



**BOARD OF GOVERNORS**  
OF THE  
**FEDERAL RESERVE SYSTEM**

WASHINGTON, D.C. 20551

DIVISION OF SUPERVISION  
AND REGULATION

**SR 20-12**

**May 8, 2020**

**Revised April 21, 2023**

**Revision History:**

On April 21, 2023, the *Interagency Policy Statement on Allowances for Credit Losses*, which is attached to this letter, was revised to remove references to troubled debt restructurings (TDRs) to conform with U.S. generally accepted accounting principles (GAAP) following the March 2022 issuance of Accounting Standards Update 2022-02 (ASU 2022-02), *Financial Instruments—Credit Losses (Topic 326): Troubled Debt Restructurings and Vintage Disclosures*. ASU 2022-02 eliminated the recognition and measurement accounting guidance for TDRs by creditors upon adoption of Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Topic 326.<sup>1</sup>

**TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK**

**SUBJECT: Interagency Policy Statement on Allowances for Credit Losses**

**Applicability:** This letter and the attached interagency policy statement are relevant for Federal Reserve supervised financial institutions,<sup>2</sup> including those with less than \$10 billion in total consolidated assets, that file regulatory reports prepared in accordance with GAAP.<sup>3</sup>

The Federal Reserve Board, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency (the agencies) are issuing the attached interagency policy statement in response to changes in the accounting for credit losses under GAAP, as promulgated by the FASB.

<sup>1</sup> Refer to Accounting Standards Update No. 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, and subsequent amendments since June 2016. These updates are codified in ASC Topic 326, *Financial Instruments – Credit Losses* (FASB ASC Topic 326).

<sup>2</sup> This includes state member banks, bank holding companies, savings and loan holding companies, Edge Act and agreement corporations, and U.S. branches and agencies of foreign banking organizations (FBOs).

<sup>3</sup> U.S. branches and agencies of FBOs may choose to, but are not required to, maintain an allowance for loan losses on an office level. These institutions should refer to the instructions for the FFIEC 002, “Report of Assets and Liabilities of U.S. Branches and Agencies of Foreign Banks,” as well as SR letter 95-4, “Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations,” and SR letter 95-42, “Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations.”

The interagency policy statement describes the measurement of expected credit losses under the current expected credit losses (CECL) methodology and the accounting for impairment on available-for-sale debt securities in accordance with FASB ASC Topic 326. The interagency policy statement also includes, and updates concepts and practices detailed in existing policy statements on the allowance for loan and lease losses that remain relevant under FASB ASC Topic 326.

This interagency policy statement is relevant for an institution when the institution adopts FASB ASC Topic 326.<sup>4</sup> For institutions that have adopted the accounting standard, this interagency policy statement replaces the policy statements on the allowance for loan and lease losses attached to the following SR letters:

- SR letter 06-17, “Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)”<sup>5</sup>
- SR letter 01-17, “Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions”

An institution should continue to refer to the policy statements attached to SR letter 06-17 and SR letter 01-17 for relevant information until it adopts FASB ASC Topic 326.

Reserve Banks are asked to distribute this letter to the supervised institutions in their districts, as well as to appropriate supervisory and examination staff. In addition, questions regarding this letter should be sent via the Board’s public website.<sup>6</sup>

Michael S. Gibson  
Director  
Division of Supervision and Regulation

## Attachments

- *Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023)*
- Federal Register notice (preamble and revised interagency policy statement)

---

<sup>4</sup> In accordance with ASU No. 2019-10, FASB ASC Topic 326 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, for public business entities that meet the definition of a Securities Exchange Commission (SEC) filer, excluding entities eligible to be small reporting companies as defined by the SEC. FASB ASC Topic 326 is effective for all other entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early application of FASB ASC Topic 326 is permitted as set forth in ASU 2016-13.

<sup>5</sup> The attached interagency policy statement does not include the “Loan Review Systems” guidance previously contained in Attachment 1 to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (See SR letter 06-17). The agencies have revised the “Loan Review Systems” guidance and issued it as stand-alone guidance. Refer to SR letter 20-13, “Interagency Guidance on Credit Risk Review Systems.”

<sup>6</sup> See <http://www.federalreserve.gov/apps/contactus/feedback.aspx>.

**Partially Supersedes:**

- SR letter 06-17, “Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)”
- SR letter 01-17, “Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions”

**Cross References to:**

- SR letter 20-13, “Interagency Guidance on Credit Risk Review Systems”
- SR letter 13-19 / CA letter 13-21, “Guidance on Managing Outsourcing Risk”
- SR letter 11-7, “Guidance on Model Risk Management”
- SR letter 95-42, “Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations”
- SR letter 95-4, “Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations”

## **Interagency Policy Statement on Allowances for Credit Losses (Revised April 2023)**

### **Purpose**

The Office of the Comptroller of the Currency (OCC), the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), and the National Credit Union Administration (NCUA) (collectively, the agencies) are issuing this Interagency Policy Statement on Allowances for Credit Losses (hereafter, the policy statement) to promote consistency in the interpretation and application of Financial Accounting Standards Board (FASB) Accounting Standards Update 2016-13, *Financial Instruments – Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, as well as the amendments issued since June 2016.<sup>1</sup> These updates are codified in Accounting Standards Codification (ASC) Topic 326, *Financial Instruments – Credit Losses* (FASB ASC Topic 326). FASB ASC Topic 326 applies to all banks, savings associations, credit unions, and financial institution holding companies (collectively, institutions), regardless of size, that file regulatory reports for which the reporting requirements conform to U.S. generally accepted accounting principles (GAAP).<sup>2</sup> This policy statement describes the measurement of expected credit losses in accordance with FASB ASC Topic 326; the design, documentation, and validation of expected credit loss estimation processes, including the internal controls over these processes; the maintenance of appropriate allowances for credit losses (ACLs); the responsibilities of boards of directors and management; and examiner reviews of ACLs.

---

<sup>1</sup> The FASB issued [Accounting Standards Update \(ASU\) 2016-13](#) on June 16, 2016. The following updates were published after the issuance of ASU 2016-13: [ASU 2018-19 – Codification Improvements to Topic 326, Financial Instruments—Credit Losses](#); [ASU 2019-04 – Codification Improvements to Topic 326, Financial Instruments—Credit Losses, Topic 815, Derivatives and Hedging, and Topic 825, Financial Instruments](#); [ASU 2019-05 – Financial Instruments – Credit Losses \(Topic 326\): Targeted Transition Relief](#); [ASU 2019-10 – Financial Instruments—Credit Losses \(Topic 326\), Derivatives and Hedging \(Topic 815\), and Leases \(Topic 842\): Effective Dates](#); [ASU 2019-11 – Codification Improvements to Topic 326, Financial Instruments—Credit Losses](#); and [ASU 2022-02, Financial Instruments – Credit Losses \(Topic 326\): Troubled Debt Restructurings and Vintage Disclosures](#). Additionally, institutions may refer to [FASB Staff Q&A-Topic 326, No. 1, Whether the Weighted-Average Remaining Maturity Method is an Acceptable Method to Estimate Expected Credit Losses](#), and [FASB Staff Q&A-Topic 326, No. 2, Developing an Estimate of Expected Credit Losses on Financial Assets](#).

