed before reaching conclusions concerning any potential changes to regulatory capital requirements that may be necessitated by CECL.

Treasury will continue to actively monitor CECL implementation and consult with relevant stakeholders, including the prudential regulators, FASB, and the SEC. Treasury makes the following recommendations at this time:

1. ***The prudential regulators should continue to monitor the effects of CECL on regulatory capital and financial institution lending practices, and calibrate capital requirements, as necessary***. The banking regulators have committed to closely monitoring the effects of CECL on regulatory capital and bank lending practices, including reviewing data provided by banking organizations, as well as information observed from banking organizations before their adoption of CECL.[86] Once greater amounts of data become available regarding financial institutions' experience with CECL, the prudential regulators should consider quantitatively studying the implications of CECL for regulatory capital, including any procyclical effects and operating costs.

2. ***The prudential regulators should monitor the use and impact of transitional relief granted, and extend or amend the relief, as necessary***. The COVID-19 global pandemic and its effects across the global economy have been acute, despite extraordinary efforts to manage and dampen its effects on the financial system and the economy. The targeted relief provided by the CARES Act and the banking regulators (and proposed by the NCUA) are well-tailored to help ease the transition to CECL, given the uncertainty and challenges facing financial institutions related to the COVID-19 global pandemic. The prudential regulators should continue to monitor the use and impact of the regulatory transition periods, and extend or amend the relief, as necessary. The banking regulators' monitoring could consider, for example, whether refinements to the transition calculation to better approximate CECL's effect on regulatory capital are warranted.

3. ***FASB should further study CECL's anticipated benefits***. FASB, in consultation with the SEC, should continue its outreach efforts to preparers and users of financial

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COMPARECARDS (July 22, 2020), https://www.comparecards.com/blog/credit-card-limits-cut-card-accounts-closed-pandemic/.

[86] *See* Banking Regulators' 2019 Regulatory Capital Rule, *supra* note 16, at 4231.

statements to assess how estimates prepared under CECL are being used, in an effort to better understand how CECL has been implemented and whether it is having its intended effects. FASB should also consider publishing a report of its findings and conclusions in this area. FASB should also examine how it could coordinate with the prudential regulators to consider the results of any of their reviews and consider whether any potential changes to CECL (or other accounting standards) could help limit potential procyclical effects or other consequences to lending practices, borrowers, and lenders.

4. ***FASB should expand its efforts to consult and coordinate with the prudential regulators to understand—and take into account when considering any potential amendments to CECL—the regulatory capital effects of CECL on financial institutions***. It may be impractical for FASB to specifically tailor its accounting standards on an industry-by-industry basis to address potential implications for every sector. However, at the same time, given the significant role that regulatory capital requirements and other forms of prudential regulation have for financial institutions and the financial system more generally, Treasury recommends that FASB expand its efforts to consult and coordinate with the prudential regulators when considering any potential future amendments to CECL.

5. ***FASB should, in consultation with relevant stakeholders, explore the costs and benefits of further aligning the timing of the accounting recognition of fees associated with financial assets under GAAP with the earlier accounting recognition of potential credit losses under CECL***. While CECL results in earlier accounting recognition of potential credit losses, GAAP does not provide for early accounting recognition of revenues associated with financial assets. Conceptually, the deferral and amortization of the recognition of fees, in particular, is not entirely consistent with the upfront recognition of lifetime expected credit losses under CECL. As a result of these accounting treatments, there may be a mismatch between the information in a financial institution's financial statements and the state of the firms' financial health (a dynamic that also exists under ILM).[87] Therefore, FASB should—in consultation with investors and other users of financial statements, financial institutions, the SEC, and the prudential regulators—explore the costs and benefits of further aligning the timing of the accounting recognition of loss reserves under CECL with the timing of the accounting recognition of fees associated with the relevant financial asset.

6. ***FASB, together with the prudential regulators, should examine the application of CECL to smaller lenders***. As discussed above, FDIC Chairman McWilliams and NCUA Chairman Hood separately requested relief from FASB for community banks and credit unions, respectively. FASB should also examine how it can coordinate with the

[87] *See supra* note 22.

prudential regulators to evaluate and account for the costs and benefits of the transition to CECL for community banks and credit unions—and assess the potential costs and benefits of exempting them from CECL or providing other relief.