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NASHVILLE NOTES

Thursday, January 17, 2013 7:03 AM ET

FASB change may move the goalpost

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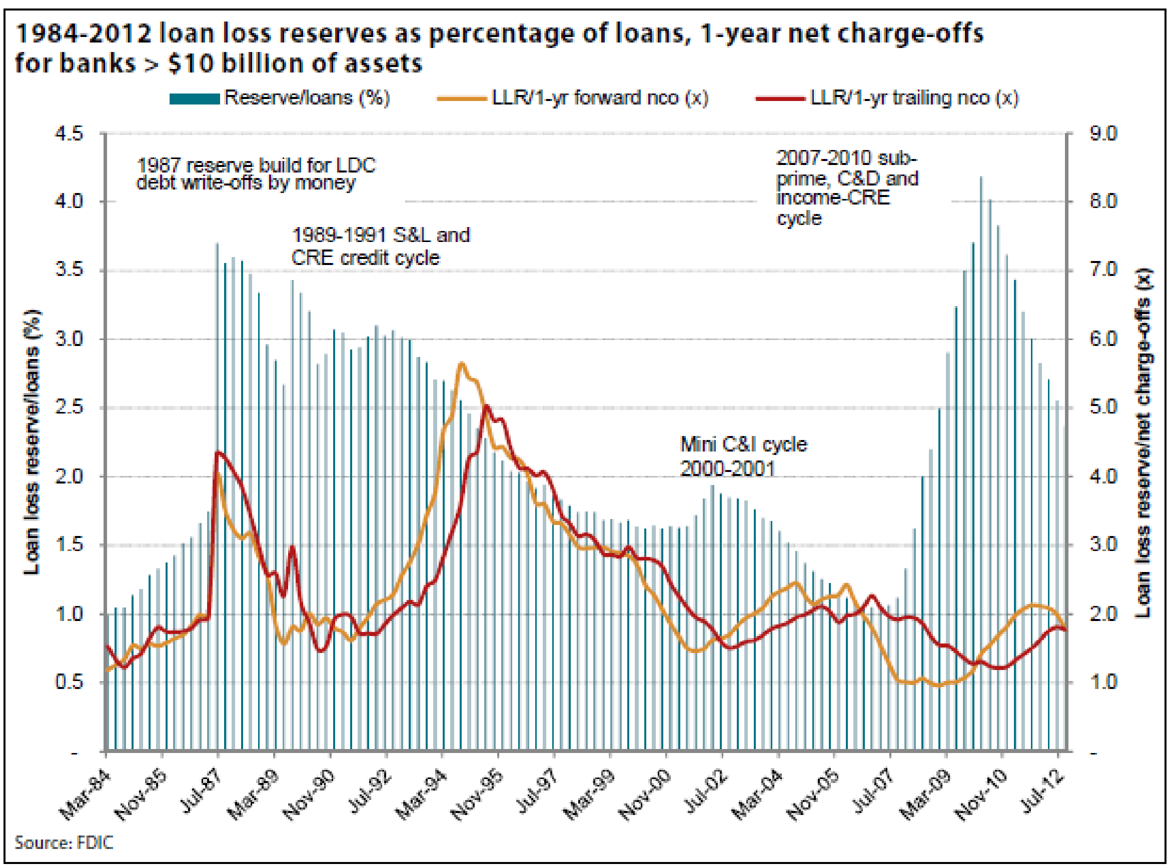
In mid-2006, I was in Birmingham, Ala., visiting with AmSouth Bancorp.'s chief credit officer, Mike Willoughby. AmSouth was a couple of months away from merging with Regions Financial Corp. in a quasi-MOE (62%-38% ownership). Although the Street's focus was on the combined company's earning power with a dollop of skepticism (about $2.0 billion net income for 2007/2008, compared to about $1.1 billion expected for 2013), there also was a clear sense that the credit cycle was turning.

Willoughby had a spreadsheet that showed AmSouth's long-term credit experience. Aside from a few bumps in commercial lending, the record compared well with peers. Losses in the commercial real estate portfolio had been particularly low for many years. I asked him what he thought the long-term CRE loss rate through the business cycle was. He responded something along the line of "that is the $64,000 question." We knew it was higher, but not so high that it would bring the combined Regions-AmSouth and many other banks to their knees within three years. (Disclosure: I started my banking career in 1985, working for AmSouth in Mobile, Ala., under future Whitney Holding Co. executives Bill Marks and John Hope.)