<sup>2</sup> U.S. branches and agencies of foreign banking organizations may choose to, but are not required to, maintain ACLs on a branch or agency level. These institutions should refer to the instructions for the FFIEC 002, *Report of Assets and Liabilities of U. S. Branches and Agencies of Foreign Banks*; Supervision and Regulation (SR) Letter 95-4, *Allowance for Loan and Lease Losses for U. S. Branches and Agencies of Foreign Banking Organizations*; and SR Letter 95-42, *Allowance for Loan and Lease Losses for U.S. Branches and Agencies of Foreign Banking Organizations*.

This policy statement is effective at the time of each institution's adoption of FASB ASC Topic 326.<sup>3</sup> The following policy statements are no longer effective for an institution upon its adoption of FASB ASC Topic 326: the 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 (collectively, ALLL Policy Statements). After FASB ASC Topic 326 is effective for all institutions, the agencies will rescind the ALLL Policy Statements.

The principles described in this policy statement are consistent with GAAP, applicable regulatory reporting requirements,<sup>4</sup> safe and sound banking practices, and the agencies' codified guidelines establishing standards for safety and soundness.<sup>5</sup> The operational and managerial standards included in those guidelines, which address such matters as internal controls and information systems, an internal audit system, loan documentation, credit underwriting, asset quality, and earnings, should be appropriate for an institution's size and the nature, scope, and risk of its activities.

## Scope

This policy statement describes the current expected credit losses (CECL) methodology for determining the ACLs applicable to loans held-for-investment, net investments in leases, and held-to-maturity debt securities accounted for at amortized cost.<sup>6</sup> It also describes the estimation

---

<sup>3</sup> As noted in Accounting Standards Update 2019-10, FASB ASC Topic 326 is effective for fiscal years beginning after December 15, 2019, including interim periods within those fiscal years, for public business entities that meet the definition of a Securities Exchange Commission (SEC) filer, excluding entities eligible to be small reporting companies as defined by the SEC. FASB ASC Topic 326 is effective for all other entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. For all entities, early application of FASB ASC Topic 326 is permitted as set forth in ASU 2016-13.

<sup>4</sup> For FDIC-insured depository institutions, section 37(a) of the Federal Deposit Insurance Act (12 U.S.C. 1831n(a)) states that, in general, the accounting principles applicable to the Consolidated Reports of Condition and Income (Call Report) "shall be uniform and consistent with generally accepted accounting principles." Section 202(a)(6)(C) of the Federal Credit Union Act (12 U.S.C. 1782(a)(6)(C)) establishes the same standard for federally insured credit unions with assets of \$10 million or greater, providing that, in general, the "[a]ccounting principles applicable to reports or statements required to be filed with the [NCUA] Board by each insured credit union shall be uniform and consistent with generally accepted accounting principles." Furthermore, regardless of asset size, all federally insured credit unions must comply with GAAP for certain financial reporting requirements relating to charges for loan losses. See 12 CFR 702.113(d).

<sup>5</sup> FDIC-insured depository institutions should refer to the *Interagency Guidelines Establishing Standards for Safety and Soundness* adopted by their primary federal regulator pursuant to section 39 of the Federal Deposit Insurance Act (12 U.S.C. 1831p-1) as follows: For national banks and federal savings associations, Appendix A to 12 CFR part 30; for state member banks, Appendix D to 12 CFR part 208; and for state nonmember banks, state savings associations, and insured state-licensed branches of foreign banks, Appendix A to 12 CFR part 364. Federally insured credit unions should refer to section 206(b)(1) of the Federal Credit Union Act (12 U.S.C. 1786) and 12 CFR 741.3.

<sup>6</sup> FASB ASC Topic 326 defines the amortized cost basis as the amount at which a financing receivable or investment is originated or acquired, adjusted for applicable accrued interest, accretion, or amortization of premium, discount, and net deferred fees or costs, collection of cash, write-offs, foreign exchange, and fair value hedge accounting adjustments.

of the ACL for an available-for-sale debt security in accordance with FASB ASC Subtopic 326-30. This policy statement does not address or supersede existing agency requirements or guidance regarding appropriate due diligence in connection with the purchase or sale of assets or determining whether assets are permissible to be purchased or held by institutions.<sup>7</sup>

The CECL methodology described in FASB ASC Topic 326 applies to financial assets measured at amortized cost, net investments in leases, and off-balance-sheet credit exposures (collectively, financial assets) including:

- Financing receivables such as loans held-for-investment;
- Overdrawn deposit accounts (i.e. overdrafts) that are reclassified as held-for-investment loans;
- Held-to-maturity debt securities;
- Receivables that result from revenue transactions within the scope of Topic 606 on revenue from contracts with customers and Topic 610 on other income, which applies, for example, to the sale of foreclosed real estate;
- Reinsurance recoverables that result from insurance transactions within the scope of Topic 944 on insurance;
- Receivables related to repurchase agreements and securities lending agreements within the scope of Topic 860 on transfers and servicing;
- Net investments in leases recognized by a lessor in accordance with Topic 842 on leases; and
- Off-balance-sheet credit exposures including off-balance-sheet loan commitments, standby letters of credit, financial guarantees not accounted for as insurance, and other similar instruments except for those within the scope of Topic 815 on derivatives and hedging.

The CECL methodology does not apply to the following financial assets:

- Financial assets measured at fair value through net income, including those assets for which the fair value option has been elected;
- Available-for-sale debt securities;<sup>8</sup>
- Loans held-for-sale;
- Policy loan receivables of an insurance entity;

---

<sup>7</sup> See the final guidance attached to OCC Bulletin 2012-18, *Guidance on Due Diligence Requirements in Determining Whether Securities Are Eligible for Investment* (for national banks and federal savings associations), 12 CFR part 1, *Investment Securities* (for national banks), and 12 CFR part 160, *Lending and Investment* (for federal savings associations). Federal credit unions should refer to 12 CFR part 703, *Investment and Deposit Activities*. Federally insured, state-chartered credit unions should refer to applicable state laws and regulations, as well as 12 CFR 741.219 (“investment requirements”).

<sup>8</sup> Refer to FASB ASC Subtopic 326-30, Financial Instruments – Credit Losses – Available-for-Sale Debt Securities (FASB ASC Subtopic 326-30).

- Loans and receivables between entities under common control; and
- Receivables arising from operating leases.

## **Measurement of ACLs for Loans, Leases, Held-to-Maturity Debt Securities, and Off-Balance-Sheet Credit Exposures**

### *Overview of ACLs*

An ACL is a valuation account that is deducted from, or added to, the amortized cost basis of financial assets to present the net amount expected to be collected over the contractual term<sup>9</sup> of the assets. In estimating the net amount expected to be collected, management should consider the effects of past events, current conditions, and reasonable and supportable forecasts on the collectibility of the institution's financial assets.<sup>10</sup> FASB ASC Topic 326 requires management to use relevant forward-looking information and expectations drawn from reasonable and supportable forecasts when estimating expected credit losses.

