Farm Credit Administration

1501 Farm Credit Drive
McLean, VA 22102-5090
(703) 883-4000

BOOKLETTER

October 13, 2022

To: Chair, Board of Directors
Chief Executive Officer
Each Farm Credit System Institution

From: Glen R. Smith
Board Chairman and Chief Executive Officer

Subject: Adequacy of Farm Credit System institutions' allowance for credit losses for financial assets measured at amortized cost (BL-049, revised)

The Farm Credit Administration is issuing this revised bookletter to inform Farm Credit System (System) institutions of our expectations regarding the processes for determining the allowance for credit losses (ACL) for loans and other financial assets measured at amortized cost.[1] We have updated this bookletter to reflect changes to processes necessary to implement Accounting Standards Codification (ASC) 326—Financial Instruments—Credit Losses, which System institutions will implement on January 1, 2023.

This bookletter provides your institution with guidance for developing, governing, maintaining, and documenting processes for determining an adequate level of the ACL. It applies to institution practices beginning January 1, 2023.

By issuing this bookletter, our objective is to establish minimum criteria consistent with sound business practices, such as those outlined in guidance from four federal financial regulators and the Securities and Exchange Commission (SEC).[2] FCA examiners will use the criteria in this bookletter to evaluate the processes your institution uses to determine its ACL for financial assets measured at amortized cost.

[1] This revised bookletter does not apply to the Federal Agricultural Mortgage Corporation (Farmer Mac). References to System institutions or institutions in this bookletter refer only to System banks and associations.

[2] See Frequently Asked Questions on the New Accounting Standard on Financial Instruments—Credit Losses, last updated April 3, 2019, and the Interagency Policy Statement on Allowances for Credit Losses (PDF), 85 FR 32991 (June 1, 2020), both published by the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the National Credit Union Administration (NCUA), and the Office of the Comptroller of the Currency (OCC). See also Staff Accounting Bulletin No. 119, issued November 25, 2019, by the SEC. While System banks and associations are not subject to SEC requirements or guidance, this staff accounting bulletin outlines sound guidance on the ACL.

With the adoption of this updated bookletter, we rescind the informational memorandum on allowance for loan losses, dated June 30, 2009. We have included and updated the key points from that informational memorandum in this bookletter.

Background information

Section 621.5 of FCA's accounting and reporting regulations sets forth our regulatory requirements addressing the ACL of System institutions. As amended effective January 1, 2023, this regulation calls for each institution to "maintain at all times an allowance for credit losses that is determined according to generally accepted accounting principles."[3]

We first published this bookletter in 2004 to provide guidance on the application of this broad regulatory requirement. We are updating the bookletter to address significant changes in U.S. generally accepted accounting principles (GAAP).

On June 16, 2016, the Financial Accounting Standards Board issued an Accounting Standards Update (ASU), ASU 2016-13 Financial Instruments—Credit Losses (codified in ASC 326).[4] Here are some of the more important ways the updated accounting standard differs from prior GAAP:

- The updated accounting standard replaces the allowance for "incurred losses" methodology under the previous standard with an allowance for current *expected* credit losses (CECL) methodology. Under CECL, the ACL measures the difference between an asset's amortized cost basis and the amount expected to be collected over the lifetime of the asset (that is, lifetime credit losses). CECL eliminates the requirement for losses to be probable and incurred prior to recognition; this change should help institutions recognize credit losses earlier.
- The updated standard requires consideration of a broader range of data, including past events, current conditions, and reasonable and supportable forecasts that affect expected collectibility. Nonetheless, financial institutions will continue to incorporate both qualitative and quantitative factors when estimating credit losses.
- The updated standard applies a single measurement for all financial assets carried at amortized cost, whereas prior GAAP used five credit impairment models for different financial assets. That said, CECL does not specify a single method for measuring expected credit losses. Any reasonable approach is allowed as long as the estimate of expected credit losses achieves the objective of the accounting standard.
- For purchased financial assets, the updated accounting standard replaces the purchased credit-impaired (PCI) methodology under prior GAAP with the purchased credit-deteriorated (PCD) methodology, by which expected credit losses are separately recognized at acquisition.

