Federal Housing Finance Agency
Office of Inspector General

The Current Expected Credit Loss (CECL) Methodology and the Enterprises and FHLBanks

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Executive Summary

In June 2016, the Financial Accounting Standards Board (FASB) issued Accounting Standards Update 2016-13, requiring a substantial change in how certain organizations, including Fannie Mae and Freddie Mac (the Enterprises) and the Federal Home Loan Banks (FHLBanks) (collectively, regulated entities), must record credit losses in their financial statements. Specifically, FASB announced that the Current Expected Credit Loss (CECL) methodology would replace the "incurred loss" methodology for calculating expected losses on covered assets.

Under the incurred loss methodology currently in effect, a covered organization must establish a reserve for an asset once a determination has been made that the asset has become impaired. The incurred loss methodology is a backward-looking approach in which reserves are not established in financial statements until it is probable or likely, based on current information and past events, that the asset is impaired and the amount of the loss can be estimated. Application of the incurred loss methodology captures the probable current losses in a portfolio. To develop an incurred loss estimate to determine the size of the reserve, FASB permits consideration of past events and current conditions.

The CECL methodology requires covered organizations to establish reserves for expected losses on assets at the time that such assets are created or acquired. Organizations will be required to identify an expected loss in the first reporting period (and subsequent reporting periods) after the asset is created or acquired. Because the CECL methodology requires organizations to estimate expected losses that may occur in the future, these organizations will need to incorporate both forward-looking projections and historical information to develop supportable forecasts. According to FASB, application of the CECL methodology reflects the current risk in a portfolio.

The regulated entities are required to adopt the CECL methodology as of January 1, 2020. Under CECL, the Enterprises will record a one-time adjustment to their reserves and retained earnings reflecting the difference between the incurred loss and the CECL methodologies. Going forward, the reserve for the estimated expected credit loss will be updated as needed on a quarterly basis. The majority of the FHLBanks have publicly disclosed that implementation of the CECL methodology will not result in a material impact on their financial statements.

Many have expressed concerns that implementation of the CECL methodology will be challenging. According to the Federal Housing Finance Agency (FHFA or Agency) and Enterprise officials, implementation of CECL

may be less challenging for the Enterprises than for other financial institutions. For example, officials from both Enterprises reported to us that the Enterprises have developed models and model review processes for other business purposes that are being used as the foundation for models to implement CECL. FHFA officials explained to us that the Enterprises already collect the data they will need to implement CECL. FHFA officials told us that Fannie Mae and Freddie Mac will be ready to implement CECL on January 1, 2020.

With regard to the FHLBanks, FHFA officials advised that FHFA expects that implementation of the CECL methodology will not have a significant impact on their financial condition because their largest asset class—advances—has no historical losses. FHFA officials told us that the FHLBanks will be ready to implement CECL on January 1, 2020.

In recognition of the potential risks associated with this change in methodology, we are issuing this white paper, which discusses the background of the CECL methodology and what FHFA, the Enterprises, and the FHLBanks view as its potential impact on the regulated entities.

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ABBREVIATIONS

CECL	Current Expected Credit Loss
Enterprises	Fannie Mae and Freddie Mac
FASB	Financial Accounting Standards Board
FHFA or Agency	Federal Housing Finance Agency
FHLBank	Federal Home Loan Bank
GAAP	Generally Accepted Accounting Principles
MBS	Mortgage-backed securities
OCA	Office of the Chief Accountant
OIG	Federal Housing Finance Agency Office of Inspector General
Regulated entities	Enterprises and FHLBanks
SEC	U.S. Securities and Exchange Commission

BACKGROUND

FHFA serves as conservator as well as regulator and supervisor for Fannie Mae and Freddie Mac, and it is also the regulator and supervisor for the FHLBank System. FHFA's role includes oversight of the accounting practices of the Enterprises and FHLBanks. FHFA considers the audited financial statements of the regulated entities as an important input for the Agency's safety and soundness supervision process. Within FHFA, the Office of the Chief Accountant (OCA), Division of Enterprise Regulation, and Division of Federal Home Loan Bank Regulation are involved in this oversight.

