Evolution from Incurred Losses to Expected Losses

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Challenges in Loan Loss Provision Accounting Design

- Banks are are subject to multiple regulators with differing
  - missions
  - views of credit risk economics
  - concepts of accounting for uncertainty
  - ideas about influencing economic behavior
  - academic backgrounds

Differing Regulatory Missions

The fundamental mission of the Federal Reserve System is to foster the stability, integrity and efficiency of the nation's monetary, financial and payment systems in order to ***promote optimal macroeconomic performance.***

Our mission is to develop IFRS Standards that ***bring transparency, accountability and efficiency to financial markets around the world***.

Our work serves the public interest by fostering trust, growth and long-term financial stability in the global economy.

The FASB's mission is ***to establish and improve financial accounting and reporting standards to provide useful information to investors and other users of financial reports*** and educate stakeholders on how to most effectively understand and implement those standards.

Differing Views of Credit Risk Economics

Credit risk is most simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms.

The ***goal of credit risk management is to maximise a bank's risk-adjusted rate of return*** by maintaining credit risk exposure within acceptable parameters.

Primary objective to ensure an allowance balance sufficient to cover all estimated credit losses for the remaining life of an instrument, which would require an entity to estimate cash flows not expected to be collected over the life of the instruments and recognize a related amount immediately in the period of estimate.

If an entity expects not to collect all amounts, a loss exists and should be recognized immediately.

Dissenting Opinions on ASU 2016-13 (CECL)

Messrs. Kroeker and Smith believe that:

•***Originating a loan is typically a positive event and in successful organizations it is fundamental to long-term profitability.***

•However, under ***CECL***, a growing portfolio of loans ***will have a negative effect on profitability because of the requirement to record full lifetime expected losses when the loans are originated.***

•This result is puzzling and counterintuitive.

•Furthermore, recognizing full lifetime losses on loans (in a manner inconsistent with the underlying economics) could have unintended implications to lending institutions' willingness to lend under certain circumstances and to certain types of borrowers.

•This illustrates a significant flaw in the model, which results from the lack of neutral financial reporting.

Differing Concepts of the Role of Uncertainty in Accounting

Barker and Penman (2017) argue that

•In the (hypothetical) absence of uncertainty, there would be no reason not to capitalise all expected (net) inflows on the balance sheet.

•Once uncertainty is introduced, however, economic value of the entity could not be reliably 'known' to the accountant at the balance sheet date, and therefore it could not be communicated in the form of recognised (net) assets in the balance sheet.

•This limitation of the balance sheet under uncertainty opens up an informationally useful role for the income statement.

•***A combination of balance-sheet and income-statement approaches enhances the communication of information under conditions of uncertainty***. Conditions of uncertainty render both the balance sheet and the income statement 'incomplete', yet complementary.

•In short, ***the challenge caused by uncertainty calls for the design of an accrual accounting system that adopts both a balance-sheet and an income-statement perspective.***

Dissenting Opinions on ASU 2016-13 (CECL)

Messrs. Kroeker and Smith believe that

•recognition of lifetime expected credit losses as an expense at inception through the income statement is inconsistent with the definition of an expense.

•conceptual shortcoming of this ASU results in financial reporting that does not faithfully reflect the economics of lending activities.

•the transparency of reporting lifetime expected credit losses can be provided without recording a Day-1 loss.

•there are several models that could have been developed to provide the transparency of providing information about lifetime expected losses while reflecting the risk of loss in a manner that attempts to correspond to the compensation for bearing the related credit risk

•the reporting of operating results under the CECL model is a poorer reflection of the economics of lending activities than the existing incurred loss model.