On September 1, 2016, FCA issued an informational memorandum on the New Accounting Standard on Financial Instruments—Credit Losses (PDF) to provide initial information to System institutions about the new standard. That document covers planning and transitioning to the new standard. It conveys our expectation that the standard will be

[3] Existing § 621.5 sets forth requirements addressing the allowance for loan losses (ALL). A final rule published in May 2022, which is effective on January 1, 2023 (the same day that System institutions are to implement ASC 326), has amended the regulation to replace ALL with ACL. See 87 FR 27483 (PDF) (May 9, 2022).

[4] The Financial Accounting Standards Board later issued updates that are also codified in ASC 326.

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 having to use costly and complex models. The 2016 informational memorandum includes many of the elements addressed in a Joint Statement on the New Accounting Standard (PDF) issued by the OCC, the FRB, the FDIC, and the NCUA on June 17, 2016.

This bookletter supplements the 2016 informational memorandum by outlining the key sound practices our examiners will look for when evaluating your institution's ACL processes.

I. Board of directors' responsibilities

Under FCA regulations, your institution's board of directors must certify that reports to shareholders are financially accurate.[5] The ACL is one of the most significant estimates in your institution's financial statements and regulatory reports. Further, the recognition of credit risk and related losses through the ACL is central to your institution's overall risk management processes. Effective board oversight is crucial to your board's understanding of the process used to estimate the lifetime credit losses in financial assets carried at amortized cost, and to your board's determination that the level of the ACL is adequate. To properly fulfill its responsibilities, your board should at a minimum do the following:

- Review and approve appropriate policies at least annually and direct management to apply implementing procedures and internal controls to ensure that the ACL is accurate; determined in accordance with GAAP, as required by regulations; and adequately supported.
- Ensure that the models used to determine the ACL are appropriately governed in accordance with your institution's model risk management framework.[6]
- Oversee and monitor the ACL process, as well as any revisions to ACL methodologies or processes, to ensure that the ACL is determined in accordance with management procedures, GAAP, and your institution's policies (including policies for identifying nonaccrual loans and assets to be individually evaluated for credit losses, and for recording loan charge-offs). Your board may oversee and monitor the ACL process either directly or through a board-established committee.
- Coordinate and communicate with your institution's independent qualified public accountant with respect to the audit of your ACL process.
- Review and approve management's documented ACL analysis, as well as the recommended ACL level. The recommended ACL level is reported on a quarterly basis.
- Preclude management from implementing ACL methodologies that would allow your institution's earnings to be inappropriately manipulated.

[5] Under FCA regulation §§ 620.3(b) and (c), a board member formally designated by action of the board is required to sign, and certify the financial accuracy of, shareholder reports on behalf of the individual board members.

[6] Model validation is part of an effective model risk management framework. The scope and frequency of validation should be commensurate with the complexity and potential impact of the model. Sound principles for model risk management are discussed in the governance section of FCA's Examination Manual (PDF).

- Ensure appropriate internal audit coverage of lending functions, risk identification, and ACL processes.

II. Management's responsibilities

Under our regulations, your board and management share the responsibility for ensuring that shareholder reports are financially accurate.[7] Further, understanding credit risk and its impact on your institution's financial condition and performance are crucial to appropriate risk management. To properly fulfill its responsibilities and ensure the adequacy of your institution's ACL, management should at a minimum do the following:

- Develop and maintain procedures and internal controls that implement the board's policies addressing the adequacy of your institution's ACL.
- Ensure that the methodologies for determining the ACL are well documented and supported, and remain appropriate for your institution.
- Ensure that CECL model risk is managed in accordance with your institution's model risk management framework.
- Support the periodic independent review of your institution's lending functions to ensure that credit risk is appropriately identified.
- Conduct a periodic management review of ACL methodologies to ensure that they remain appropriate.[8]
- Maintain records and documentation, as discussed below, to support overall ACL levels (determined quarterly), and loss measurement methods, assumptions, and processes used to estimate the ACL in accordance with GAAP.
- Implement and maintain information systems that allow for access to necessary data elements to determine the ACL.[9]

---

[7] Under §§ 620.3(b) & (c), your institution's chief executive officer and chief financial officer, or the officer responsible for preparing financial reports, are required to sign shareholder reports that certify to their financial accuracy.