ACLs are evaluated as of the end of each reporting period. The methods used to determine ACLs generally should be applied consistently over time and reflect management's current expectations of credit losses. Changes to ACLs resulting from these periodic evaluations are recorded through increases or decreases to the related provisions for credit losses (PCLs). When available information confirms that specific loans, securities, other assets, or portions thereof, are uncollectible, these amounts should be promptly written off<sup>11</sup> against the related ACLs.

Estimating appropriate ACLs involves a high degree of management judgment and is inherently imprecise. An institution's process for determining appropriate ACLs may result in a range of estimates for expected credit losses. An institution should support and record its best estimate within the range of expected credit losses.

### *Collective Evaluation of Expected Losses*

FASB ASC Topic 326 requires expected losses to be evaluated on a collective, or pool, basis when financial assets share similar risk characteristics. Financial assets may be segmented based on one characteristic, or a combination of characteristics.

Examples of risk characteristics relevant to this evaluation include, but are not limited to:

---

<sup>9</sup> Consistent with FASB ASC Topic 326, an institution's determination of the contractual term should reflect the financial asset's contractual life adjusted for prepayments and renewal and extension options that are not unconditionally cancellable by the institution. For more information, see the "Contractual Term of a Financial Asset" section in this policy statement.

<sup>10</sup> Recoveries are a component of management's estimation of the net amount expected to be collected for a financial asset. Expected recoveries of amounts previously written off or expected to be written off that are included in ACLs may not exceed the aggregate amounts previously written off or expected to be written off. In some circumstances, the ACL for a specific portfolio or loan may be negative because the amount expected to be collected, including expected recoveries, exceeds the financial asset's amortized cost basis.

<sup>11</sup> Consistent with FASB ASC Topic 326, this policy statement uses the verbs "write off" and "written off" and the noun "write-off." These terms are used interchangeably with "charge off," "charged off," and "charge-off," respectively, in the agencies' regulations, guidance, and regulatory reporting instructions.

- Internal or external credit scores or credit ratings;
- Risk ratings or classifications;
- Financial asset type;
- Collateral type;
- Size;
- Effective interest rate;
- Term;
- Geographical location;
- Industry of the borrower; and
- Vintage.

Other risk characteristics that may be relevant for segmenting held-to-maturity debt securities include issuer, maturity, coupon rate, yield, payment frequency, source of repayment, bond payment structure, and embedded options.

FASB ASC Topic 326 does not prescribe a process for segmenting financial assets for collective evaluation. Therefore, management should exercise judgment when establishing appropriate segments or pools. Management should evaluate financial asset segmentation on an ongoing basis to determine whether the financial assets in the pool continue to share similar risk characteristics. If a financial asset ceases to share risk characteristics with other assets in its segment, it should be moved to a different segment with assets sharing similar risk characteristics if such a segment exists.

If a financial asset does not share similar risk characteristics with other assets, expected credit losses for that asset should be evaluated individually. Individually evaluated assets should not be included in a collective assessment of expected credit losses.

#### *Estimation Methods for Expected Credit Losses*

FASB ASC Topic 326 does not require the use of a specific loss estimation method for purposes of determining ACLs. Various methods may be used to estimate the expected collectibility of financial assets, with those methods generally applied consistently over time. The same loss estimation method does not need to be applied to all financial assets. Management is not precluded from selecting a different method when it determines the method will result in a better estimate of ACLs.

Management may use a loss-rate method,<sup>12</sup> probability of default/loss given default (PD/LGD) method, roll-rate method, discounted cash flow method, a method that uses aging schedules, or another reasonable method to estimate expected credit losses. The selected

---

<sup>12</sup> Various loss-rate methods may be used to estimate expected credit losses under the CECL methodology. These include the weighted-average remaining maturity (WARM) method, vintage analysis, and the snapshot or open pool method.



method(s) should be appropriate for the financial assets being evaluated, consistent with the institution's size and complexity.

#### *Contractual Term of a Financial Asset*

FASB ASC Topic 326 requires an institution to measure estimated expected credit losses over the contractual term of its financial assets, considering expected prepayments. Renewals, extensions, and modifications are excluded from the contractual term of a financial asset for purposes of estimating the ACL unless the renewal and extension options are part of the original or modified contract and are not unconditionally cancellable by the institution. If such renewal or extension options are present, management must evaluate the likelihood of a borrower exercising those options when determining the contractual term.

#### *Historical Loss Information*

Historical loss information generally provides a basis for an institution's assessment of expected credit losses. Historical loss information may be based on internal information, external information, or a combination of both. Management should consider whether the historical loss information may need to be adjusted for differences in current asset specific characteristics such as differences in underwriting standards, portfolio mix, or when historical asset terms do not reflect the contractual terms of the financial assets being evaluated as of the reporting date.

Management should then consider whether further adjustments to historical loss information are needed to reflect the extent to which current conditions and reasonable and supportable forecasts differ from the conditions that existed during the historical loss period. Adjustments to historical loss information may be quantitative or qualitative in nature and should reflect changes to relevant data (such as changes in unemployment rates, delinquency, or other factors associated with the financial assets).

#### *Reasonable and Supportable Forecasts*

When estimating expected credit losses, FASB ASC Topic 326 requires management to consider forward-looking information that is both reasonable and supportable and relevant to assessing the collectibility of cash flows. Reasonable and supportable forecasts may extend over the entire contractual term of a financial asset or a period shorter than the contractual term. FASB ASC Topic 326 does not prescribe a specific method for determining reasonable and supportable forecasts nor does it include bright lines for establishing a minimum or maximum length of time for reasonable and supportable forecast period(s). Judgment is necessary in determining an appropriate period(s) for each institution. Reasonable and supportable forecasts may vary by portfolio segment or individual forecast input. These forecasts may include data from internal sources, external sources, or a combination of both. Management is not required to search for all possible information nor incur undue cost and effort to collect data for its forecasts. However, reasonably available and relevant information should not be ignored in assessing the collectibility of cash flows. Management should evaluate the appropriateness of the reasonable and supportable forecast period(s) each reporting period, consistent with other inputs used in the estimation of expected credit losses.

Institutions may develop reasonable and supportable forecasts by using one or more economic scenarios. FASB ASC Topic 326 does not require the use of multiple economic scenarios; however, institutions are not precluded from considering multiple economic scenarios when estimating expected credit losses.

### *Reversion*

When the contractual term of a financial asset extends beyond the reasonable and supportable period, FASB ASC Topic 326 requires reverting to historical loss information, or an appropriate proxy, for those periods beyond the reasonable and supportable forecast period (often referred to as the reversion period). Management may revert to historical loss information for each individual forecast input or based on the entire estimate of loss.