The Enterprises and FHLBanks are subject to the financial reporting requirements applicable to public companies. The regulated entities apply Generally Accepted Accounting Principles (GAAP) in their financial reporting. The U.S. Securities and Exchange Commission (SEC) has the authority to set and enforce accounting standards for public companies in the United States. In turn, the SEC has looked to FASB, a private, non-profit organization, to establish and improve these standards.

Currently, the Enterprises and FHLBanks, under GAAP, reserve for expected losses using the "incurred loss" methodology.

Incurred Loss Methodology

The incurred loss methodology under GAAP causes a reserve to be taken and maintained to cover losses that are probable and estimable as of the reserve calculation date. This methodology has been in place for about 40 years. Using this methodology, the Enterprises and FHLBanks establish a reserve on covered assets in their financial statements once a loss is "probable" or likely, and they can estimate the amount of the loss.

To develop an incurred loss estimate, FASB permits consideration of past events and current conditions. FASB guidance on the incurred loss methodology states: "It is inappropriate to consider possible or expected future trends that may lead to additional losses." Accordingly, an actual loss, when recognized, may be different than the estimated loss.

FASB reports that after the financial crisis of 2008, financial institutions and users of their financial statements expressed concern that GAAP restricted the ability to record credit losses that were expected but did not yet meet the "probable" threshold. FASB explained that, in the lead-up to the financial crisis, investors were using their own forward-looking estimates of expected credit losses in making investment decisions, even though such losses were not yet recognized in financial statements. This dynamic highlighted the different information needs of financial statement users from what was required and permitted by GAAP.

According to an FHFA official, the incurred loss methodology was viewed by some as being "too little, too late." The Financial Crisis Advisory Group, which FASB helped establish, identified the delayed recognition of credit losses and potential overstatement of assets as a weakness in GAAP, and it recommended exploring more forward-looking alternatives to the incurred loss methodology.

FASB Adoption of Current Expected Credit Loss Methodology

In June 2016, FASB issued Accounting Standards Update 2016-13, requiring a substantial change in how certain organizations, including the Enterprises and FHLBanks, must record credit losses in their financial statements.[1] Specifically, FASB introduced the CECL methodology to replace the incurred loss methodology for estimating expected losses on covered assets.

The CECL methodology requires institutions to establish reserves, or allowances, for expected losses on certain assets (such as loans, held-to-maturity debt securities, net investment in leases, advances, reinsurance, and trade receivables) when the assets are created or acquired, instead of delaying loss recognition until some future triggering event occurs. According to the American Bankers Association, CECL "represents the biggest accounting change in banking history."

Because the CECL methodology does not provide prescriptive guidance regarding how to project a future expected loss and estimate the amount of the reserve, each institution will need to develop a modeling methodology based on its historical experience, current conditions, and reasonable and supportable forecasts.[2]

According to FASB, it expects the CECL methodology to provide:

- Earlier measurement of credit losses;
- More transparency about the extent of expected credit losses and changes in expected credit losses;

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[1] Since Accounting Standards Update 2016-13 was issued, FASB also has issued related supplementary guidance.

[2] According to FASB, the size of the entity and its access to information may result in approaches with varying degrees of sophistication. For example, some entities may be able to forecast over the entire estimated life of an asset, while other entities may forecast over a shorter period. For periods beyond which an entity is able to make or obtain reasonable and supportable forecasts of expected credit losses, it must revert to historical loss information.

- Increased usefulness of the financial statements by requiring timely inclusion of forecasted information; and
- Better alignment of the accounting guidance with underwriting decisions because, generally, expected losses (rather than only incurred losses) are considered when underwriting a loan.

Beginning January 1, 2020, the Enterprises and the FHLBanks are required to adopt the CECL methodology.