[8] If changes frequently occur during management or credit committee reviews of the ACL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology used.

[9] CECL is forward-looking and broadens the range of data that must be considered in the estimation of credit losses. As discussed below, common data elements that are needed to support the computation of the ACL under CECL include

- origination and maturity dates;
- par amounts;
- initial and subsequent charge-off amounts and dates;
- recovery amounts and dates;
- cumulative loss amounts for loans with similar risk characteristics; and
- data elements to support portfolio segmentation, including credit scores or ratings, internal risk ratings or classifications, financial asset types, collateral types, asset size, effective interest rates, terms, geographic locations, industry of the borrower, and vintage information.

Beyond supporting portfolio segmentation, data available should support establishing historical or expected credit loss patterns, and determining reasonable and supportable forecast periods. You may need additional control structures to ensure the accuracy and completeness of data elements not previously used in allowance processes.

- Manage relationships with model vendors and other third parties providing services, processes, or applications that are central to the ACL process.

Management must assess the adequacy of your institution's ACL on a regular basis but not less than quarterly.[10] If management determines that the level of your ACL is inadequate or excessive, a provision or reversal should be made to the ACL to ensure the accuracy of financial statements. Likewise, management must ensure that loan losses are charged off when the loan or portions of them are known to be uncollectible.[11] Management should also ensure that recoveries are appropriately recognized when realized.

III. Policies and procedures

Although policies and procedures should be tailored to the size and complexity of the financial assets carried at amortized cost, at a minimum they should address the following:

- A description of the methods you're using to determine the ACL, the primary elements of the ACL process,[12] and the methods you're using to determine any significant judgments.
- The roles and responsibilities of personnel involved in determining or reviewing your institution's ACL. In addition to senior managers, board members, and members of board committees, these personnel may include individuals involved in lending, credit reviews, financial reporting, and internal audits.
- Documentation standards requiring appropriate written support for ACL methodologies and the quarterly ACL determination. These standards should ensure that all relevant factors are appropriately considered in the ACL analysis.
- Policies for charge-offs, recoveries, and the fair value of collateral, where applicable.
- Changes to the ACL process and methodologies.
- The loan-grading system and process.
- Inclusion in the institution's model risk management framework of any models used to determine and support the ACL.
- The system of internal controls providing reasonable assurance that the ACL is determined in accordance with GAAP.

IV. Methodologies

We expect your institution to develop and document the methodologies you use to determine the ACL and related provisions for credit losses. The new accounting standard does not specify a single method for measuring expected credit losses. You are expected to use sound judgment in developing estimation methods that are well documented, applied consistently, and appropriately estimate the collectibility of financial assets by applying the principles in ASC 326. ACL methodologies must incorporate management's current judgments about the credit losses expected from existing financial assets carried at

---

[10] Effective January 1, 2023, § 621.5(a) requires System institutions to maintain at all times an allowance for credit losses in accordance with GAAP. FCA regulation § 620.10 requires System institutions to prepare financial reports quarterly.

[11] § 621.5(c).

[12] Question 4 in the SEC's Staff Accounting Bulletin 119 lists multiple factors that could be key elements of the ACL methodology to be documented in policy.

amortized cost. This includes considering reasonable and supportable forecasts about changes in credit quality in these portfolios.

