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Accounting for Credit Losses – Let's Predict the Future

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There are many who do not believe that Subtopic 825-15, Financial Instruments – Credit Losses will ever become final. The exposure draft was issued December 2012 and comments were due April 2013. This disbelief is not only without merit but is borderline delusional. Let's take a look at why this drastic change in accounting for anticipated credit losses is inevitable and look at how drastic this change appears while focusing on its effect on financial statements in general.

The regulators embrace this change in accounting principle as evidenced by remarks made by Thomas Curry, Comptroller of the Currency before the AICPA Banking Conference in September 2013, "I want to say a few words about why we believe the approach at the heart of FASB's proposal—the 'expected loss' model—is not only sound but preferable to the existing 'incurred loss' regime." Mr. Curry goes on to point out, "the financial crisis revealed a distinct flaw in the incurred loss model." As previously noted, the comment period ended April 2013. Yet, in July 2014, Donna Fisher, SVP, Tax, Accounting and Financial Management with the American Bankers Association, fires off a letter, delivered via email, to Russell G. Golden, FASB Chairman, taking exceptions with many basic provisions inside of the proposed change. These exceptions revolve around two major factors. Ms. Golden says, "The ALLL estimation process for all banks – will explode from a relatively simple three step process into a process that will require many layers of new work." She also goes on to argue that these changes are "not in the best interest of banking industry investors." This is clearly articulation of a widely shared belief that earnings will decrease under this new principle.

As previously noted, the biggest change from what we are doing today is the switch from a historic loss experience model to an expected, predicted loss

model. The new principle is looking for a number that reflects all known losses in the portfolio today plus future losses expected based on forecasted events. The first thing we need is for someone to tell us what the economy will do over the next 5 years. Companies will have to develop correlated analysis based on environmental and economic data to support their forecasts. We need to know what areas of the economy will be adversely affected and most importantly which of our loan pools will be negatively impacted. We all know that some economic factors are more global or nationwide, while others are more localized. Some events affect certain regions of our country more than other regions. Remember regression analysis that is rarely done by community financial institutions? Well, historical regression analysis will be needed under the new principle to support loan loss rates based on life cycle loan data. A prime example of this was the most recent recession where states heavily dependent on the sale of 1-4 family housing and related construction jobs were more adversely affected. So, it would appear that our first job would be to consider how the 5-year economic forecasts would impact our specific loan pools. Then we will need to quantify and justify our predictive loss model. Exactly how will an anticipated drought affect our agriculture based loan pool(s)? What about the reduction in military spending? How will this affect our business loans made to companies that support the military, especially if the local military base gets cut back or closed? What if a significant local employer is contemplating relocation? How will any of these events impact our mortgage and consumer loans? Will the banks in California have to contemplate more frequent fires?

It is clear from reviewing the proposed principle's exposure draft that the amount of work required in estimating expected losses based on anticipated events is much more complicated. One can no longer assume that historic portfolio loss trends will adequately predict future losses, not even in similar pools of loans, because the current historic losses are simply roll forward rates and are not tied to a loan pool's life cycle. Under the new principle, we need to know at what point in the life cycle pool we are and what affect economic events will have on this pool at that point. We certainly would have not been able to predict the latest 2008 economic implosion by looking back 5, 10 or 15 years. There was no similar trend like it to prompt reasons for concern. Likewise, we can't just predict future pool losses by just mapping out a future trend of losses based on the period of 2008-2013. Subprime lending with related secondary market activity does not now exist, nor does many of the economic elements that aided that financial crisis. So, now let's predict the future cash flows based on anticipated economic conditions over the life of our loans. That should be easy enough!

Before we get ready to quantify our Allowance for Credit Losses (ACL), we must define our loan pools. Under CECL, more loan pools will likely be beneficial. It could allow us to pinpoint smaller groups of loans that will be impacted or impacted more than others. It will become beneficial to be knowledgeable as to what events could impact each loan segment and be able to separate them in pools accordingly. Back to our examples, crop agriculture loans will be impacted more during a drought than livestock loans. If all of your similar service and/or manufacturing business loans were all computer coded the same as those to companies supporting military operations, it would be difficult to segment the specific military based loans. Thus, higher loss percentages could be applied to non-military supported loans, which would overstate your ACL and cost your investors return on equity (ROE). Likewise, this could affect bonus payouts and other incentives within the organization.