FASB ASC Topic 326 does not require the application of a specific reversion technique or use of a specific reversion period. Reversion to historical loss information may be immediate, occur on a straight-line basis, or use any systematic, rational method. Management may apply different reversion techniques depending on the economic environment or the financial asset portfolio. Reversion techniques are not accounting policy elections and should be evaluated for appropriateness each reporting period, consistent with other inputs used in the estimation of expected credit losses.

FASB ASC Topic 326 does not specify the historical loss information that is used in the reversion period. This historical loss information may be based on long-term average losses or on losses that occurred during a particular historical period(s). Management may use multiple historical periods that are not sequential. Management should not adjust historical loss information for existing economic conditions or expectations of future economic conditions for periods beyond the reasonable and supportable period. However, management should consider whether the historical loss information may need to be adjusted for differences in current asset specific characteristics such as differences in underwriting standards, portfolio mix, or when historical asset terms do not reflect the contractual terms of the financial assets being evaluated as of the reporting date.

### *Qualitative Factor Adjustments*

The estimation of ACLs should reflect consideration of all significant factors relevant to the expected collectibility of the institution's financial assets as of the reporting date. Management may begin the expected credit loss estimation process by determining its historical loss information or obtaining reliable and relevant historical loss proxy data for each segment of financial assets with similar risk characteristics. Historical credit losses (or even recent trends in losses) generally do not, by themselves, form a sufficient basis to determine the appropriate levels for ACLs.

Management should consider the need to qualitatively adjust expected credit loss estimates for information not already captured in the loss estimation process. These qualitative factor adjustments may increase or decrease management's estimate of expected credit losses. Adjustments should not be made for information that has already been considered and included in the loss estimation process.

Management should consider the qualitative factors that are relevant to the institution as of the reporting date, which may include, but are not limited to:

- The nature and volume of the institution’s financial assets;
- The existence, growth, and effect of any concentrations of credit;
- The volume and severity of past due financial assets, the volume of nonaccrual assets, and the volume and severity of adversely classified or graded assets;<sup>13</sup>
- The value of the underlying collateral for loans that are not collateral-dependent;<sup>14</sup>
- The institution’s lending policies and procedures, including changes in underwriting standards and practices for collections, write-offs, and recoveries;
- The quality of the institution’s credit review function;
- The experience, ability, and depth of the institution’s lending, investment, collection, and other relevant management and staff;
- The effect of other external factors such as the regulatory, legal and technological environments; competition; and events such as natural disasters; and
- Actual and expected changes in international, national, regional, and local economic and business conditions and developments<sup>15</sup> in which the institution operates that affect the collectibility of financial assets.

Management may consider the following additional qualitative factors specific to held-to-maturity debt securities as of the reporting date:<sup>16</sup>

- The effect of recent changes in investment strategies and policies;
- The existence and effect of loss allocation methods, the definition of default, the impact of performance and market value triggers, and credit and liquidity enhancements associated with debt securities;

---

<sup>13</sup> For banks and savings associations, adversely classified or graded loans are loans rated “substandard” (or its equivalent) or worse under the institution’s loan classification system. For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution’s credit grading system, i.e., those loans that tend to be included in the credit union’s “watch lists.” Criteria related to the classification of an investment security may be found in the interagency policy statement *Uniform Agreement on the Classification and Appraisal of Securities Held by Depository Institutions* issued by the FDIC, Board, and OCC in October 2013.

<sup>14</sup> See the “Collateral-Dependent Financial Assets” section of this policy statement for more information on collateral-dependent loans.

<sup>15</sup> Changes in economic and business conditions and developments included in qualitative factor adjustments are limited to those that affect the collectibility of an institution’s financial assets and are relevant to the institution’s financial asset portfolios. For example, an economic factor for current or forecasted unemployment at the national or state level may indicate a strong job market based on low national or state unemployment rates, but a local unemployment rate, which may be significantly higher, for example, because of the actual or forecasted loss of a major local employer may be more relevant to the collectibility of an institution’s financial assets.

<sup>16</sup> This list is not all-inclusive, and all of the factors listed may not be relevant to all institutions.

- The effect of structural subordination and collateral deterioration on tranche performance of debt securities;
- The quality of underwriting for any collateral backing debt securities; and
- The effect of legal covenants associated with debt securities.

Changes in the level of an institution's ACLs may not always be directionally consistent with changes in the level of qualitative factor adjustments due to the incorporation of reasonable and supportable forecasts in estimating expected losses. For example, if improving credit quality trends are evident throughout an institution's portfolio in recent years, but management's evaluation of reasonable and supportable forecasts indicates expected deterioration in credit quality of the institution's financial assets during the forecast period, the ACL as a percentage of the portfolio may increase.

### *Collateral-Dependent Financial Assets*

FASB ASC Topic 326 describes a collateral-dependent asset as a financial asset for which the repayment is expected to be provided substantially through the operation or sale of the collateral when the borrower, based on management's assessment, is experiencing financial difficulty as of the reporting date. 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.<sup>17</sup>

When estimating the ACL for a collateral-dependent loan, FASB ASC Topic 326 requires the fair value of collateral to be adjusted to consider estimated costs to sell if repayment or satisfaction of the loan depends on the sale of the collateral. ACL adjustments for estimated costs to sell are not appropriate when the repayment of a collateral-dependent loan is expected from the operation of the collateral.

The fair value of collateral securing a collateral-dependent loan may change over time. If the fair value of the collateral as of the ACL evaluation date has decreased since the previous ACL evaluation date, the ACL should be increased to reflect the additional decrease in the fair value of the collateral. Likewise, if the fair value of the collateral has increased as of the ACL evaluation date, the increase in the fair value of the collateral is reflected through a reduction in the ACL. Any negative ACL that results is capped at the amount previously written off. Changes in the fair value of collateral described herein should be supported and documented through recent appraisals or evaluations.<sup>18</sup>

---

<sup>17</sup> The agencies, at times, prescribe specific regulatory reporting requirements that fall within a range of acceptable practice under GAAP. These specific reporting requirements, such as the requirement for institutions to apply the practical expedient in ASC 326-20-35-5 for collateral-dependent loans, regardless of whether foreclosure is probable, have been adopted to achieve safety and soundness and other public policy objectives and to ensure comparability among institutions. The regulatory reporting requirement to apply the practical expedient for collateral-dependent financial assets is consistent with the agencies' long-standing practice for collateral-dependent loans, and it continues to be limited to collateral-dependent loans. It does not apply to other financial assets such as held-to-maturity debt securities that are collateral-dependent.

<sup>18</sup> For more information on regulatory expectations related to the use of appraisals and evaluations, see the *Interagency Appraisal and Evaluation Guidelines* published on December 10, 2010. Insured depository institutions

### *Purchased Credit-Deteriorated Assets*

FASB ASC Topic 326 introduces the concept of purchased credit-deteriorated (PCD) assets. PCD assets are acquired financial assets that, at acquisition, have experienced more-than-insignificant deterioration in credit quality since origination. FASB ASC Topic 326 does not provide a prescriptive definition of more-than-insignificant credit deterioration. The acquiring institution's management should establish and document a reasonable process to consistently determine what constitutes a more-than-insignificant deterioration in credit quality.

