RISK INSIGHT

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New Loan-Loss Accounting Rules Will Help Stakeholders Keep Banks Honest

When a bank makes loans and they start to go bad, at what point should it tell shareholders that the loans are going to lose money? This question is at the heart of new rules being proposed in Europe and the U.S. to address distortions caused by the so-called incurred loss method currently required under loan accounting rules.

According to the incurred loss method, this point comes when loans are "impaired" and losses are "incurred." In one example provided by the International Accounting Standards Board, credit card borrowers are impaired if they die. While U.S. GAAP, does require some early provision for loan losses, this is based on historical loss rates. Before the end of the housing bubble those were small.

That results in a cliff-edge effect. Banks may have information that their borrowers are in trouble, and that information might leak into the market, affecting stock and bond prices. However, the loans have to be reported as being virtually at par right up to the moment that borrowers stop paying and the loans get written down.

Because banks are leveraged, it's easy to guess what happens next. A big loan write-down wipes out shareholders equity, and the bank is forced to raise new capital in the market, just at the moment it has released bad news. The outcome is often the closure of the bank (if it's small enough) or a bailout (if it's a big bank).

The big bank examples are well-known. Belgium's **Dexia SA** and Dutch lender **SNS Reaal NV** were promptly bailed out or nationalized in a matter of days after the size of loan impairments became known. In the U.S., ten states with large numbers of community bank failures reported that delays in recognizing impaired real estate loans were contributing factors in those failures, according to a report published in January by the Government Accountability Office.

One solution was proposed by Spanish regulators well over a decade ago. In October 2000, economists from the central Bank of Spain presented a paper to the Bank for International Settlements on a method known as "dynamic provisioning." Under this method, the amount that banks provision for bad loans depends on the point in the credit cycle. During a credit boom, banks increase provisions (by setting aside part of the income on loans in a reserve), and in a downturn the provisions are reduced, lessening the impact of a credit crunch.

In the early years of the crisis, that model was praised by the Bank of England and touted by the Spanish themselves as an example for the world to follow. Unfortunately for the Spaniards, the amount that the country's central bank required banks to provision during the boom proved woefully inadequate to cushion them against the collapse of the Spanish real estate market.

That led to situations such as those faced by the Spanish government and Bankia SA. The bank reported loan impairment losses of 620 million euros in its 2011 half-year report and by the 2011 year-end accounts this had ballooned to a charge of 3.9 billion euros. By the time that revised number was disclosed in June 2012, it had increased to 6.63 billion euros, shortly before the bank received a government bailout, and Spain requested its own 100 billion euro banking system bailout from the European Union. Today, Bankia's loan provisions stand at 26.8 billion euros. Clearly, dynamic provisioning failed to save Spain from the cliff-edge effect.

Following this kind of experience, accounting standard-setters have come back with a new approach for recognizing loan loss impairments on bank balance sheets. Under the so-called expected loss method, at each reporting date, lenders assess what they expect to lose over the lifetime of their loans. Under FASB proposals[1] released on Dec. 20, banks should use that lifetime loss estimate to provision against loans and reflect credit deterioration in income statements, a change that may increase U.S. bank loan-loss provisions by 50 percent according to analysts.

On March 7, the IASB proposed its own expected loss method[2], which is less punitive than FASB's in that only a year's worth of expected losses need to be provisioned immediately.

The interesting part is what the IASB does with the remaining part of the lifetime loss. According to a summary of the IASB proposal, when "credit quality deteriorates significantly from that expected at origination or purchase," banks are then required to recognize the entire amount in provisions. In a detailed 149-page document, the IASB provides some examples of how this works.

To take one example, banks that hold bonds at face value in loan portfolios will have to use market prices as an input in recognizing lifetime expected losses. That would probably put an end to the widely-criticized practice of European banks not marking to market their holdings of sovereign bonds.

In another example, banks with real estate loan portfolios would have to look at whether macroeconomic changes in a particular region were hampering the possibility of borrowers repaying, and immediately reflect that in loss provisions under the new system. That might have given investors in Bankia or SNS Reaal some warning of what was to come.

Of course, regulators might be expected to have already required these things of the banks they supervise. Then again, didn't the European Banking Authority give Dexia, Bankia and SNS Reaal pass grades in their stress tests? Or as one of the architects of the dynamic provisioning system wrote in a presentation to the World Bank, "the Spanish system is based on detailed information about credit losses from the credit register managed by Banco de España." We now know how that worked out.

While the new accounting proposals aren't perfect, at least they give shareholders and bondholders a chance to keep banks honest themselves.

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1 *http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB/FASBContent_C/NewsPage&cid=1176160587833*

2 *http://www.ifrs.org/Alerts/ProjectUpdate/Pages/IASB-publishes-revised-proposals-for-loan-loss-provisioning.aspx*