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Federal banking agencies issue proposed policy statement on the allowance for credit losses

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KPMG explains the regulator's expectations of banks subsequent to the adoption of the credit losses standard.[1]

Applicability

Financial institutions regulated by US federal banking agencies[2] that report under US GAAP.

Why are the federal banking regulators proposing the changes?

The new current expected credit losses (CECL) standard will substantially change the way banks account for credit losses. In response, federal banking regulators proposed updates[3] to their guidance that explains the banking regulators' views on banks' accounting for their allowance for credit losses (ACL). The proposed interagency policy statement describes the CECL methodology for estimating expected credit losses. It would replace the existing policy statements related to the allowance for loan and lease losses (ALLL).[4] The policy statement would provide insights into what regulators are looking for when they examine banks' accounting related to the CECL standard. The policy statement would be effective at the time each bank adopts CECL.

The banking agencies also developed proposed guidance on supervisory expectations for effective credit risk review.[5] Rather than updating the agencies' guidance on loan review systems as part of the proposed interagency policy statement on ACLs, banking regulators propose rescinding the attachment to the 2006 policy statement and providing separate stand-alone guidance with broader application. Comments for the proposed interagency policy statement on the allowance and the proposed credit risk review systems guidance are due December 16, 2019, and regulated entities, as well as other constituents, have been encouraged to provide comments.

Proposed changes

The proposed updates to the regulators' policy statement focus on these areas:

— measurement of ACLs;
— qualitative factor adjustments;

[1] ASU 2016-13, Measurement of Credit Losses on Financial Statements

[2] The Federal Banking Agencies are the Office of the Comptroller of the Currency (OCC); the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation (FDIC); and the National Credit Union Administration (NCUA).

[3] Interagency Policy Statement on Allowances for Credit Losses

[4] ALLL Policy Statements that would be superseded include the agencies' December 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses; the July 2001 Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions; and the NCUA's May 2002 Interpretive Ruling and Policy Statement 02-3, Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions.

[5] Interagency Guidance on Credit Risk Review Systems

- documentation standards;
- analyzing and validating ACL estimates;
- responsibilities of boards of directors;
- responsibilities of management; and
- examiner reviews.

Measurement of ACLs

The proposed policy statement highlights that the CECL standard does not prescribe how key assumptions are determined nor how estimation methods are used. For example, the CECL standard gives banks the flexibility to determine the segmentation of financial asset portfolios, the use of one or more economic scenarios, reversion techniques or periods, and whether to use different loss estimation methods for different asset portfolios.

The proposed policy statement indicates that estimating appropriate ACLs involves a high degree of management judgment and is inherently imprecise and that a bank's process for determining appropriate ACLs may result in a range of estimates for expected credit losses. The policy statement also states that a bank would be expected to support and record its best estimate within the range of expected credit losses. When an appropriate expected credit loss framework has been used, it would be inappropriate to make additional adjustments to ACLs for the sole purpose of reporting ACLs that correspond to a peer group median, target ratio, budgeted amount or benchmark amount.

A bank would be expected to support and record its best estimate of expected credit losses, it would be inappropriate to make additional adjustments to ACLs for the sole purpose of reporting ACLs that correspond to a peer group median, target ratio, budgeted amount or benchmark amount.

The proposed policy statement indicates that, for regulatory reporting purposes, the ACL for a collateral-dependent loan is measured using the fair value of collateral, regardless of whether foreclosure is probable.

The proposed policy statement also highlights that the CECL standard requires that the:

- contractual term should not consider renewals, extensions and modifications unless it is a troubled debt, and restructuring is reasonably expected or if renewal options are not unconditionally cancellable by the bank; and
- accrued interest receivables can be written off by either reversing interest income, recognizing the loss through the provision for credit losses or a combination of both.

Qualitative factor adjustments

Management would be expected to consider the need to qualitatively adjust expected credit loss estimates for information not already captured in the loss estimation process. The nine qualitative factors that banks are familiar with from the existing allowance policy statement would be modified. In addition, the proposed policy statement would indicate that changes in ACLs may not always be directionally consistent with changes in the level of qualitative factor adjustments because reasonable and supportable forecasts are included in estimating expected credit losses. The proposed policy statement also would include additional qualitative factors specific to debt securities.

Documentation standards

A bank’s policies and procedures would be expected to describe the processes for evaluating the credit quality and collectibility of financial asset portfolios. Among other expectations, a bank’s policies and procedures for the systems, processes and controls would be expected to address the:

- roles, responsibilities and segregation of duties of personnel who provide input, determine or review the ACL;
- processes for determining key assumptions such as historical credit loss periods, as well as approaches for adjusting historical credit loss information, reasonable and supportable forecasts, reversion techniques and segmentation;
- information systems that supply the relevant and reliable information necessary, whether obtained internally or externally; and
- policies and procedures for validating the ACL estimation process.

Analyzing and validating ACL estimates

Management would be expected to use various techniques to analyze and evaluate the appropriateness of its ACL estimates, including comparison to actual write-offs, key ratios and peer groups. While these comparisons would provide a supplemental check on the reasonableness of assumptions and analyses, they would not eliminate the need for a comprehensive analysis of financial asset portfolios and the factors affecting their collectibility. In addition to these analytical comparisons, management would be expected to periodically validate its ACL estimation process to determine that it is suitable for use.

Responsibilities of the board of directors

The oversight responsibilities of the board of directors would include, but not be limited to:

— reviewing and approving the bank's written ACL policies at least annually;
— reviewing management's assessments and justifications for ACL estimates reported each period; and
— approving internal and external audit plans, and reviewing and monitoring resolution of audit findings.

Responsibilities of management

Management's responsibilities would include, but not be limited to:

— establishing and maintaining appropriate governance activities, including challenging assumptions and designing and executing effective internal controls over ACL methods and assumptions;
— periodically validating ACL methods, models and processes;
— engaging in sound risk management of third parties; and
— evaluating ACL models before they are put into use, including supporting any adjustments made to the models or outputs of the models.

Examiner reviews

Examiners would assess the appropriateness of management's processes and ACL estimates as part of their supervisory activities, which may include:

— evaluating the adequacy of the policies, procedures and documentation around loss estimation methods, models, key assumptions and the effectiveness of the controls;
— assessing the effectiveness of the board of directors' performance of their oversight responsibilities;
— reviewing the appropriateness of ACLs by assessing whether ACLs are consistently and materially over or under predicting actual losses, which may indicate a weakness in management's process;
— reviewing model validation findings, management's response to findings and action plans to remediate concerns; and
— reviewing the effectiveness of the bank's third-party risk management, including the monitoring of risks and deficiencies in third-party relationships.

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