Chapter 21*

Banks' Loan Loss Reserving

Background

Banks currently have to reserve for loan losses, under both U.S. and international generally accepted accounting principles (GAAP), using the "incurred loss model." Under this model, banks accrue allowances (reductions of net loans outstanding) and provisions (expenses) for loan losses only when those losses: (1) are inherent in banks' existing loan portfolios; and (2) are both "probable" and "capable of reasonable estimation" based on available information. As a proxy for the unobservable losses inherent in banks' loan portfolios, certain accounting guidance provided largely by bank regulators allows banks to accrue only for loan losses expected to be realized (through loan charge-offs) over a relatively short horizon (such as a year), even when the remaining life of loans is considerably longer than that.

Various parties -- notably the Financial Stability Forum, in an April 2009 report, and the U.S. Treasury, in its June 2009 proposals to reform the financial system -- have argued that the incurred loss model yields loan loss allowances in good economic times that are too low to absorb loan losses when the economic cycle turns, as it inevitably does, thereby exacerbating the cyclicality of the financial system. These parties often suggest replacing the incurred loss model with "dynamic" loan loss reserving -- in which banks accrue for loan losses based on long-run or "through the cycle" default probabilities and expected losses given default, even when the expected time until the cycle turns is beyond the remaining life of the loans. Dynamic loss reserving is intended to induce banks to build up more capital in good economic times so that they are better able to weather periods of economic weakness.

"Expected" loss reserving constitutes a middle ground between the incurred loss model and dynamic loss reserving. Under this approach, banks reserve for loan losses expected to occur over the remaining life of their existing loans. That is, this approach eliminates the probable and capable of reasonable estimation thresholds to accrual of loan losses, as well as the use of a horizon shorter than the remaining life of the loans. Expected loss reserving is similar to the incurred loss model for banks with loans whose remaining life is shorter than the time to the expected turn of the business cycle, and is similar to dynamic loss reserving for banks with loans whose remaining life is longer than the time to the expected business cycle turn. Expected loss reserving is currently under consideration by the International Accounting Standards Board (IASB) and the Financial Accounting Standards Board (FASB).

The Issues

There are two primary issues: First, should the incurred loss model in GAAP be replaced by either dynamic or expected loss reserving approaches? Second, should GAAP loan loss reserving be tilted to induce banks to build up sufficient capital in good economic times in order to prepare better for the inevitable economic downturns?

We believe that the incurred loss model yields artificially low loss accruals for loans with longer remaining lives than the horizon over which realized losses are considered, and therefore

* Working group: Stephen Ryan, Joshua Ronen

should be replaced by an expected loss approach. The same is true for heterogeneous loans for which it is difficult to meet the probable and capable of reasonable estimation thresholds for accounting recognition. Moreover, the expected loss approach is consistent with economic valuation and with the fair value accounting used for some other financial instruments.

The proposal for dynamic loss reserving should be rejected because it is completely at odds with accounting concepts -- which never accrue for firms' general business risks unrelated to existing exposures -- as well as with the accounting for banks' other financial instruments. The effective maturity of most loans is shorter than the highly uncertain period of the business cycle, and so dynamic loss reserving obscures actual credit loss experience and yields artificially smooth earnings.

Dynamic loss reserving is an indirect means to the goal of banks' bolstering capital reserves in good economic times. While that appears to be a worthy goal, it should be addressed head on by requiring higher capital ratios when the economy is robust or through regulatory accounting principles, not by compromising the consistency of GAAP and the transparency of financial reports based on GAAP.

Recommendation

The incurred loss model should be replaced with an expected loss approach because it is more consistent with economic valuation and with the fair value accounting used for other financial instruments. The proposal for dynamic loss reserving is unsuitable, as it is completely at odds with established accounting concepts. Encouraging banks to build up capital during periods of economic strength is a laudable goal, but it must not be accomplished by compromising the consistency of GAAP.