When recording the acquisition of PCD assets, the amount of expected credit losses as of the acquisition date is added to the purchase price of the financial assets rather than recording these losses through PCLs. This establishes the amortized cost basis of the PCD assets. Any difference between the unpaid principal balance of the PCD assets and the amortized cost basis of the assets as of the acquisition date is the non-credit discount or premium. The initial ACL and non-credit discount or premium determined on a collective basis at the acquisition date are allocated to the individual PCD assets.

After acquisition, ACLs for PCD assets should be adjusted at each reporting date with a corresponding debit or credit to the PCLs to reflect management's current estimate of expected credit losses. The non-credit discount recorded at acquisition will be accreted into interest income over the remaining life of the PCD assets on a level-yield basis.

### *Financial Assets with Collateral Maintenance Agreements*

Institutions may have financial assets that are secured by collateral (such as debt securities) and are subject to collateral maintenance agreements requiring the borrower to continuously replenish the amount of collateral securing the asset. If the fair value of the collateral declines, the borrower is required to provide additional collateral as specified by the agreement.

FASB ASC Topic 326 includes a practical expedient for financial assets with collateral maintenance agreements where the borrower is required to provide collateral greater than or equal to the amortized cost basis of the asset and is expected to continuously replenish the collateral. In those cases, management may elect the collateral maintenance practical expedient and measure expected credit losses for these qualifying assets based on the fair value of the collateral.<sup>19</sup> If the fair value of the collateral is greater than the amortized cost basis of the financial asset and management expects the borrower to replenish collateral as needed, management may record an ACL of zero for the financial asset when the collateral maintenance practical expedient is applied. Similarly, if the fair value of the collateral is less than the

---

should also refer to the interagency regulations on appraisals adopted by their primary federal regulator as follows: For national banks and federal savings associations, Subpart C of 12 CFR part 34; for state member banks, 12 CFR parts 208 and 225; for state nonmember banks, state savings associations, and insured state-licensed branches of foreign banks, 12 CFR part 323; and for federally insured credit unions, 12 CFR part 722.

<sup>19</sup> For example, an institution enters into a reverse repurchase agreement with a collateral maintenance agreement. Management may not need to record the expected credit losses at each reporting date as long as the fair value of the security collateral is greater than the amortized cost basis of the reverse repurchase agreement. Refer to ASC 326-20-55-46 for more information.

amortized cost basis of the financial asset and management expects the borrower to replenish collateral as needed, the ACL is limited to the difference between the fair value of the collateral and the amortized cost basis of the asset as of the reporting date when applying the collateral maintenance practical expedient.

#### *Accrued Interest Receivable*

FASB ASC Topic 326 includes accrued interest receivable in the amortized cost basis of a financial asset. As a result, accrued interest receivable is included in the amounts for which ACLs are estimated. Generally, any accrued interest receivable that is not collectible is written off against the related ACL.

FASB ASC Topic 326 permits a series of independent accounting policy elections related to accrued interest receivable that alter the accounting treatment described in the preceding paragraph. These elections are made upon adoption of FASB ASC Topic 326 and may differ by class of financing receivable or major security-type level. The available accounting policy elections<sup>20</sup> are:

- Management may elect not to measure ACLs for accrued interest receivable if uncollectible accrued interest is written off in a timely manner. Management should define and document its definition of a timely write-off.
- Management may elect to write off accrued interest receivable by either reversing interest income, recognizing the loss through PCLs, or through a combination of both methods.
- Management may elect to separately present accrued interest receivable from the associated financial asset in its regulatory reports and financial statements, if applicable. The accrued interest receivable is presented net of ACLs (if any).

#### *Financial Assets with Zero Credit Loss Expectations*

There may be certain financial assets for which the expectation of credit loss is zero after evaluating historical loss information, making necessary adjustments for current conditions and reasonable and supportable forecasts, and considering any collateral or guarantee arrangements that are not free-standing contracts. Factors to consider when evaluating whether expectations of zero credit loss are appropriate may include, but are not limited to:

- A long history of zero credit loss;
- A financial asset that is fully secured by cash or cash equivalents;
- High credit ratings from rating agencies with no expected future downgrade;<sup>21</sup>
- Principal and interest payments that are guaranteed by the U.S. government;

---

<sup>20</sup> The accounting policy elections related to accrued interest receivable that are described in this paragraph also apply to accrued interest receivable for an available-for-sale debt security that, for purposes of identifying and measuring an impairment, exclude the applicable accrued interest from both the fair value and amortized cost basis of the securities.

<sup>21</sup> Management should not rely solely on credit rating agencies but should also make its own assessment based on third party research, default statistics, and other data that may indicate a decline in credit rating.

- The issuer, guarantor, or sponsor can print its own currency and the currency is held by other central banks as reserve currency; and
- The interest rate on the security is recognized as a risk-free rate.

A loan that is fully secured by cash or cash equivalents, such as certificates of deposit issued by the lending institution, would likely have zero credit loss expectations. Similarly, the guaranteed portion of a U.S. Small Business Administration (SBA) loan or security purchased on the secondary market through the SBA's fiscal and transfer agent would likely have zero credit loss expectations if these financial assets are unconditionally guaranteed by the U.S. government. Examples of held-to-maturity debt securities that may result in expectations of zero credit loss include U.S. Treasury securities as well as mortgage-backed securities issued and guaranteed by the Government National Mortgage Association, the Federal Home Loan Mortgage Corporation, and the Federal National Mortgage Association. Assumptions related to zero credit loss expectations should be included in the institution's ACL documentation.

#### *Estimated Credit Losses for Off-Balance-Sheet Credit Exposures*

FASB ASC Topic 326 requires that an institution estimate expected credit losses for off-balance-sheet credit exposures within the scope of FASB ASC Topic 326 over the contractual period during which the institution is exposed to credit risk. The estimate of expected credit losses should take into consideration the likelihood that funding will occur as well as the amount expected to be funded over the estimated remaining contractual term of the off-balance-sheet credit exposures. Management should not record an estimate of expected credit losses for off-balance-sheet exposures that are unconditionally cancellable by the issuer.

Management must evaluate expected credit losses for off-balance-sheet credit exposures as of each reporting date. While the process for estimating expected credit losses for these exposures is similar to the one used for on-balance-sheet financial assets, these estimated credit losses are not recorded as part of the ACLs because cash has not yet been disbursed to fund the contractual obligation to extend credit. Instead, these loss estimates are recorded as a liability, separate and distinct from the ACLs.<sup>22</sup> The amount needed to adjust the liability for expected credit losses for off-balance-sheet credit exposures as of each reporting date is reported in net income.

