December 21, 2018

Board of Governors of the Federal Reserve System

Statement on the current expected credit loss methodology (CECL) and stress testing

In 2016, the Financial Accounting Standards Board issued Accounting Standards Update No. 2016-13, Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments, known as the current expected credit loss methodology or CECL. The effective date of CECL varies for different banking organizations; however, by 2022 all banking organizations will be subject to CECL. Once adopted, CECL will require firms to recognize lifetime expected credit losses for financial assets measured at amortized cost, rather than those credit losses that are probable of having been incurred as of the financial reporting date. In December 2018, the Federal Reserve amended its stress testing rules to require a banking organization that has adopted CECL to incorporate CECL in its stress testing methodologies, data, and disclosure beginning in the cycle coinciding with its first full year of CECL adoption.[1] For example, firms that have adopted CECL in 2020 are required to reflect their CECL provision for credit losses beginning in the 2020 stress test cycle.

This statement provides additional information on positions that the Federal Reserve plans to take on incorporating the CECL accounting standard into its supervisory stress test and into its assessment of company-run stress tests.

Supervisory stress test – Currently in the supervisory stress test, the appropriate level of allowances for loan and lease losses (ALLL) at the end of a given quarter is generally assumed to be the amount needed to cover projected loan losses over the next four quarters.[2] Because this calculation of ALLL is based on projected losses under the severely adverse scenario, it typically differs from a banking organization's actual level of ALLL at the beginning of the planning horizon, which is based on the banking organization's estimate of probable incurred losses as of the balance sheet date. Reflecting the uncertainty in the timing of when banking

[1] See https://www.federalreserve.gov/newsevents/pressreleases/bcreg20181221a.htm. The Federal Reserve also revised regulatory capital rules to identify which credit loss allowances under the new accounting standard are eligible for inclusion in regulatory capital and provided banking organizations the option to phase in the day-one adverse effects on regulatory capital that may result from the adoption of the new accounting standard.

[2] See Board of Governors of the Federal Reserve System (2018), "Dodd-Frank Act Stress Test 2018: Supervisory Stress Test Methodology and Results" (Washington, DC: Board of Governors, June 2018), https://www.federalreserve.gov/publications/files/2018-dfast-methodology-results-20180621.pdf

organizations realize losses, any difference between the actual level of ALLL and the assumed ALLL under stress at the beginning of the planning horizon is spread out over the nine quarters of the planning horizon to smooth its effect on capital. Despite differences in the horizon over which losses are estimated, the current approach is conceptually similar to the CECL standard, as both methods are based on a forward-looking estimate of losses.

To reduce uncertainty, allow for better capital planning at affected firms, and gather additional information on the impact of CECL, the Federal Reserve plans to maintain the current framework for calculating allowances on loans in the supervisory stress test until the impact of CECL on banking organizations' financial reporting is better known and understood.[3] The Federal Reserve intends to maintain this framework for the 2020 and 2021 supervisory stress test cycles and to evaluate appropriate future enhancements to this framework as best practices for implementing CECL are developed. The Federal Reserve expects that maintaining the current framework, which takes into account a banking organization's allowances at the beginning of the planning horizon, will largely offset any impact in the supervisory stress test that may result from the expected increase in the allowances under the CECL standard.

Company-run stress tests – With respect to firms' own company-run stress tests, the Federal Reserve plans to collect information necessary to determine the range of practice used by firms to incorporate the new accounting standard into stress testing and capital planning and share its observations with firms. However, the Federal Reserve would not issue supervisory findings on firms' stressed estimation of the allowance under CECL in CCAR's qualitative assessment any earlier than 2022.

[3] Specifically, the Federal Reserve plans to maintain the current assumption that ALLL covers four-quarter-ahead losses and to spread out any difference between actual and stressed ALLL over nine quarters. The Federal Reserve intends to incorporate its projection of expected credit losses on securities in the Allowance for Credit Losses, in accordance with Financial Accounting Standards Board Accounting Standards Update No. 2016-13, Financial Instruments – Credit Losses (Topic 326).