Lawmakers and trade associations have raised concerns about the potential negative impacts of implementing CECL. One of their concerns is that CECL could adversely affect the availability or cost of credit, particularly for long-term mortgages. A related concern is that CECL could exacerbate downturns in the economy. Legislators also have criticized CECL for applying the same CECL standard to small and large institutions. Members of Congress have introduced legislation to postpone implementation of CECL until one year after a study of CECL's potential impact. Several financial industry trade associations have expressed support for such a delay. Enterprise officials told us that they have not taken a position on the matter.

On August 15, 2019, FASB proposed for comment extending the implementation date of CECL for certain companies.[3] However, the extra time would not apply to the Enterprises, the FHLBanks, or generally to large SEC-filing companies.

IMPLEMENTATION OF CECL METHODOLOGY BY THE ENTERPRISES AND THE FHLBANKS ....

The Enterprises

In a recent survey of lenders, less than half expressed confidence that they will have sufficient data to implement CECL. According to FHFA, the Enterprises already have the data needed for CECL implementation. Effective models will be critical to CECL implementation. Officials from both Enterprises reported to us that CECL may pose less of a challenge for the Enterprises than some other financial institutions because they have developed the models and model review processes for other business purposes and are building on this base to implement CECL.

[3] The proposed delay applies to smaller public companies (as defined by the SEC), private companies, and nonprofit organizations.

Fannie Mae, in its second quarter 2019 10-Q, reported that it was continuing to update its models that will be used to estimate credit losses for CECL, and was validating their results.[4] Fannie Mae officials told us that Fannie Mae has a vetting process to review models for use in CECL implementation that identified items needing correction or documentation. The Enterprise added that it has established a model validation process to review data, methodologies, calculations, and implementation.[5]

Freddie Mac, in its second quarter 2019 10-Q, stated that it had developed its models for CECL implementation and that the models were undergoing testing and validation. It also reported that it is developing an appropriate governance process for estimating credit losses under CECL. Freddie Mac officials told us that Freddie Mac's testing and validation are focused mainly on newly developed models, rather than existing models that it is using for CECL, such as its house price appreciation and interest rate models. Freddie Mac also said that it had performed back-testing on the newly developed models over a range of economic environments, comparing model projections to actual results. The Enterprise added that its model risk group reviewed the design and implementation of newly developed models.

Officials from both Enterprises advised us that the Enterprises intend to run essentially parallel processes for the incurred loss and CECL methodologies. While the Enterprises will continue to report financial results using the incurred loss methodology through year-end 2019, they intend to run their models and processes for CECL as well to test them before adoption. Fannie Mae plans to conduct CECL operational testing for its book of business as of July, August, and September 2019, focusing on the process of producing the estimated losses. Freddie Mac plans parallel runs for the third and fourth quarters of 2019, which will include governance and certain financial reporting steps, along with providing the information to their external auditors. According to FHFA, it will not oversee the Enterprises' parallel runs, but might review particular results from one or more of them.

In a public statement, Fannie Mae said it was "well-prepared for the operational transition" to the CECL methodology. A Freddie Mac official told us that Freddie Mac was on target to implement CECL on time and should do so, absent major unforeseen events.

The Enterprises frequently updated their board committees about CECL, including their audit committees, according to an FHFA official. Additionally, they kept FHFA apprised of those

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[4] According to FHFA, validation is the process of determining that a model's results accurately meet the requirements of its intended use and that the model is reasonable for use. FHFA expects a group independent of those who developed and tested the models to perform the validations.

[5] In this white paper, we report representations by the Enterprises on their testing and validation. Because we have not undertaken a review of the effectiveness of any "vetting process" or other validation efforts employed by FHFA or the regulated entities regarding the reliability of their models, we have no view whether implementation of CECL may not be as challenging for the Enterprises as for other financial institutions.

communications. According to an internal Fannie Mae document, the Enterprise intends to seek approval from the audit committee of its board for its implementation of CECL during the fourth quarter of 2019. A Freddie Mac official told us that the Enterprise would submit its plans to implement CECL to the audit committee of the Freddie Mac board.