Remember all the wrestling with impaired loans, SOP 03-3 and special accounting for TDR's? Deleting these requirements has been on our wish list forever, correct? Well, in the new principle, there is no complete separation of troubled debt restructured loans, impaired loans and/or purchased credit impaired (PCI) loans from the portfolio. So, while these loans may be individually marked and charged down to a current liquidation value in the portfolio, their remaining balances will still be subjected to the expected loss ratio down at the loan pool level. Yes, that's correct! You have marked a loan down to net realizable value, $250,000, which is the amount of cash you will receive after the collateral is liquidated. If the loan is 1-4 owner occupied, detached dwelling and the loss percentage for that loan pool is 2.5%, there will be another $6,250 required in the ACL. Some call it double dipping, but it is reality under the new principle.

The issue of projecting average life or the expected life of each loan pool must now be addressed. This matters greatly in the overall calculation. If the economic event being forecasted is 4 or 5 years out and many of the loans in the affected pools will be paid out prior to this event, the amount needed in the ACL today is less. However, if we project the average lives of certain affected loan pools longer, then all balances in these pools will be subjected to the forecasted economic event and maybe over multiple years. This would require greater balances and a larger projected loss percentage for these affected loan pools. For example, if 1-4 owner occupied home equity loans have a 5-7 year average life and the projected economic turndown is scheduled to happen in years 4 thru 7, most of this pool will likely be affected and require increased loss balances in ACL. However, if we can prove our home equity pool has an average life of 3-4 years, this projected event will have a much less effect on ACL for this pool. Historic data for all established loan pools can be very helpful in minimizing the effects of predicted economic downturns. It is not just good enough under the new guidelines to guess average loan lives. You must prove them empirically.

Now it's time to tie some of this together. Let's assume that the predictive economic model sees another downturn almost identical to what happened in 2008. It is now 2028 and 2008 was 20 years ago. Yet, you know what loan pools were affected and you know what the percentage losses were during that 2-3 year downturn. You have the data to prove all of these assumptions. Now, all you need is the year it is predicted to happen and you can run a regression analysis on these loss rates, which will dramatically increase your ACL comparatively speaking. However, maybe your financial institution was affected much less that the average institution. Ownership of the data to prove what happened and application of this in the predictive model will satisfy the requirements of the new accounting principle. Having the same knowledge with support for any historic downturn due to droughts, floods, major employer closings, military cutbacks will be valuable as we move forward under the new principle. Using a recent OCC publication, which outlines macro level factors that can be used for stress testing loan portfolios under expected and adverse assumptions, may also be used to support forecasts. Regardless, we need historic loan pool level data to complete the task, because regression analysis will vary at the pool level based on the life cycle of the loans and their historic performance during that life cycle under certain economic events.

Getting back to the predictive mission, it is clear to most that if we combine what we expect to lose today based on historical loan life cycles with what we expect to lose in the future based on economic predictions and we apply this to our loan portfolio segments, the ACL account will be a larger reserve long-term than if we stayed with the current, reactive, historic model. In proving this let's look back in 1998 when the Securities and Exchange Commission (SEC) successfully called in to question the loan loss reserve policy of SunTrust Bank. In summary, SunTrust management had incorporated into their loan loss provisioning expectations about future losses due to changes in economic conditions that affect credit defaults for loan losses, even if no event has yet occurred to indicate specific estimable losses. The SEC essentially argued that SunTrust had no such previous loss experience to justify the higher levels of loan loss reserves. As a result, SunTrust reduced and restated earnings and changed its loan loss policies. I find it most ironic that after the 2008 recession, many of the same regulatory agencies that chastised SunTrust are now suggesting that all financial institutions quantify and incorporate future predicted economic conditions as a part of what we will soon call Accounting for Credit Losses. Will SunTrust now get the last laugh on these agencies? Will they get to now go undo the restatement? Get prepared soon financial institutions! Historic data, including regression analysis, may become your best line of defense as you approach this historic change in accounting principle.

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