While different institutions may use different methods, there are certain common elements that should be included in any methodology to be considered effective. Your institution's methodologies generally should do the following:

- Identify relevant risk characteristics and pool loans based on those characteristics, which might include credit scores or ratings, internal risk ratings or classifications, asset or loan type, collateral type, asset size, effective interest, term, geographic location, borrower industry, loan vintage, historical or expected loss patterns, or reasonable and supportable forecast periods.
- Consider expected credit losses over the contractual term of all existing loans (on a group or individual basis), and measure expected credit losses on loans on a collective (pool) basis when similar risk characteristics exist.
- Require analyses, estimates, reviews, and other ACL functions be performed by competent and well-trained personnel.
- Consider available information relevant to assessing collectibility of cash flows, such as market or industry conditions, macroeconomic conditions, trends in delinquencies and nonaccruals, collateral values, changes in government support programs, volatility in the agricultural operating environment, the overall quality of your institution’s credit review programs, concentrations of lending in a single sector, and the overall quality and experience of management.
- Be based on reliable and relevant data[13] and an analysis of current conditions and reasonable and supportable forecasts.
- Determine the point at which a financial asset may extend beyond a reasonable and supportable forecast period, such that processes should revert to historical loss information.
- Include a systematic and logical method to consolidate the loss estimates allowing the ACL to be recorded in accordance with GAAP.

Question 4 in the SEC’s Staff Accounting Bulletin 119 provides further detail on the type of key elements that could be included in your institution’s systematic approach to determining the ACL.

V. Documentation

Estimating allowance levels involves a significant amount of management judgment. That’s why documentation is critical to your institution's ACL process; it should provide evidence that your institution is maintaining an adequate level of ACL. Appropriate written supporting documentation facilitates the loan loss review process, builds consistency into the determination process, and ensures that all relevant factors are considered in the analysis process.

An important part of the ACL process includes documenting the link between the findings of the detailed review of the institution's financial assets carried at amortized cost and the

[13] If your institution supplements its own data with third-party data sets, your methodologies should establish and document that the data used is appropriate for your institution’s financial assets carried at amortized cost.

level of the ACL and related provisions reported by your institution. Documentation should support all key management decisions in establishing an ACL methodology under CECL, determining appropriate ACL levels on a periodic basis, and periodically reviewing and validating methodologies as business processes or conditions change.

When establishing or revising your ACL methodologies, here are some of the key aspects to document:

- Methods used to estimate expected credit losses for each portfolio segment, including the evaluation and conclusions regarding the appropriateness of methods selected or any subsequent changes in methods used.
- All key assumptions related to the current estimate of expected credit losses, including support for any changes in key assumptions over time.
- Support for loan pooling decisions showing that loans in each pool have similar risk characteristics.
- Determination of historical loss rates and any adjustments to reflect differences between current conditions and reasonable and supportable forecasts and the conditions that existed for the period over which historical information was evaluated.
- Processes for determining and revising how and when to revert to historical credit loss information when the contractual term of a financial asset or off-balance-sheet credit exposure extends beyond the reasonable and supportable forecast period.
- Support for the relevance and reliability of any external data used in determining loss rates.
- Support for assumptions and data used to develop forecasts of expected cash flows and to discount those cash flows to present values (when discounted cash flow methodologies are used).

When documenting how you estimate the ACL and determine periodic provisions or reversals, here are some of the key factors to include:

- Current conditions and reasonable and supportable forecasts used to develop expected loss estimates,[14] and how those factors affected the expected credit loss measurements.
- Factors affecting collectibility that are not reflected in your institution's historical loss information and any resulting adjustments (e.g., qualitative adjustments), including support for the adjustment and why the adjustment is necessary.
- Support for the identified range of expected credit losses and the rationale for determining which is the best estimate within the range identified.
- When applicable, the basis for the conclusion that the asset qualifies under GAAP for measurement of expected losses based on the fair value of the collateral, and how

[14] Common factors to consider would include the levels and trends in delinquencies, loan performance, write-offs, and recoveries; trends in loan volume and terms; impacts of changes in reasonable and supportable economic forecasts; impacts of changes in underwriting standards, lending policies, procedures or practices; changes in prepayment expectations or other factors affecting assessments of contractual terms; industry or commodity conditions; and the effects of changes in credit concentrations.

the fair value of the collateral was determined, including how recent and reliable the appraisal or other valuation was.