#### **Measurement of the ACL for Available-for-Sale Debt Securities**

FASB ASC Subtopic 326-30, *Financial Instruments – Credit Losses – Available-for-Sale Debt Securities* (FASB ASC Subtopic 326-30) describes the accounting for expected credit losses associated with available-for-sale debt securities. Credit losses for available-for-sale debt securities are evaluated as of each reporting date when the fair value is less than amortized cost. FASB ASC Subtopic 326-30 requires credit losses to be calculated individually, rather than collectively, using a discounted cash flow method, through which management compares the present value of expected cash flows with the amortized cost basis of the security. An ACL is

---

<sup>22</sup> The ACL associated with off-balance-sheet credit exposures is included in the "Allowance for credit losses on off-balance-sheet credit exposures" in *Schedule RC-G – Other Liabilities* in the Call Report and in the *Liabilities* schedule in NCUA Call Report Form 5300.

established, with a charge to the PCL, to reflect the credit loss component of the decline in fair value below amortized cost. If the fair value of the security increases over time, any ACL that has not been written off may be reversed through a credit to the PCL. The ACL for an available-for-sale debt security is limited by the amount that the fair value is less than the amortized cost, which is referred to as the fair value floor.

If management intends to sell an available-for-sale debt security or will more likely than not be required to sell the security before recovery of the amortized cost basis, the security's ACL should be written off and the amortized cost basis of the security should be written down to its fair value at the reporting date with any incremental impairment reported in income.

A change during the reporting period in the non-credit component of any decline in fair value below amortized cost on an available-for-sale debt security is reported in other comprehensive income, net of applicable income taxes.<sup>23</sup>

When evaluating impairment for available-for-sale debt securities, management may evaluate the amortized cost basis including accrued interest receivable, or may evaluate the accrued interest receivable separately from the remaining amortized cost basis. If evaluated separately, accrued interest receivable is excluded from both the fair value of the available-for-sale debt security and its amortized cost basis.<sup>24</sup>

## **Documentation Standards**

For financial and regulatory reporting purposes, ACLs and PCLs must be determined in accordance with GAAP. ACLs and PCLs should be well documented, with clear explanations of the supporting analyses and rationale. Sound policies, procedures, and control systems should be appropriately tailored to an institution's size and complexity, organizational structure, business environment and strategy, risk appetite, financial asset characteristics, loan administration procedures, investment strategy, and management information systems.<sup>25</sup> Maintaining, analyzing, supporting, and documenting appropriate ACLs and PCLs in accordance with GAAP is consistent with safe and sound banking practices.

The policies and procedures governing an institution's ACL processes and the controls over these processes should be designed, implemented, and maintained to reasonably estimate expected credit losses for financial assets and off-balance-sheet credit exposures as of the reporting date. The policies and procedures should describe management's processes for evaluating the credit quality and collectibility of financial asset portfolios, including reasonable and supportable forecasts about changes in the credit quality of these portfolios, through a disciplined and consistently applied process that results in an appropriate estimate of the ACLs.

---

<sup>23</sup> Non-credit impairment on an available-for-sale debt security that is not required to be recorded through the ACL should be reported in other comprehensive income as described in ASC 326-30-35-2.

<sup>24</sup> The accounting policy elections described in the "Accrued Interest Receivable" section of this policy statement apply to accrued interest receivable recorded for an available-for-sale debt security if an institution excludes applicable accrued interest receivable from both the fair value and amortized cost basis of the security for purposes of identifying and measuring impairment.

<sup>25</sup> Management often documents policies, procedures, and controls related to ACLs in accounting or credit risk management policies, or a combination thereof.



Management should review and, as needed, revise the institution's ACL policies and procedures at least annually, or more frequently if necessary.

An institution's policies and procedures for the systems, processes, and controls necessary to maintain appropriate ACLs should address, but not be limited to:

- Processes that support the determination and maintenance of appropriate levels for ACLs that are based on a comprehensive, well-documented, and consistently applied analysis of an institution's financial asset portfolios and off-balance-sheet credit exposures. The analyses and loss estimation processes used should consider all significant factors that affect the credit risk and collectibility of the financial asset portfolios;
- The roles, responsibilities, and segregation of duties of the institution's senior management and other personnel who provide input into ACL processes, determine ACLs, or review ACLs. These departments and individuals may include accounting, financial reporting, treasury, investment management, lending, special asset or problem loan workout teams, retail collections and foreclosure groups, credit review, model risk management, internal audit, and others, as applicable. Individuals with responsibilities related to the estimation of ACLs should be competent and well-trained, with the ability to escalate material issues;
- Processes for determining the appropriate historical period(s) to use as the basis for estimating expected credit losses and approaches for adjusting historical credit loss information to reflect differences in asset specific characteristics, as well as current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period(s);
- Processes for determining and revising the appropriate techniques and periods 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(s);
- Processes for segmenting financial assets for estimating expected credit losses and periodically evaluating the segments to determine whether the assets continue to share similar risk characteristics;
- Data capture and reporting systems that supply the quality and breadth of relevant and reliable information necessary, whether obtained internally or externally, to support and document the estimates of appropriate ACLs for regulatory reporting requirements and, if applicable, financial statement and disclosure requirements;
- The description of the institution's systematic and logical loss estimation process(es) for determining and consolidating expected credit losses to ensure that the ACLs are recorded in accordance with GAAP and regulatory reporting requirements. This may include, but is not limited to:
  - Management's judgments, accounting policy elections, and application of practical expedients in determining the amount of expected credit losses;
  - The process for determining when a loan is collateral-dependent;

- The process for determining the fair value of collateral, if any, used as an input when estimating the ACL, including the basis for making any adjustments to the market value conclusion and how costs to sell, if applicable, are calculated;
- The process for determining when a financial asset has zero credit loss expectations;
- The process for determining expected credit losses when a financial asset has a collateral maintenance provision; and
- A description of and support for qualitative factors that affect collectibility of financial assets;
- Procedures for validating and independently reviewing the loss estimation process as well as any changes to the process from prior periods;
- Policies and procedures for the prompt write-off of financial assets, or portions of financial assets, when available information confirms the assets to be uncollectible, consistent with regulatory reporting requirements; and
- The systems of internal controls used to confirm that the ACL processes are maintained and periodically adjusted in accordance with GAAP and interagency guidelines establishing standards for safety and soundness.

Internal control systems for the ACL estimation processes should:

- Provide reasonable assurance regarding the relevance, reliability, and integrity of data and other information used in estimating expected credit losses;
- Provide reasonable assurance of compliance with laws, regulations, and the institution's policies and procedures;
- Provide reasonable assurance that the institution's financial statements are prepared in accordance with GAAP, and the institution's regulatory reports are prepared in accordance with the applicable instructions;
- Include a well-defined and effective loan review and grading process that is consistently applied and identifies, measures, monitors, and reports asset quality problems in an accurate, sound and timely manner. The loan review process should respond to changes in internal and external factors affecting the level of credit risk in the portfolio; and
- Include a well-defined and effective process for monitoring credit quality in the debt securities portfolio.

