

D.C. OUTLOOK: Accounting Issues

Loan loss reserves: FASB's latest proposal ushers in renewed debate

This article is an online companion to the January 2013 ABA Banking Journal cover story, "The Road Ahead." To read that article and other online articles in the report, please [click here](#).

By Steve Cocheo, executive editor & digital content manager

There's never any shortage of bank accounting issues in play, but 2013 will see a big one come center stage. The Financial Accounting Standards Board's late December 2012 proposal for a major shift in approach to setting the allowance for loan and lease loss reserves (ALLL) potentially impacts every banking company, from the smallest community bank to the largest holding company. And, alongside center stage will be establishing reserves for debt securities--something that has not been seen before.

Basics of the shift

The Exposure Draft--officially FASB's Proposed Accounting Standards Update: Financial Instruments-Credit Losses (Subtopic 825-15)--represents the accounting rule-setter's third pass since 2009 at amending how banks handle the establishment of reserves. The proposal involves a significant shift in the viewpoint on which the calculations are based.

Currently, generally accepted accounting principles and regulatory practice call for reserves to be set based on "incurred losses." Under this approach, recognition in reserves of a credit loss doesn't occur until the loss is either probable or has actually happened and it can be reasonably estimated.

The December proposal would shift to an "expected loss" method of setting reserves. In full, the method is called the "current expected credit loss" model (CECL).

Under this concept, according to FASB, "the allowance for expected credit losses would reflect management's current estimate of the contractual cash flows that the company does not expect to collect, based on its assessment of credit risk as of the reporting date." [Emphasis added.] Banks would be expected to strike a middle ground between the possibility of loss and the possibility of no loss.

To elaborate on the differences between the two approaches, the incurred loss model only permits a bank to use past events and current conditions to set its reserve. The expected loss model is intended to be more forward-looking. That is, it would add forecasts of credit conditions to past events and current conditions. Ultimately, losses would be recognized earlier under the proposed model

That's the issue, in brief, but, as usual, the devil is in the details. This article is based on an interview with Donna Fisher, senior vice-president of tax, accounting, and financial management and Michael Gullette, vice-president, accounting and financial management; an analysis of FASB's proposal and related documents; and an extensive Q&A that ABA published on the FASB draft on Jan. 4.

Road to the current proposal

Genesis of the latest reserve proposal was the belief that the current rules didn't leave the industry prepared for the financial crisis.

"The impairment changes proposed in this exposure draft are in response to the 'too little, too late' criticisms made during the financial crisis," says Fisher. "Some felt that banks were inadequately reserved before the crisis, due to constraints of the current incurred loss impairment model."

If adopted, "this will be a big change for U.S. banks, and especially for community banks, even if you just look at the kind of data they will have to keep in order to keep their loan loss allowance model up to date," says Mike Gullette.

Elaborating, Gullette explains that historically banks have worked from measures such as annualized chargeoff rates. "But that won't be good enough anymore."

He explains that if a bank's portfolio contractually would return 6%, but that sufficient nonperformance would cut that to 4%, then the two-percentage-point difference would have to be reflected in the allowance. "And that's whether you think there are problems with any of those loans or not," says Gullette. This will apply for the life of the loan, ABA says, though the term isn't explicitly used in the FASB exposure draft.

On this point, the ABA Q&A states in question 6:

"ABA believes most banks do not currently have sufficient 'life-of-loan' (LOL) loss data to support ALLL estimates needed for the exposure draft. Bankers also realize the reliability of their forecasts of the economy and credit performance diminish greatly past one year--forecasting several years into the future can be a dream or a nightmare, with neither providing good information to users of financial statements. Therefore, ABA believes that for most banks, the type of documentation that might be required for LOL loss allowances could start with, on a practical basis, market data from Moody's or other rating agencies. Banks will then have to make adjustments from this data to align with their specific underwriting terms, geographic location, etc. Supporting the market data as well as these adjustments will be very challenging, and changes to any assumed loss rates, since they potentially apply to many years, could potentially add significant volatility to the ALLL without improving the information.

"On the other hand, if the CECL emphasizes that a bank should just estimate 'what they can estimate' with reasonable confidence, without any regard to whether a loss has been incurred, this may greatly reduce the changes needed to the credit evaluation process." [Emphasis added.]

Fisher says ABA believes at this time that allowances will likely rise when banks make the shift from the current methodology to the expected loss approach. Institution by institution this may vary, depending on whether a given bank has currently been releasing reserves. Fisher adds that some bankers felt that they should have been permitted to set higher reserves before and during the crisis. Even prior to the crisis, reserves had been a matter of debate, with players such as the Securities and Exchange Commission resisting reserve levels that it considered part of a potential "earnings management" effort.

