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Reg Pulse

Allowance for credit losses and FFIEC 002 reporting

The significant changes in the accounting for credit losses (e.g., Current Expected Credit Losses or "CECL", and International Financial Reporting Standards 9 or "IFRS 9") can have a unique effect on the US branches and agencies of foreign banking organizations (FBOs). As US banking institutions are in the process of getting ready for the upcoming requirement, this may also be a good time to discuss the relevant Allowance for Loan and Lease Losses (ALLL) considerations for the US branches and agencies of the FBOs. In this article, we consider the current reporting, common problems, and issues to be considered concerning the adoption of CECL.

Background

For supervisory purposes, US branches and agencies of FBOs are treated as distinct stand-alone entities, even though they are not legally distinct entities from their parent bank perspective. As such, the FBOs are required to prepare quarterly balance sheet and supplemental schedules in the form of a Call Report (FFIEC 002) for each of their US branches or agencies (there is limited consolidation for branches and agencies located in the same state). Due to the unique nature of branches and agencies, FFIEC 002 has several differences from domestic bank Call Reports (FFIEC 031/041/051):

- There is no capital schedule
- A detailed "related" party schedule is required
- There is no income statement; income is considered as part of the due to account with the head office
- Allowance for credit losses are not required to be held at the branch level

The FFIEC 002 is prepared in conformance with US GAAP, and the home country accounting standards or IFRS cannot be applied. Since US GAAP is the required accounting framework, US branches and agencies will need to consider assessing and implementing (as required) a CECL-based approach for its US reporting independent of the IFRS 9 methodology used for head office reporting.

Overview of IFRS 9 and CECL impairment models

Both the IFRS 9 and CECL impairment models are based on expected credit losses; however, they diverge when it comes to measuring and recognizing those losses:

- IFRS 9 uses a three-stage model that classifies debt instruments as either performing assets, underperforming assets, or nonperforming assets with varying degrees of credit losses recognized for each category. This model requires institutions to recognize a loss allowance at an amount equal to 12-month expected credit losses for performing assets and expected lifetime losses for all assets not considered performing debt instruments.
- The CECL standard uses a life-of-loan methodology to determine expected credit losses. In addition, banks will be required to incorporate "reasonable and supportable forecasts" in their methodology, which may impact their reserve estimate and corresponding ALLL processes. The life-of-loan approach is widely viewed as replacing the loss emergence period, creating the potential for estimates to cover a longer or shorter loss horizon depending on the contractual term. CECL will allow institutions to factor prepayments but ignore extensions. CECL also will have important effects on established reserves, recognized credit losses, and regulatory capital ratios.

Current reporting

General allowance accounts

Branches and agencies of foreign banks are not required to hold a "general" credit allowance. Since as a practical matter, the parent bank often will only assess credit losses at the consolidated bank level and not the individual branch level. In addition, since the FFIEC 002 must conform with US GAAP, the allowance for credit loss methodology conducted at the parent level will likely differ from US GAAP accounting for allowance of credit loss accounting. A branch may establish a general credit reserve at the branch level; however, once that determination is reached, the branch or agency is required to report that allowance on the FFIEC 002 using U.S. GAAP (currently ASC 450-20 or FAS 5).

A branch may establish a general credit reserve at the branch level; however, once that determination is reached, the branch or agency is required to report that allowance on the FFIEC 002 using U.S. GAAP (currently ASC 450-20 or FAS 5). Unlike domestic banks' Call Reports, this allowance is not disclosed on the balance sheet (Schedule RAL) or the loan schedule (Schedule C). Instead, the amount of the general allowance carried on the books of a branch or agency is included as part of the due to parent bank line item of confidential related party schedule (Schedule M, Part I) and also disclosed separately in Part III of the same schedule.

By excluding the general allowance from the balance sheet, consistent comparisons cannot be made between branches and agencies that choose to maintain a general allowance and branches and agencies that do not. A branch or agency that is currently calculating ALLL using US GAAP may want to consider if maintaining a general allowance is warranted given the need to update its processes to meet with CECL requirements.

Common reporting errors

There are several common errors for the reporting of a general allowance for credit losses, including:

- Excluding the allowance for credit losses from the due to parent bank accounts
- Using home country account standards or supervisory polices for calculating the amount of the allowance for credit losses
- Including specific reserves in the general reserve amount
- Including reserves for commitments and other assets in the amount reporting allowances for loan losses in schedule M

Specific reserves

US branches and agencies commonly establish specific reserves for specific assets or portfolios. As it relates to loan accounting, these are established for:

- Specific loans under US GAAP (ASC 310-10 or FAS 114 reserves)
- Identified losses that are equivalent to a charge-off

All specific reserves established are reported by reducing the value of the asset by the amount of the specific impairment. There are no disclosures for the amount of the specific reserve, and since the amount of the asset is reduced, unlike general reserves, the amount of specific reserves is not included in the due to the parent bank account. While ASC 310-10 reserves are based on US GAAP, branches and agencies are establishing specific reserves for identified losses that under US accounting and regulatory policies would be charged-off. These are often established to comply with home country supervisory policies and practices.

Common reporting errors

There are several common errors for the reporting of a specific general allowance for credit losses, including:

- Specific reserves are established when there is no identified loss
- The amount of specific reserves is not deducted from the value of the underlying asset.
- Specific reserves are combined with general credit reserves

Provision of credit losses

Since there is no income statement on the FFIEC 002, the accounting for provision for credit losses differs from other bank Call Reports. Like other income and expense balances, the provision is included as part of the amount of net unremitted profits (losses) on the FFIEC002. This has the effect of neutralizing the impact on the due to account of increases to the provision for general allowance.

Looking ahead

Implementing IFRS 9 and CECL will be a major undertaking for branches and agencies, with widespread impacts across operations, credit models, and IT systems. Institutions affected by IFRS 9 have been preparing for the new standard's adoption since it was finalized in July 2014. Through that long road of implementation, these institutions have gained experience and insights that can be helpful to US branches and agencies of FBOs that now need to develop a credit loss model under CECL. IFRS 9 experience can guide CECL modeling, governance approach, and more.

US branches and agencies of FBOs should begin assessing the impact of CECL requirements on their US regulatory reporting and developing approach for implementation. Given the regulatory deadline for reporting as of December 2019 for non-SEC filers and December 2020 for non-SEC filers, the time to start is now.

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