- Summary information, including the estimate of expected credit losses identified using your institution’s ACL methodologies, a summary of the current ACL balance, the amount (if any) by which the ACL balance is to be adjusted through provisions or reversals, and any detailed sub-schedules of loss estimates that reconcile to the overall summary.

Your institution should also document ACL validation processes. This documentation should describe the specific validation procedures performed and any findings from reviewers. If the ACL methodology is changed because of a validation finding, your institution should describe and support any changes made. We expect you to incorporate into your model risk management framework all models that you use to determine ACL.

VI. Internal controls

For safe and sound operations, your institution must maintain an internal control system over its operations, programs, and resources, including its ACL process.[15] Sound internal controls will ensure that your ACL process is reasonable and that you are maintaining the level of the ACL in accordance with GAAP. A sound internal control system should do the following:

- Include measures to provide assurance regarding the reliability and integrity of information used in the ACL process, including the design and implementation of appropriate controls over new data elements used to estimate expected credit losses.
- Ensure compliance with relevant laws and regulations, internal policies and procedures, GAAP, and other applicable guidance.
- Include a review of the documentation that supports the ACL methodologies and processes for completeness and sufficiency.
- Include a well-defined loan review process that contains an effective loan-grading system, ensures all relevant loan review information is appropriately considered in estimating losses, and provides clear formal communications and coordination among all parties within your institution who are involved in the ACL process.
- Provide for coverage of the ACL process and an evaluation of the adequacy of the level of the ACL as part of the audit of your institution’s financial statements. The audit should be performed by a qualified public accountant who is independent of your institution.
- Reasonably ensure that the level of the ACL is adequate to cover the estimated lifetime credit losses in your institution's financial assets carried at amortized cost and ensure that the level of the ACL is maintained in accordance with GAAP.

VII. FCA's examination

Our examiners will assess the adequacy of your institution's ACL by evaluating the overall processes you’re using. Our assessment will focus on your policies and procedures, methodologies, documentation, internal controls, and other tools used to determine the

[15] See § 618.8430.

adequacy of your ACL.[16] The depth of our assessment will be commensurate with your institution's size, complexity, and risk profile. Our examiners will look for a well-documented and thorough analysis of expected credit losses. The analysis should provide adequate details to give your board and management a comprehensive understanding of expected credit losses and the impacts of the risks emanating from the general economy and the industries you're financing.[17] We will consider the adequacy and effectiveness of your institution's ACL methodologies when evaluating your asset quality, credit risk management, earnings, and capital adequacy in accordance with our Financial Institution Rating System.

VIII. Additional guidance

The sound principles outlined in this bookletter are largely consistent with guidance previously published by the OCC, the FRB, the FDIC, the NCUA, and the SEC. Therefore, we encourage you to review the following publications:

- Interagency Policy Statement on Allowances for Credit Losses (PDF), 85 FR 32991 (June 1, 2020)
- SEC Staff Accounting Bulletin 119 (November 25, 2019)
- Interagency Guidance—Frequently Asked Questions on the New Accounting Standard on Financial Instruments—Credit Losses (PDF) (April 3, 2019)

If you have questions about this bookletter, please contact one of the following:

- Jason Moore, Associate Director, Operations, Management, and Accounting Team, Office of Regulatory Policy, at 703-883-4256 (mooreja@fca.gov).
- Katherine Friedman, Senior Accounting Specialist, Office of Examination, at 469-359-4115 (friedmank@fca.gov).

[16] Further information on aspects considered in the examination of an institution's ACL levels and processes can be found in the FCA Examination Manual.

[17] With the increases in shared assets within the System and the responsibility to report financial results at a Systemwide level, institutions must communicate effectively and apply a consistent approach to risk classification and charge-offs.