Farm Credit Administration

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INFORMATIONAL MEMORANDUM

September 1, 2016

To: Chairman, Board of Directors
Chief Executive Officer
All Farm Credit System Institutions

From: Gary K. Van Meter, Director
Office of Regulatory Policy

Subject: New Accounting Standard on Financial Instruments - Credit Losses

Purpose

The purpose of this Farm Credit Administration (FCA) Informational Memorandum (IM) is to provide initial information to Farm Credit System (FCS) institutions about the new accounting standard, Accounting Standard Update (ASU) No. 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*.[1]

The Financial Accounting Standards Board (FASB) recently issued this new accounting standard, which introduces the current expected credit losses (CECL) methodology for estimating allowances for credit losses. The CECL methodology is based on *expected* losses rather than *incurred* losses. The new accounting standard allows a financial institution to leverage its current internal credit risk systems as a framework for estimating expected credit losses.

Highlights

Highlights from the ASU include:

- Under CECL, the allowance for credit losses is a valuation account measured as the difference between the amortized cost basis of financial assets and the net amount expected to be collected on the assets (i.e., lifetime credit losses);[2]

[1] The FASB issued ASU 2016-13 on June 16, 2016. A complete copy of the document is available here. This IM guidance is substantially similar to the *Joint Statement on the New Accounting Standard on Financial Instruments – Credit Losses* issued June 17, 2016, by The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency.

[2] Paragraph 326-20-30-1 of the ASU states: "The allowance for credit losses is a valuation account that is deducted from the amortized cost basis of the financial asset(s) to present the net amount expected to be collected on the financial asset."

- It applies to financial assets carried at amortized cost, including loans held for investment and held-to-maturity securities;
- The standard allows expected credit loss estimation approaches that build on existing credit risk management systems and processes as well as existing methods for estimating credit losses. However, certain inputs into these methods will need to change to achieve an estimate of lifetime credit losses; and
- To estimate expected credit losses under CECL, institutions will use a broader range of data than under existing accounting standards. These data include information about past events, current conditions, and reasonable and supportable forecasts relevant to assessing the collectability of the cash flows of financial assets.

Effective dates

The FASB has set the following effective dates for the new standard, which depend on an institution's characteristics:

- Public business entities[3] (PBEs) that are U.S. Securities and Exchange Commission (SEC) filers[4] (SEC filers): Fiscal years beginning after December 15, 2019, including interim periods within those fiscal years.
- Other PBEs (non-SEC filers): Fiscal years beginning after December 15, 2020, including interim periods within those fiscal years.
- Non-PBEs (private companies): Fiscal years beginning after December 15, 2020, including interim periods beginning after December 15, 2021.

For all entities, early application of the new standard is permitted for fiscal years beginning after December 15, 2018, including interim periods within those fiscal years.

It is our understanding that FCS institutions will implement the new standard for purposes of the Systemwide combined financial statements for the call report quarter ending March 31, 2021. The effective date for SEC filers, such as Farmer Mac, will be for the quarter ending March 31, 2020.

Measurement, Transition and Implementation

Until institutions implement the new accounting standard, they must continue to calculate their allowances for loan and lease losses using the existing incurred loss methodology. Institutions should not adjust their allowance levels from those appropriate under existing U.S. GAAP in advance of the new standard's effective date. However, FCS institutions are encouraged to take steps to assess the potential impact on capital.

Although the FCA recognizes the impact of CECL will vary from institution to institution, we

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[3] See ASU 2013-12, *Definition of a Public Business Entity*, issued in December 2013.
[4] An SEC filer, as defined in U.S. GAAP, is an entity that files its financial statements with the SEC.

encourage each institution to start planning and preparing for their transition to the new accounting standard by:

- Becoming familiar with the new accounting standard;
- Discussing with the board of directors, industry peers, external auditors,[5] and FCA examiners how best to implement the new accounting standard in a manner appropriate to the institution's size and the nature, scope, and risk of their lending and debt securities investment activities;
- Reviewing existing allowance and credit risk management practices to identify processes that can be leveraged when applying the new accounting standard;
- Identifying data needs and necessary system changes to implement the new accounting standard consistent with its requirements, the allowance estimation method or methods to be used, and supervisory expectations;
- Determining how and when to begin collecting the additional data that may be needed for implementation; and
- Planning for the potential impact of the new accounting standard on capital.

Senior management, under the oversight of the board of directors, should work closely with staff in their accounting, lending, credit risk management, internal audit, and information technology functions during the transition period leading up to the effective date of the new accounting standard as well as after its adoption.

While there are differences between today's incurred loss methodology and CECL, FCA expects the new accounting standard will be scalable to institutions of all sizes, and that smaller and less complex institutions will be able to adjust their existing allowance methodologies to meet the new accounting requirements without the use of costly and complex models.

FCA encourages institutions to plan and prepare for the transition to the new accounting standard, including assessing the potential impact on capital. Because appropriate allowance levels are institution-specific amounts, FCA will not establish benchmark targets or ranges for the change in institutions' allowance levels upon adoption of CECL, or for allowance levels going forward.

Conclusion

FCA supports an implementation of the FASB's new accounting standard that is both reasonable and practical, taking into consideration the size, complexity, volatility, and risk profile of each institution. Any questions regarding this IM should be directed to Ryan Leist, Office of Regulatory Policy, at (703) 883-4223 (leistr@fca.gov) or Katherine Friedman, Office of Examination, at (469) 359-4115 (friedmank@fca.gov).

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[5] When discussing the new accounting standard and its implementation with their external auditors, institutions and their audit committees should be mindful of applicable auditor independence requirements.