As conservator, FHFA requires the Enterprises to submit material changes in accounting policy to FHFA for approval before implementation. Both Enterprises and FHFA told us that the Enterprises would formally request FHFA's approval (as conservator) for their implementation of CECL, likely in the fourth quarter of 2019. As part of the approval process, OCA will analyze and conclude on the reasonableness of each Enterprise's accounting policy conclusions, the related internal controls over financial reporting, and the draft external financial disclosures. A recommendation on whether to approve the Enterprises' CECL implementation, with input from various FHFA divisions, will be made to the FHFA Director. Approval from the FHFA Director will be required before the Enterprises implement CECL.[6]

FHFA officials told us that the Enterprises would be ready to implement CECL on time on January 1, 2020.

The FHLBanks

A committee formed by the controllers for the eleven FHLBanks assists the FHLBanks to develop reasonably consistent approaches in implementing new GAAP standards, such as CECL. After FASB issued CECL, the controllers' committee in 2017 began to focus on preparing for implementation of the CECL methodology. In accordance with the FHLBanks' general practice for new accounting policies, the committee developed white papers,[7] which focused on the classes of FHLBank financial transactions to which CECL applies: advances,[8] agency securities, mortgage loans, private-label residential mortgage-backed securities (MBS), municipal securities, standby bond purchase agreements, short-term investments, and repurchase agreements. Each white paper discussed, among other things, the credit history of the financial instrument and support for how the credit losses (if any) would be estimated and/or calculated.

In addition to focusing on the accounting methodology for its assets, FHLBanks also have devoted attention since 2017 to becoming operationally ready for CECL. Some of the

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[6] FASB requires the Enterprises and other similarly situated organizations to implement CECL by January 1, 2020, and FHFA acknowledges that it lacks authority to extend that deadline.

[7] According to FHFA, the white papers are a structure for the FHLBanks to follow, but they do not serve as specific CECL policies for the individual FHLBanks. Each FHLBank is responsible for its own policies and reporting. Because the FHLBanks issue combined financial statements, consistency is important to facilitate the FHLBanks' disclosures.

[8] FHLBanks lend to their member institutions in the form of secured loans, also known as advances.

FHLBanks' efforts have centered on the models and systems required to produce the credit loss estimates. OCA told us that most models were already in place at the FHLBanks, and the FHLBanks developed additional models, as necessary, in 2018 to support the execution of CECL.[9] For example, the FHLBanks needed to revise their credit loss models to factor in lifetime losses. The FHLBanks were scheduled to implement those models and perform test runs in 2019. In addition, the FHLBanks are required to validate the models used to estimate credit impairment.[10]

OCA officials told us that the FHLBanks will conduct parallel runs of their CECL processes in the third and fourth quarters of 2019. Those same officials reported to us that they might review the outcomes of the FHLBanks' parallel runs if significant exceptions or anomalies arise. FHFA approval will not be required for the FHLBanks to implement CECL.

POTENTIAL FINANCIAL IMPACT FROM IMPLEMENTATION OF CECL METHODOLOGY ....

Judgment has always been needed to establish reserves for probable loan losses under the incurred loss methodology. Because FASB did not specify a single method for measuring expected credit losses under the CECL methodology, each affected organization will need to develop reasonable and supportable estimation methods. According to a Freddie Mac official, the CECL methodology will increase the use of judgment and forward-looking information. In the view of that official, changing the construct for how reserves are calculated presents risk.

Former FHFA Director Watt, in written testimony to the House Financial Services Committee in October 2017, acknowledged that "[r]egulatory changes, such as the Current Expected Credit Loss (CECL) accounting change, have one-time and ongoing impacts on reported net income."

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[9] The FHLBanks will report credit losses on mortgage loans issued through two programs and on private-label MBS. The estimate of expected credit losses for mortgage loans will be forward-looking, which will require the use of forecasts about future economic conditions to estimate the expected credit loss over the remaining life of an instrument. The FHLBanks have developed a common evaluation process for determining and approving the modeling assumptions for credit losses on private-label MBS.