Multi-cultural debate goes on

Both FASB and its international counterpart, the International Accounting Standards Board, favor a shift in ALLL procedure, but do not currently agree on how to address it. The current FASB proposal represents the organization's departure from a model that IASB and FASB had been developing in cooperation. The split came in recognition of differences in U.S. and international attitudes on reserves. The formerly joint proposal was called the "three-bucket model." FASB stated in its recent In Focus newsletter that during outreach to industry and users of financial statements it heard "significant concerns that the three-bucket impairment model would not be understandable, operable, or auditable."

"The debate is over how to account for your good loans, in setting the reserve," explains Fisher. "We all sort of agree on bad loans. Some countries believe you should have no accruals for good loans, but in the U.S., we do. That's a big difference and it's the dividing line philosophically between FASB and IASB." (Note that the proposal also addresses reserving for other than temporary impairment for debt securities in banks' portfolios. ABA opposes inclusion of debt securities in the FASB proposal.)

Fisher adds that a similar schism has been seen, historically, on the Basel accounting committee, between U.S. and other countries' regulators. She says she has heard that these regulators may be coming closer together.

IASB is expected to publish its own proposal in February. Here Fisher shares a bit of insight: "Many in the press have indicated that FASB pulled away from the IASB and did their own thing. Actually, the truth of the matter is that IASB refused to address the issues that American banks needed to have addressed. And IASB refused to work with FASB on those issues. So, FASB couldn't ignore its constituents [bankers, regulators, and investors], who felt IASB's three-bucket model wouldn't work."

ABA has expressed to FASB the need for both proposals to have the same comment period deadline in order to ensure that both proposals can be fully explored and compared. The FASB's deadline is April 13, 2013, and the IASB's is likely to be mid-June. Approval of a final rule may not occur until the end of 2013 or possibly 2014, ABA believes, and implementation at banks will not likely be required until 2015. Gullette says that early adoption may be permitted, but it is hard to say at this time.

Outlook for change

Where the matter will go, and the ultimate impact on banks, remains to be seen. There is a certain degree of "creative tension," if you will, between the deliberations over reserves and aspects of the original Basel III capital proposals.

In addition, ABA believes that some of what regulators have been trying to accomplish over the last few years, by requiring higher capital levels than would strictly be required under risk-based capital standards, would be accomplished should the expected loss proposal go through. Some pundits have talked about that with phrases like "10% is the new 8%."

"Examiners have been saying, 'You've met the minimum capital level, but because of risks in your portfolio we're going to say you need 2% more'," says Gullette. "We think that should go away" if the expected loss method is adopted as proposed.

"ABA has always believed that estimating loan loss allowances is highly judgmental and bankers should be able to reserve for amounts that are not necessarily supported closely by quantitative models," the Q&A states in question 9. "ABA believes that past efforts by the SEC to curb 'earnings management' led bankers to minimize the ALLL at times when it was needed the most. Therefore, ABA generally supports a change from the strict incurred loss accounting standard for loans, though we do not yet support a change for debt securities." ABA does have concerns about the life-of-loan issue, as noted above and addressed in greater depth in its

Q&A.

One facet of the debate concerns the users of financial statements, including bank analysts. In the course of discussing analysts' needs, ABA notes in Question 9 that:

"Bank analysts tell ABA that they generally believe banks should be reserving now for the 'rainy day.' However, that can be a very different concept than what is in a [life-of-loan] expected loss model. While consideration of the economic cycle is a factor in the CECL model, no 'rainy day' fund exists. As a result, ABA expects all estimates to be subject to rigorous support and documentation requirements that exclude consideration of any 'rainy day.'"

And, speaking of rainy days, ABA believes that banks will continue to need to account for troubled debt restructurings under the proposed change.

"ABA has strongly encouraged both the FASB and the banking agencies to eliminate TDRs," the association states in question 12 of the Q&A, "because under an expected loss approach, the TDR designation is unnecessary. Even though the banking agencies agree that TDR accounting should be eliminated while improving disclosures about TDRs, the FASB has chosen to retain TDR accounting."

Getting involved in ALLL debate

Many bankers will be concerned about the FASB exposure draft. Member bankers who wish to be involved can join ABA's working group. Contact Nora Colbert for more information.

Investors with an interest in this issue can contact Mike Gullette at ABA.

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