### **Analyzing and Validating the Overall Measurement of ACLs**

To ensure that ACLs are presented fairly, in accordance with GAAP and regulatory reporting requirements, and are transparent for regulatory examinations, management should document its measurements of the amounts of ACLs reported in regulatory reports and financial statements, if applicable, for each type of financial asset (e.g., loans, held-to-maturity debt securities, and available-for-sale debt securities) and for off-balance-sheet credit exposures. This documentation should include ACL calculations, qualitative adjustments, and any adjustments to the ACLs that are required as part of the internal review and challenge process. The board of directors, or a committee thereof, should review management's assessments of and justifications for the reported amounts of ACLs.

Various techniques are available to assist management in analyzing and evaluating the ACLs. For example, comparing estimates of expected credit losses to actual write-offs in aggregate, and by portfolio, may enable management to assess whether the institution's loss estimation process is sufficiently designed.<sup>26</sup> Further, comparing the estimate of ACLs to actual write-offs at the financial asset portfolio level allows management to analyze changing portfolio characteristics, such as the volume of assets or increases in write-off rates, which may affect future forecast adjustments. Techniques applied in these instances do not have to be complex to be effective, but, if used, should be commensurate with the institution's size and complexity.

Ratio analysis may also be useful for evaluating the overall reasonableness of ACLs. Ratio analysis assists in identifying divergent or emerging trends in the relationship of ACLs to other factors such as adversely classified or graded loans, past due and nonaccrual loans, total loans, historical gross write-offs, net write-offs, and historic delinquency and default trends for securities.

Comparing the institution's ACLs to those of peer institutions may provide management with limited insight into management's own ACL estimates. Management should apply caution when performing peer comparisons as there may be significant differences among peer institutions in the mix of financial asset portfolios, reasonable and supportable forecast period assumptions, reversion techniques, the data used for historical loss information, and other factors.

When used prudently, comparisons of estimated expected losses to actual write-offs, ratio analysis, and peer comparisons can be helpful as a supplemental check on the reasonableness of management's assumptions and analyses. Because appropriate ACLs are institution-specific estimates, the use of comparisons does not eliminate the need for a comprehensive analysis of financial asset portfolios and the factors affecting their collectibility.

When an appropriate expected credit loss framework has been used to estimate expected credit losses, it is inappropriate for the board of directors or management to make further adjustments to ACLs for the sole purpose of reporting ACLs that correspond to a peer group median, a target ratio, or a budgeted amount. Additionally, neither the board of directors nor management should further adjust ACLs beyond what has been appropriately measured and documented in accordance with FASB ASC Topic 326.

After analyzing ACLs, management should periodically validate the loss estimation process, and any changes to the process, to confirm that the process remains appropriate for the institution's size, complexity, and risk profile. The validation process should include procedures for review by a party with appropriate knowledge, technical expertise, and experience who is independent of the institution's credit approval and ACL estimation processes. A party who is independent of these processes could be from internal audit staff, a risk management unit of the institution independent of management supervising these processes, or a contracted third-party.

---

<sup>26</sup> Institutions using models in the loss estimation process may incorporate a qualitative factor adjustment in the estimate of expected credit losses to capture the variance between modeled credit loss expectations and actual historical losses when the model is still considered predictive and fit for use. Institutions should monitor this variance, as well as changes to the variance, to determine if the variance is significant or material enough to warrant further changes to the model.

One party need not perform the entire analysis as the validation may be divided among various independent parties.<sup>27</sup>

### **Responsibilities of the Board of Directors**

The board of directors, or a committee thereof, is responsible for overseeing management's significant judgments and estimates used in determining appropriate ACLs. Evidence of the board of directors' oversight activities is subject to review by examiners. These activities should include, but are not limited to:

- Retaining experienced and qualified management to oversee all ACL and PCL activities;
- Reviewing and approving the institution's written loss estimation policies, including any revisions thereto, at least annually;
- Reviewing management's assessment of the loan review system and management's conclusion and support for whether the system is sound and appropriate for the institution's size and complexity;
- Reviewing management's assessment of the effectiveness of processes and controls for monitoring the credit quality of the investment portfolio;
- Reviewing management's assessments of and justifications for the estimated amounts reported each period for the ACLs and the PCLs;
- Requiring management to periodically validate, and, when appropriate, revise loss estimation methods;
- Approving the internal and external audit plans for the ACLs, as applicable; and
- Reviewing any identified audit findings and monitoring resolution of those items.

### **Responsibilities of Management**

Management is responsible for maintaining ACLs at appropriate levels and for documenting its analyses in accordance with the concepts and requirements set forth in GAAP, regulatory reporting requirements, and this policy statement. Management should evaluate the ACLs reported on the balance sheet as of the end of each period (and for credit unions, prior to paying dividends), and debit or credit the related PCLs to bring the ACLs to an appropriate level as of each reporting date. The determination of the amounts of the ACLs and the PCLs should be based on management's current judgments about the credit quality of the institution's financial assets and should consider known and expected relevant internal and external factors that significantly affect collectibility over reasonable and supportable forecast periods for the institution's financial assets as well as appropriate reversion techniques applied to periods beyond the reasonable and supportable forecast periods. Management's evaluations are subject to review by examiners.

---

<sup>27</sup> Engaging the institution's external auditor to perform the validation process described in this paragraph when the external auditor also conducts the institution's independent financial statement audit, may impair the auditor's independence under applicable auditor independence standards and prevent the auditor from performing an independent audit of the institution's financial statements.

In carrying out its responsibility for maintaining appropriate ACLs, management should adopt and adhere to written policies and procedures that are appropriate to the institution's size and the nature, scope, and risk of its lending and investing activities. These policies and procedures should address the processes and activities described in the "Documentation Standards" section of this policy statement.

Management fulfills other responsibilities that aid in the maintenance of appropriate ACLs. These activities include, but are not limited to:

- Establishing and maintaining appropriate governance activities for the loss estimation process(es). These activities may include reviewing and challenging the assumptions used in estimating expected credit losses and designing and executing effective internal controls over the credit loss estimation method(s);
- Periodically performing procedures that compare credit loss estimates to actual write-offs, at the portfolio level and in aggregate, to confirm that amounts recorded in the ACLs were sufficient to cover actual credit losses. This analysis supports that appropriate ACLs were recorded and provides insight into the loss estimation process's ability to estimate expected credit losses. This analysis is not intended to reflect the accuracy of management's economic forecasts;
- Periodically validating the loss estimation process(es), including changes, if any, to confirm it is appropriate for the institution; and
- Engaging in sound risk management of third parties involved<sup>28</sup> in ACL estimation process(es), if applicable, to ensure that the loss estimation processes are commensurate with the level of risk, the complexity of the third-party relationship and the institution's organizational structure.

