FEDERAL RESERVE BANK OF RICHMOND
Richmond • Baltimore • Charlotte

Supervision News Flash

November 9, 2015

CECL – What You Can Do Now

By now everyone has heard the term CECL many times. While there's still uncertainty on when the final rule will be issued and exactly when the rule will be effective, we do believe there are things you should consider now to ensure a successful transition to the new model.

What is CECL?

The Current Expected Credit Loss standard will require financial institutions to impair their financial assets by all contractual cash flows not expected to be collected on the day an asset is acquired and at each reporting date. Institutions will use all available information, both internal and external, to estimate losses over the expected life of the asset. This will be a shift from existing "incurred loss" models and will remove the probable thresholds needed to recognize losses. Institutions will continue to analyze historical loss experiences and current conditions, but will now be required to include reasonable and supportable forecasts of future events that affect the collectability of an asset's remaining cash flow.

What should financial institutions do now?

As you anticipate the final guidance and a confirmed implementation date, we encourage you to take steps to prepare:

- Become familiar with the proposed accounting standard
- Discuss the proposed accounting changes with external auditors and industry peers
- Involve all areas within your company to identify data points and any potential system changes
- Review current ALLL and credit risk management practices to identify processes that might be leveraged
- Begin collecting data for all existing credits as well as any new loan originations that might be used in a lifetime expected credit loss model
- Begin drafting an initial, high-level plan for CECL implementation
- Continue following existing GAAP guidance for maintaining the allowance until the new rule is effective

- Don’t build allowance balance in anticipation of transitioning to CECL beyond those appropriate under GAAP
- Begin evaluating capital levels to ensure they will be sufficient to support the implementation of CECL on day one

What resources are available?

The Federal Reserve, in collaboration with other regulatory agencies, will provide additional guidance on CECL. Currently, you may find some helpful presentations on the Board of Governors website. You can also view the Ask the Fed session held October 22. You may also provide your auditors, consultants or attorneys this link to the “FedPerspectives” session held October 30.

As always, you may reach out to your portfolio team at the Richmond Fed for assistance or clarification on any area of the proposed rule. **Additionally we’ll have a break-out session on CECL at our Community Bankers Forum in Richmond on Nov. 12-13.** Contact Sean O’Hara if you’re a senior bank leader who has yet to register for our Forum.

Enhancing Transparency in the Federal Reserve’s Applications Process

In early 2014, the Federal Reserve System issued guidance to financial institutions and the general public regarding our approach to banking applications that don’t meet statutory requirements or that raise regulatory concerns. This guidance, SR Letter 14-2/CA 14-1, can be found on the Federal Reserve’s web site.

Generally speaking, ***the information in this guidance doesn’t represent a change in how the Federal Reserve processes applications, rather it provides in one document clarification of the factors that we consider.***

For complex filings, substantive issues usually can be resolved by applicants providing additional information or making changes to the proposal that would allow for approval. However, in some instances, the issues cannot be resolved, so we recommend that the Board of Governors deny the proposal. In these cases, the Federal Reserve’s general practice has been to inform the filer of the denial recommendation to allow the filer the option to withdraw the proposal.

The SR Letter provides detailed examples of common issues that have resulted in applications being withdrawn, including organizations with less than satisfactory ratings or enforcement

actions, weaknesses in financial factors, managerial issues, inadequate Bank Secrecy Act compliance, as well as other considerations.

Additionally, the Federal Reserve System committed to issuing semi-annual reports that provide information on filed applications, such as the average processing time, the number of approvals, the number of withdrawals and the reasons for the withdrawals. We recommend that leaders at state member banks, bank holding companies, and savings and loan holding companies read this guidance before entering into a transaction that would require an application with the Federal Reserve. We believe you'll find it helpful and it'll possibly reduce the likelihood of having to withdraw an application later.

If you have any questions about this SR Letter, or banking applications in general, feel free to email Adam Drimer or Wayne Cox.

Erase Those Doubts on Doubtful Loans

Have you ever had a credit relationship classified as doubtful and wondered just what the regulatory implications and expectations were? You're not alone because we field a lot of questions when the topic of doubtful loans comes up, such as:

- Whether loans classified as doubtful should still be accruing interest
- Confusion about whether you're required to charge-off 50 percent of the doubtful classification
- How long a relationship can remain in the doubtful category.

When reviewing asset quality at our banking institutions, examiners focus on migration of assets between classification categories, and how problem assets are being internally managed. We periodically see loan relationships that have been either internally classified doubtful, or so classified during an earlier examination, without timely remediation to move the relationship out of this transitional classification category.

Here's some reminders about expectations for handling doubtful assets so that you can avoid any issues in this area on your next examination.

Difference between Substandard and Doubtful

A ***Substandard*** asset is inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets in this classification must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the institution will sustain some loss if the deficiencies are not corrected.