Differing Views about Economic Consequences

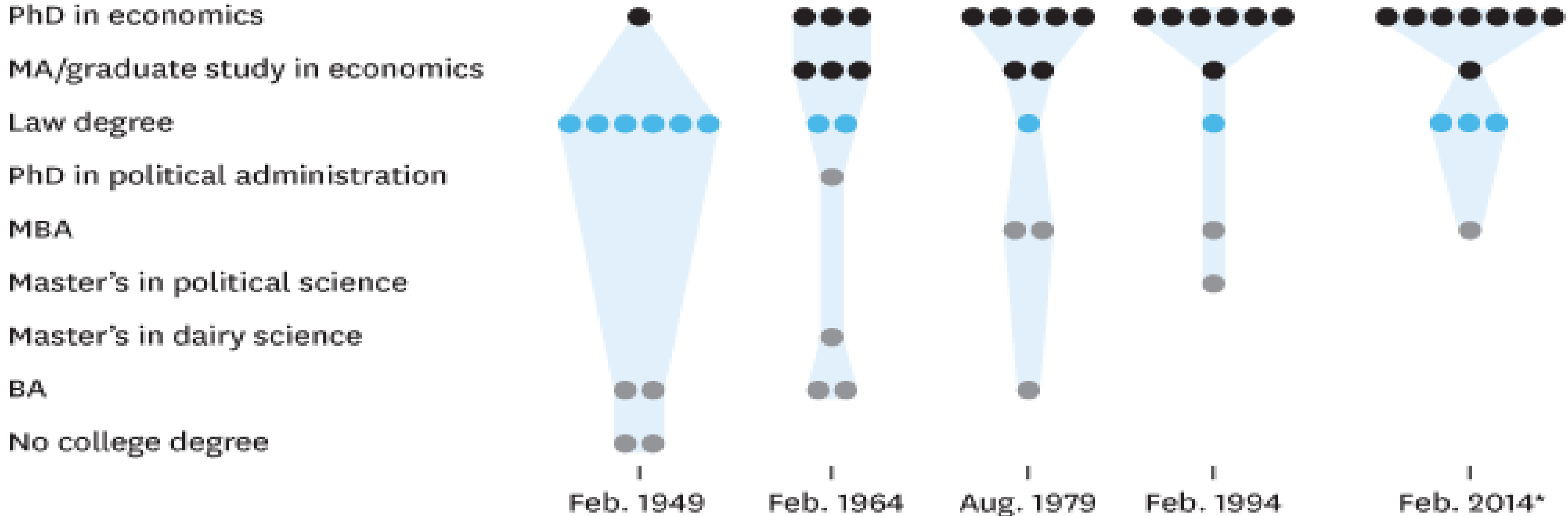
- Fed Chairman Bernanke (2006) argued that good regulatory policies should ***maximize social benefits and minimize social costs.***
- The FASB's stated objective in developing accounting standards is to show a complete and unbiased picture of a company's financial position and performance. The FASB argues that:
  - Better information (which could be favorable or unfavorable for a particular organization) is expected to change capital allocation decisions, but ***the Board does not try to influence the outcome of those decisions.***
  - ***The economic consequences of a new financial reporting standard are separate and distinct from an analysis of costs and benefits.***
  - The role of financial reporting is not to determine or influence what capital allocation decisions should be made or what actions should be taken by management. Rather, the role of financial reporting is to promote decisions that are well-informed and to provide investors information they need to make those decisions.

Accounting Event and Economic Behavioral Change

Research evidence suggests that when accounting changes affect regulatory capital, banks change their economic behavior to mitigate the regulatory capital impact even if the they would not in the absence of a regulatory capital effect

Event/Accounting Issue	Economic Behavioral Change
Adoption of FV accounting for investment securities (FAS 115) with uncertain regulatory capital effects	Banks decreased proportions of assets held in investment securities and decreased maturity of holdings
Exclusion of AFS gains and losses from regulatory capital & HTM reclassification amnesty	Banks increase proportion of securities classified as AFS
Financial Crisis / incurred loan loss provisioning	Banks that delay loan loss recognition cut lending and increase systemic risk during recessions after the adoption of explicit regulatory capital requirements but not before

Differing Academic Backgrounds



The FASB states that its board members "individually have diverse backgrounds" and collectively have "knowledge of accounting, finance, business, accounting education, and research."

- The current 6 FASB board members include 1 Ph.D. in accounting, 2 MBAs, and 3 Bachelor degrees in accounting

Methodological Challenges - Evaluating Regulations

- Change in Regulation
  - A typical approach taken to evaluate newly enacted regulations is to compare firms before and after the change
    - Control firms are hard to find if regulation applies to all banks
      - Changes cannot cleanly be attributed to the new regulation
      - Control variables used to rule out other explanations
- Proposed Regulation
  - Greater methodological challenges when trying to predict the effect of a proposed regulation that will likely alter bank behaviour
    - Accounting research has typically drawn conclusions about these proposed policies assuming that there will be no change in banks economic behaviour
    - This is not likely to be a valid assumption for many policy changes
    - A prediction model of behavior change may be needed

Conclusion

- "Prediction is very difficult, especially if it's about the future." ~ Niels Bohr
- This is true when estimating future losses and is true when predicting the effects of the implementation of expected credit loss accounting.