Additionally, if an institution uses loss estimation models in determining expected credit losses, management should evaluate the models before they are employed and modify the model logic and assumptions, as needed, to help ensure that the resulting loss estimates are consistent with GAAP and regulatory reporting requirements.<sup>29</sup> To demonstrate such consistency, management should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with models. When used for multiple purposes within an institution, models should be specifically adjusted and validated for use in ACL loss estimation processes. Management should document and support any adjustments made to the models, the outputs of

---

<sup>28</sup> Guidance on third party service providers may be found in SR Letter 13-19/Consumer Affairs Letter 13-21, *Guidance on Managing Outsourcing Risk* (FRB); Financial Institution Letter (FIL) 44-2008, *Guidance for Managing Third Party Risk* (FDIC); Supervisory Letter No. 07-01, *Evaluating Third Party Relationships* (NCUA); and OCC Bulletin 2013-29, *Third Party Relationships: Risk Management Guidance*, OCC Bulletin 2017-7, *Third Party Relationships: Supplemental Examination Procedures*, and OCC Bulletin 2017-21, *Third Party Relationships: Frequently Asked Questions to Supplement OCC Bulletin 2013-29*.

<sup>29</sup> See the interagency statement titled, *Supervisory Guidance on Model Risk Management*, published by the Board in SR Letter 11-7 and OCC Bulletin 2011-12 on April 4, 2011. The statement also addresses the incorporation of vendor products into an institution's model risk management framework following the same principles relevant to in-house models. The FDIC adopted the interagency statement on June 7, 2017. Institutions supervised by the FDIC should refer to FIL-22-2017, *Adoption of Supervisory Guidance on Model Risk Management*, including the statement of applicability in the FIL.

the models, and compensating controls applied in determining the estimated expected credit losses.

### **Examiner Review of ACLs**

Examiners are expected to assess the appropriateness of management's loss estimation processes and the appropriateness of the institution's ACL balances as part of their supervisory activities. The review of ACLs, including the depth of the examiner's assessment, should be commensurate with the institution's size, complexity, and risk profile. As part of their supervisory activities, examiners generally assess the credit quality and credit risk of an institution's financial asset portfolios, the adequacy of the institution's credit loss estimation processes, the adequacy of supporting documentation, and the appropriateness of the reported ACLs and PCLs in the institution's regulatory reports and financial statements, if applicable. Examiners may consider the significant factors that affect collectibility, including the value of collateral securing financial assets and any other repayment sources. Supervisory activities may include evaluating management's effectiveness in assessing credit risk for debt securities (both prior to purchase and on an on-going basis). In reviewing the appropriateness of an institution's ACLs, examiners may:

- Evaluate the institution's ACL policies and procedures and assess the loss estimation method(s) used to arrive at overall estimates of ACLs, including the documentation supporting the reasonableness of management's assumptions, valuations, and judgments. Supporting activities may include, but, are not limited to:
  - Evaluating whether management has appropriately considered historical loss information, current conditions, and reasonable and supportable forecasts, including significant qualitative factors that affect the collectibility of the financial asset portfolios;
  - Assessing loss estimation techniques, including loss estimation models, if applicable, as well as the incorporation of qualitative adjustments to determine whether the resulting estimates of expected credit losses are in conformity with GAAP and regulatory reporting requirements; and
  - Evaluating the adequacy of the documentation and the effectiveness of the controls used to support the measurement of the ACLs;
- Assess the effectiveness of board oversight as well as management's effectiveness in identifying, measuring, monitoring, and controlling credit risk. This may include, but is not limited to, a review of underwriting standards and practices, portfolio composition and trends, credit risk review functions, risk rating systems, credit administration practices, investment securities management practices, and related management information systems and reports;
- Review the appropriateness and reasonableness of the overall level of the ACLs relative to the level of credit risk, the complexity of the institution's financial asset portfolios, and available information relevant to assessing collectibility, including consideration of current conditions and reasonable and supportable forecasts. Examiners may include a quantitative analysis (e.g., using management's results comparing expected write-offs to actual write-offs as well as ratio analysis) to assess the appropriateness of the ACLs.

This quantitative analysis may be used to determine the reasonableness of management's assumptions, valuations, and judgments and understand variances between actual and estimated credit losses. Loss estimates that are consistently and materially over or under predicting actual losses may indicate a weakness in the loss forecasting process;

- Review the ACLs reported in the institution's regulatory reports and in any financial statements and other key financial reports to determine whether the reported amounts reconcile to the institution's estimate of the ACLs. The consolidated loss estimates determined by the institution's loss estimation method(s) should be consistent with the final ACLs reported in its regulatory reports and financial statements, if applicable;
- Verify that models used in the loss estimation process, if any, are subject to initial and ongoing validation activities. Validation activities include evaluating and concluding on the conceptual soundness of the model, including developmental evidence, performing ongoing monitoring activities, including process verification and benchmarking, and analyzing model output.<sup>30</sup> Examiners may review model validation findings, management's response to those findings, and applicable action plans to remediate any concerns, if applicable. Examiners may also assess the adequacy of the institution's processes to implement changes in a timely manner; and
- Review the effectiveness of the institution's third-party risk management framework associated with the estimation of ACLs, if applicable, to assess whether the processes are commensurate with the level of risk, the complexity and nature of the relationship, and the institution's organizational structure. Examiners may determine whether management monitors material risks and deficiencies in third-party relationships, and takes appropriate action as needed.<sup>31</sup>

When assessing the appropriateness of ACLs, examiners should recognize that the processes, loss estimation methods, and underlying assumptions an institution uses to calculate ACLs require the exercise of a substantial degree of management judgment. Even when an institution maintains sound procedures, controls, and monitoring activities, an estimate of expected credit losses is not a single precise amount and may result in a range of acceptable outcomes for these estimates. This is a result of the flexibility FASB ASC Topic 326 provides institutions in selecting loss estimation methods and the wide range of qualitative and forecasting factors that are considered.

Management's ability to estimate expected credit losses should improve over the contractual term of financial assets as substantive information accumulates regarding the factors affecting repayment prospects. Examiners generally should accept an institution's ACL estimates and not seek adjustments to the ACLs, when management has provided adequate support for the loss estimation process employed, and the ACL balances and the assumptions used in the ACL estimates are in accordance with GAAP and regulatory reporting requirements. It is inappropriate for examiners to seek adjustments to ACLs for the sole purpose of achieving ACL levels that correspond to a peer group median, a target ratio, or a benchmark amount when

---

<sup>30</sup> See footnote 29.

<sup>31</sup> See footnote 28.

management has used an appropriate expected credit loss framework to estimate expected credit losses.

If the examiner concludes that an institution's reported ACLs are not appropriate or determines that its ACL evaluation processes or loss estimation method(s) are otherwise deficient, these concerns should be noted in the report of examination and communicated to the board of directors and senior management.<sup>32</sup> Additional supervisory action may be taken based on the magnitude of the shortcomings in ACLs, including the materiality of any errors in the reported amounts of ACLs.

---

<sup>32</sup> Each agency has formal and informal communication channels for sharing supervisory information with the board of directors and management depending on agency practices and the nature of the information being shared. These channels may include, but are not limited to, institution specific supervisory letters, letters to the industry, transmittal letters, visitation findings summary letters, targeted review conclusion letters, or official examination or inspection reports.