[10] According to the FHLBanks, their model validation generally will include some type of benchmarking of results to other models, back-testing to actual loss experience, or comparison of model assumptions to alternate sources, such as home prices or assumptions used in regulatory stress testing.

The Enterprises

The Enterprises told us that the impact of application of the CECL methodology will come predominantly from single-family mortgages they have purchased. Mortgages subject to CECL represented more than 90% of each Enterprise's assets at year-end 2018.

Under CECL, the Enterprises will record a one-time adjustment to their credit loss allowances and retained earnings equal to the difference between the amount of credit loss allowances under the incurred loss and the CECL methodologies. Going forward, the reserve for the estimated expected credit loss will be updated as needed on a quarterly basis.

Initial Impact

In its 2018 Report to Congress, FHFA advised that implementation of the CECL methodology could increase the Enterprises' allowances for credit losses and decrease—perhaps substantially—their retained earnings for first quarter 2020 when they adopt CECL. FHFA cautioned that the initial impact of CECL "could result in a net worth deficit" for the Enterprises; such a deficit would require them to draw funds from Treasury under terms of the senior preferred stock purchase agreements with Treasury. For application of the CECL methodology to result in a draw, the impact would have to exceed an Enterprise's remaining capital cushion plus any additions to its net worth from its earnings in the quarter of adoption. The senior preferred stock purchase agreements, as amended, currently permit each Enterprise to retain up to $3 billion in capital reserves.

In its second quarter 2019 10-Q, Freddie Mac reported that it did not expect the implementation of CECL to require it to request a draw from Treasury. (It did not provide an estimate of the initial CECL impact.) It added that the impact at adoption would depend upon characteristics of the portfolio as well as macroeconomic conditions and forecasts at that time. In its second quarter 2019 10-Q, Fannie Mae reported that it estimated the initial impact of CECL on its retained earnings to be up to $4 billion on an after-tax basis, which could result in a net worth deficit (and a draw) for the quarter, depending on other factors, including its results of operations for the second half of 2019 and first quarter of 2020. Fannie Mae added that it was still assessing the impact of various implementation issues and its models were still subject to change. It advised that the impact of adopting CECL would be influenced by the credit risk profile of its loans as of the January 1, 2020, adoption date, as well as economic conditions and forecasts of future economic conditions at that time.

Ongoing Impact

Fannie Mae reported in its first quarter 2019 10-Q that application of the CECL methodology would likely introduce additional volatility in its financial results after the initial adoption. It advised that, because credit-related income or expense would include expected lifetime losses for its mortgages and other covered financial instruments, they would become more sensitive to fluctuations in factors such as home prices and interest rates. In an earnings call, Fannie Mae officials explained that, during times of economic stress, its allowance for loan losses would build faster under CECL than under the incurred loss methodology and that its earnings also should recover faster as economic conditions improved.

According to a briefing provided by Freddie Mac management to the audit committee of its board, Freddie Mac might experience increased loan loss reserve volatility and increased earnings volatility after implementation of the CECL methodology. It cautioned that changes in expectations of future conditions could contribute to greater volatility.

In an earnings call after issuance of its results for the first quarter of 2019, Fannie Mae reported publicly that it was evaluating selling additional risk using its credit risk transfer programs, which may reduce the earnings volatility associated with CECL. Freddie Mac told us that it had increased the amount of its credit risk transfer, but made this decision independently of the upcoming implementation of CECL.

The FHLBanks

Advances, which are subject to CECL, represented 66% of the FHLBanks' combined assets at December 31, 2018. FHFA officials reported to us that FHFA does not expect the impact of application of the CECL methodology will be material to the FHLBanks because their largest asset class—advances—has no historical losses. The FHLBanks do not expect credit losses on agency securities. The FHLBanks anticipate insignificant losses on some other assets in their portfolios, including municipal securities, standby bond purchase agreements, short-term investments, and repurchase agreements.[11] In total, the FHLBanks expected zero or insignificant credit losses on approximately 85% of their assets as of December 31, 2018. The FHLBanks will have to estimate the expected credit losses for mortgage loans purchased through two programs.[12]

Initial Impact

FHFA reported to us that, in its view, the impact and credit exposure from the implementation of the CECL methodology on the FHLBanks will be much lower than for other financial institutions.

