

# Guidance for Financial Institutions Addressing Recent Changes Relating to Accounting for Credit Losses in the COVID-19 Pandemic

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As part of the effort to stave off a recession amid the COVID-19 pandemic, Congress has provided relief to banking organizations by delaying the implementation of a fundamental change to the accounting for credit losses. The new accounting standard, referred to as the Current Expected Credit Losses standard (CECL) was adopted in the wake of the Great Recession with a 2020 implementation date. At that time, loan loss allowances had not kept pace with the losses experienced because the accounting was based on an *incurred* loss model that focused on current losses within a loan portfolio. By contrast, CECL requires loan loss estimates based on the losses *expected* over the life of a loan, an inherently predictive, forward-looking estimate. Under CECL, losses require management to develop and document “reasonable and supportable” forecasts to estimate expected credit losses.

Until this past week, certain financial institutions (large public filers) would have been required to implement CECL for the first quarter of 2020. Financial institutions that had spent the last few years revamping their methodologies and models in preparation for CECL suddenly faced a rapidly changing world with the COVID-19 pandemic. The closing of businesses as part of the effort to slow the spread of COVID-19 resulted in approximately 3.3 million Americans applying for unemployment benefits in recent days, nearly five times more than the previous record high, and Federal Reserve Board Chairman Jerome Powell has stated his belief that a recession already may have commenced. It is clear that many Americans and American businesses will be unable to pay their debts for some period of time. As a result, lawmakers and banking regulators pushed for a delay in CECL's implementation. Federal Deposit Insurance Corporation Chair Jelena McWilliams, for example, urged for the CECL delay, explaining that estimating expected losses had become “more speculative and less reliable.”

On March 27, 2020, the Coronavirus Aid, Relief, and Economic Security Act (CARES Act), the \$2 trillion fiscal stimulus package, was enacted. Under the CARES Act Section 4014, insured depository institutions (including credit unions), bank holding companies, and any affiliates thereof (collectively, “banking organizations”) may elect not to comply with CECL from the date of enactment of the legislation to the *earlier* of December 31, 2020 or the termination date for the President's national emergency declaration related to the COVID-19 pandemic. Separately, Section 4013 permits financial

institutions to suspend the accounting implications for COVID-19-related loan modifications that otherwise would constitute troubled debt restructurings (TDRs) under U.S. Generally Accepting Accounting Principles (GAAP), and federal banking regulators must defer to the financial institutions making such determinations. (Banking agencies also released an interagency statement that addressed similar issues relating to TDRs, albeit with some varied provisions.) Financial institutions' elections may begin on March 1, 2020, and continue through the period no later than 60 days following the lifting of the national emergency declaration.

Although these sections of the CARES Act do not constitute amendments to U.S. GAAP, and the chair of the Financial Accounting Standards Board (FASB) board of trustees had urged the removal of the CECL provisions from the CARES Act, it is expected that the SEC or FASB will issue guidance soon, consistent with the CARES Act. Such guidance may provide clarity regarding the time period of the delayed implementation of CECL or expand the entities to which the CECL deferral may apply. Under the CARES Act, the CECL provisions did not expressly provide the same relief to non-bank lenders that have no affiliation with a bank.

In the meantime, all banking organizations should consider thoughtfully whether to delay the implementation of CECL and revert to the prior accounting for loan losses under the incurred loss model or otherwise ensure they are ready to meet the CECL requirements in light of the challenges created by COVID-19. They should approach their loan loss-related accounting and disclosure decisions with careful analysis and reasoned judgments supported by a sound methodology and robust documentation. Proactive discussions involving management, the in-house accounting team, the Audit Committee and the independent auditor will be beneficial. Of course, financial institutions must consider additional banking regulatory implications relating to regulatory capital and capital plan submissions, among other matters.

Specifically, first, all financial institutions should carefully reconsider their loan losses. Banking organizations opting to delay implementing CECL should avoid proceeding mechanically with the methodology and assumptions they had applied one quarter ago. Instead, they should consider engaging in a reassessment to update their modeling as necessary in light of COVID-19. Moreover, banking organizations should not abandon their efforts relating to CECL. Instead, they should continue making internal estimates of credit losses under CECL and updating their models and methodologies given that the reprieve may end abruptly upon the termination of the national emergency declaration. In short, they must be prepared in the near term to implement CECL in the COVID-19 era and thus should continue their internal estimates as though CECL applied in the current period. Doing so will help facilitate a smoother implementation down the road.

Likewise, banking organizations electing to apply CECL now and those financial institutions not offered relief from CECL under the CARES Act should reassess the models and assumptions used to calculate their expected credit losses, mindful of the new conditions brought about by the pandemic. Assumptions should be modified to ensure they reflect the substantiated, reasonable, and supportable best estimates of lifetime losses within the loan portfolio in today's world.

Second, all financial institutions should thoroughly document their updated methodologies and assumptions, including the factors considered in arriving at their estimates of credit losses. Such documentation should provide clear explanations of the supporting analyses and rationales, and demonstrate the specific considerations given to COVID-19 and its resulting impact on credit losses.

Finally, financial institutions should ensure that they update their disclosures, in consultation with counsel, to reflect meaningful information regarding their loan loss estimates and how they were developed, whether under the incurred loss model or CECL. In short, the current uncertainty of the COVID-19 pandemic, which magnifies the effects of the judgments and subjectivity that go into such estimates, makes thoughtful disclosure even more important. Consistent with the SEC Division of Corporation Finance's recent Disclosure Guidance Topic No. 9, which addresses the Staff's current views regarding disclosures obligations arising out of COVID-19, registrants should consider disclosure about the risks and effects of COVID-19, including whether they anticipate material increases to their allowance for credit losses. Management also should consider, in the context of such estimates, what management expects the future impact of COVID-19 to be on their business and how management is responding. The guidance itself acknowledges that COVID-19's impact on a registrant will depend on numerous factors beyond the registrant's control and knowledge. To that extent, such disclosures necessarily will be forward-looking and should be drafted to benefit from the protection of the forward-looking statement safe harbors in the federal securities laws.

## CONTACTS

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