An asset classified ***Doubtful*** has all the weaknesses inherent in one classified substandard, with the added characteristic that the weaknesses make collection or liquidation in full — on the basis of currently existing facts, conditions, and values — highly questionable and improbable. (For the full details, check out Section 6003.1 that highlights Items Subject to Adverse Classification in the Commercial Bank Examination Manual.)

Based on this explanation, a doubtful loan is one where full repayment is questionable and uncertain. Repayment of loans in the doubtful category could range from a complete loss to uncertain loss unless corrective actions are taken by your bank's management. However, you can be relatively sure that some loss will be associated with the relationship.

For regulatory analysis purposes, the Federal Reserve System not only measures the volume of asset classifications through use of the Total Classification Ratio, but also measures the severity of those classifications through the Weighted Classification Ratio. In calculating WCR, assets classified doubtful are assigned a weighting of 50 percent, representing the higher likelihood of loss within those assets. While the classification ratios are measurements of risk in relation to Tier 1 capital plus reserves, we don't have a requirement that you must take 50 percent charge-offs. Instead, this transitional classification gives you time to determine actual loss.

Given the inherent uncertainties and weaknesses in these assets, doubtful loans are usually non-performing loans on which interest is overdue and full collection of principal is uncertain. This means they should be placed in nonaccrual status.

The doubtful category **should not be used as "long-term" parking for questionable loans**, rather as a transitional category to allow you time to determine the portion that will likely be repaid, and the quantifiable loss within the relationship that should be charged-off as loss.

So examiners will generally avoid repeating the doubtful classification at subsequent examinations since the time between reviews should be adequate to measure expected loss. Similarly, you should continually monitor relationships that are internally classified doubtful and ensure that they're assessed in a timely manner. These relationships should be moved out of this category when you can document sustained improvement and the relationship no longer meets the criteria of doubtful, or you're able to quantify anticipated loss.

Richmond Fed President Jeffrey Lacker Comments on His Second FOMC Dissent

"The Federal Open Market Committee decided on October 28 to maintain a target range of zero to 25 basis points for the federal funds rate. I dissented because I believe that an increase in our interest rate target is needed, given current economic conditions and the medium-term outlook…."

Recent Speeches by Members of the Board of Governors

Governor Lael Brainard

At the Economic Growth and Regulatory Paperwork Reduction Act Outreach Meeting, Federal Reserve Bank of Chicago, Chicago, Illinois; October 19th

Identifying Opportunities for Reducing Regulatory Burdens on Community Banks

"… Under EGRPRA, the federal banking agencies are required to conduct a joint review of our regulations every 10 years. At the Federal Reserve, we view the current review as a timely opportunity to step back and look for ways to reduce regulatory burden, particularly for smaller or less complex banks that pose less risk to the system. Our ultimate goal is to identify outdated, unnecessary, or unduly burdensome regulations and to take action to address those burdens…."

Chair Janet L. Yellen

At the Community Banking in the 21st Century, The Third Annual Community Banking Research and Policy Conference, Cosponsored by the Federal Reserve System and Conference of State Bank Supervisors, Federal Reserve Bank of St. Louis, St. Louis, Missouri; September 30th

Welcoming Remarks

"… My fellow Board members and I know that community banks provide essential financial services to households, small businesses, and farms in communities throughout the country. We know that community banks serve many customers that large banks do not and provide services that are not offered by large banks in many communities…."

Governor Lael Brainard

At the Community Banking in the 21st Century, The Third Annual Community Banking Research and Policy Conference, Cosponsored by the Federal Reserve System and Conference of State Bank Supervisors, Federal Reserve Bank of St. Louis, St. Louis, Missouri; September 30th

Community Banks, Small Business Credit, and Online Lending

"… Supporting the health and vitality of America's community banks is an important priority for me. Community banks have long been a central provider of finance to Main Street America. Despite the challenging environment of the past several years, community banks have continued to play a significant role in a number of key market segments…."

Recap of Supervision and Regulation Guidance Issued this Year

Supervision and Regulation Letters, commonly known as SR Letters, address significant policy and procedural matters related to the Federal Reserve System's supervisory responsibilities. Consumer Affairs letters address significant policy and procedural matters related to the Federal Reserve System's consumer compliance supervisory responsibilities. Active SR and CA letters are listed here in reverse chronological order.
Here are recently issued guidance letters:

SR 15-12: Spanish Translation of the 2014 Federal Financial Institutions Examination Council's Bank Secrecy Act/Anti-Money Laundering Examination Manual

SR 15-11 / CA 15-9: Examinations of Insured Depository Institutions Prior to Membership or Merger into a State Member Bank

SR 15-10 / CA 15-8: Expansion of the Federal Reserve's Emergency Communications System
CA 15-7: Revised Interagency Examination Procedures for Regulation P
CA 15-6: Revised Interagency Examination Procedures for Regulation Z and Regulation X
CA 15-5: Transfer of SAFE Act Supervisory Responsibilities and Publication of SAFE Act Examination Procedures

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