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[11] The FHLBanks have already recorded losses related to the performance of private-label MBS, and CECL does not require the FHLBanks to record an additional allowance if losses have already been recorded on these securities.

[12] The FHLBanks purchase loans through the Mortgage Purchase Program and the Mortgage Partnership Finance Program.

As of their second quarter 2019 10-Q filings, no FHLBank had yet publicly quantified the total expected initial credit losses from implementing CECL. However, 7 of the 11 FHLBanks disclosed that they do not anticipate implementation of CECL will have a material effect on their financial condition, and three of those seven FHLBanks cautioned that the effect on their financial condition depends upon the composition of the financial assets held at the time of adoption, as well as the economic conditions and forecasts at that time.

Ongoing Impact

As stated before, the FHLBanks expect no or insignificant credit losses on approximately 85% of their assets as of December 31, 2018. Still, the FHLBanks recognize the need for each FHLBank to monitor the fact patterns, specifically those relating to advances and agency securities, regularly (at a minimum, each reporting period).

FHFA OVERSIGHT OF ENTERPRISE AND FHLBANK EFFORTS TO IMPLEMENT CECL METHODOLOGY.....................................

FHFA's General Approach

FHFA has not issued formal guidance to the Enterprises or FHLBanks regarding CECL, though other federal financial regulators—including the Federal Reserve and the Office of the Comptroller of the Currency—issued guidance to their regulated entities. An FHFA official explained to us that, unlike other federal financial regulators that supervise thousands of institutions of various sizes, FHFA oversees two Enterprises and eleven FHLBanks. According to FHFA officials, FHFA is better able to do in-depth reviews and work with its regulated entities on an individualized basis. Agency officials explained that they consider FHFA's current supervisory approach, such as regularly meeting with the Enterprises' and FHLBanks' financial teams and reviewing their accounting policies, to be more valuable than issuing high-level guidance for adopting CECL.

While OCA officials report that FHFA's written guidance for Agency examiners has not been revised to specifically address CECL, its existing guidance requires OCA to monitor the regulated entities' adherence to OCA's policies on accounting, financial reporting, and disclosure matters. According to OCA officials, FHFA oversees the regulated entities' accounting practices through regular review of the accounting policies for each FHLBank and Enterprise. Each of FHFA's regulated entities is required to maintain a current accounting guide listing all of its accounting policies and procedures. The regulated entities must notify OCA of revisions and provide an updated guide quarterly. Annually, each FHLBank and

Enterprise is required to provide a report to OCA including all actions taken to be consistent with the Agency's accounting examination guidance.

FHFA's existing guidance also establishes expectations with respect to the regulated entities' implementation of models. By example, each regulated entity's board or its delegates should review and approve model risk management policies on an annual basis. These policies should cover all aspects of model risk management, including model development, testing, validation, and implementation. Additionally, the model risk management group should conduct a model review at least annually. Furthermore, FHFA expects the regulated entities to monitor its models, which helps to identify if an update or replacement is necessary.

Agency officials reported to us that FHFA views the risk of implementing the CECL methodology to be lower for the FHLBanks than for the Enterprises, and we have discussed the different risk profiles earlier in this white paper. Because FHFA has a risk-based supervision program, it has taken a different approach in its oversight of CECL implementation for the Enterprises than for the FHLBanks. Generally, its oversight of Enterprise implementation of CECL has been greater because of differences in perceived risk, significance to the financial statements, complexity, and cost.

Once the regulated entities have implemented CECL, an FHFA official explained to us that the Agency could spend more time overseeing CECL implementation for the Enterprises than for the FHLBanks because, for example, CECL could result in more volatility for the Enterprises' financial results over time.

FHFA's responsibilities as supervisor will include ensuring that the regulated entities comply with the CECL accounting standard after adoption effective January 1, 2020, when CECL becomes part of GAAP for the regulated entities. The regulated entities' audit committees, assisted by external auditors, also will continue to be responsible for ensuring the regulated entities' compliance with CECL.

FHFA Oversight of the Enterprises' Implementation of CECL

According to Enterprise officials, FHFA has been involved with the Enterprises' implementation of the CECL methodology since they began this effort. An FHFA official told us that the Agency met regularly with the Enterprises regarding CECL, approximately monthly, though the meetings are less frequent now. FHFA also requested information from each Enterprise about its implementation plans, and OCA provided feedback on the responses. FHFA advised Fannie Mae and Freddie Mac that it expected them to align their accounting policy conclusions for implementing CECL and, when possible, align the implementation of those policies. The Enterprises told us that they have aligned on all major policies. However, the Enterprises remain independent on their models and results.

Within FHFA, model risk oversight is performed by Division of Enterprise Regulation examination teams. Although they do not approve the models, these teams review models as part of their supervision. They have previously examined models that the Enterprises may use for CECL, such as their interest rate models. According to an FHFA official, the Agency will review new models based on whether they are significantly related to risk.

In addition to its role as their supervisor, as conservator of the Enterprises FHFA reviews the Enterprises' financial disclosures before they are filed with the SEC. FHFA officials told us that OCA will review the Enterprises' significant CECL-related disclosures for material misstatements or omissions. The Agency said that it will not opine on the accuracy of the numbers or qualitative statements unless it is aware of information to the contrary.

FHFA Oversight of the FHLBanks' Implementation of CECL

FHFA has been involved with the FHLBanks as they have prepared to implement CECL. According to an FHFA official, FHLBank representatives came to FHFA headquarters in 2017 to discuss plans for implementing CECL. OCA and Division of Federal Home Loan Bank Regulation examiners also discussed implementation status with FHLBank management and/or the audit committee chair, assessed one of the FHLBank's progress in developing models, and commented on public disclosures related to an FHLBank's CECL implementation status. An FHFA official told us that FHFA reviewed the draft white papers on CECL implementation prepared by the controllers' committee, and the committee revised the white papers to respond to FHFA's queries.

FHFA officials told us that the basic approach to supervision will not change once the FHLBanks have implemented CECL. Once CECL has been implemented, FHFA will continue to examine the FHLBanks' ongoing compliance with GAAP.

CONCLUSION

In June 2016, FASB issued Accounting Standards Update 2016-13, requiring a substantial change in how certain organizations, including the Enterprises and FHLBanks, must record credit losses in their financial statements.

Implementation of the CECL methodology will require the Enterprises to set aside reserves to cover expected lifetime credit losses at the time they purchase mortgages. Freddie Mac reported that it did not expect the implementation of CECL to require it to request a draw from Treasury, though the actual effect will depend on conditions at the time. Fannie Mae reported that it estimated the initial impact of CECL to be up to $4 billion depending on a variety of factors, which could result in a net worth deficit for the quarter, and that it was still assessing this impact. According to the Enterprises, CECL may increase the volatility of their earnings over time.

With regard to the FHLBanks, FHFA officials reported to us that FHFA does not expect that the impact of application of the CECL methodology will be material to the FHLBanks because their largest asset class—advances—has no historical losses. The FHLBanks anticipate zero or insignificant losses on the other assets in their portfolios, including agency securities, municipal securities, standby bond purchase agreements, short-term investments, and repurchase agreements. A majority of the FHLBanks have disclosed that they do not anticipate CECL to have a material effect on their financial position.

OBJECTIVE, SCOPE, AND METHODOLOGY ....

The objective of this white paper was to provide background information on the CECL methodology and what FHFA and the regulated entities see as its potential impact. The white paper also discusses the regulated entities' implementation efforts and FHFA's review. To achieve this objective, we reviewed internal FHFA and regulated entity documents as well as publicly available documents. We also interviewed FHFA and Enterprise officials.

We provided FHFA with the opportunity to respond to a draft of this white paper. We appreciate the cooperation of FHFA staff, as well as the assistance of all those who contributed to the preparation of this white paper.

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