The Financial Accounting Standards Board is considering a proposal to replace the current incurred-loss reserving model, whereby reserves cover losses that exist in the portfolio today with a forward-looking methodology called Current Expected Credit Losses Model, or CECL. The initiative is an attempt similar to new capital rules to harden the banking system to sustain a severe shock as occurred during 2007-2009. The reasonable question: Is it overkill in the context of Basel III and Dodd-Frank? And the relevant question: Would CECL have prevented or lessened the pain incurred during 2007 through 2009?



One of the criticisms of bank accounting reserving practices is that it is pro-cyclical — i.e., reserves are forced lower by accounting conventions during good times. This was apparent when loan loss reserves, as a percentage of loans, trended lower between the late 1980s and immediately before the financial crisis.

Mark Chancy once made this pro-cyclical comment to me in mid-2008 when he was CFO of SunTrust Banks Inc. I think it was meant to be an ironic comment in the context of an imploding financial system. SunTrust had been forced by the SEC in 1998 to restate its earnings higher for 1994-1996 by reducing the loan loss reserve by $100 million, which was considered to be a lot of money then. The SEC was concerned that SunTrust (and banks generally) were using reserves to smooth earnings (who knew?). Publicly traded banks subsequently began to operate with lower reserves, especially after the mild recession of 2001, when the median reserve for banks with more than $10 billion of assets fell to 1.05% of loans at year-end 2006 compared to 1.92% at year-end 1996, according to the FDIC. For the record, SunTrust's reserve as originally reported was 2.05% of loans at year-end 1996; the ratio was 0.78% at year-end 2006.

As I understand the FASB proposal, reserving for impaired loans (FAS 114) will not change; however, reserving for loans subject to FAS 5 reserves will be more forward looking. In theory, current reserving reflects expected losses over a one-year horizon based upon what is known as of the measurement date. Capital and pretax, pre-provision operating income (PPOI) are expected to cover unforeseen future losses, which is the underlying premise of the Federal Reserve's two-year forward-looking stress tests. CECL extends the loss horizon to, presumably, the life of the loan and thereby shifts loss absorption to reserves from capital and PPOI. Bankers can make a reasonable argument that there is no way to forecast much beyond a year beyond what their instinct tells them.

Is CECL a dramatic break with the past and a path to earnings management? Maybe from a theoretical standpoint, but I doubt it from an application standpoint. Bankers presently have some latitude in layering in qualitative factors with historical loss experience in setting the reserve under the current incurred-loss model. CECL seems to extend this principal — though the degree of extension is unclear. I think the bigger issue facing banks, especially small ones, is the reworking of risk-weighted assets under Basel III capital calculations.

If CECL results in slightly more conservative reserves and incrementally less earnings volatility, who is hurt by this? Reserves are intended to absorb losses, though they are not intended to be a cookie jar for earnings management. Nevertheless, the principal of conservatism necessary to operate a bank given the leverage inherent in the balance sheet requires a cushion in the form of reserves and capital. Lest it not be lost on anyone, reserves reflect an accounting segregation of equity capital to the extent provision expense exceeds net charge-offs. Under regulatory capital rules, reserves cannot be leveraged in the same manner that common equity can be (Tier 1 capital versus reserves as a limited Tier 2 component).

The criticism of the current incurred-loss reserve method is that banks had lower reserves than they otherwise would have before the crisis erupted with the SEC and the accountants leaning on the banks to reduce (relative) reserves in the middle of the last decade given the paucity of losses. The media might cynically argue that executives allowed relative reserves to decline to increase profits and bonuses. Regardless, reserves declined sharply for the decade before the crisis erupted.

Had SunTrust not been forced to lower reserves and CECL been in place years ago, banks would have entered the credit crisis with more reserves; however, that does not mean they would have weathered the crisis much better. Would another 50 basis points to 75 basis points of reserves prevent rapid growth in credit, especially in C&D and high loan-to-value first- and second-lien mortgages? I do not think so. The issue was the type of lending that occurred and the precipitous drop in asset values that occurred, though extra reserves would have cushioned the earnings blow and need for capital at the onset of the crisis, had they existed.

A corollary question is whether CECL would make bank financial statements less transparent and less comparable through time. Perhaps, at least initially as reserve levels trended a little bit higher just as they trended lower for 10 years prior to the crisis; however, an incrementally lower cost of capital might emerge if the capital and reserve position was perceived to be slightly higher. Further, investors focus on other factors, such as the level and trend in nonperforming assets, net charge-offs, core deposits and PPOI when assessing the quality of a bank.

Perhaps the better case against CECL is that it, too, is counter-cyclical. Adoption of CECL to the extent it requires higher reserves represents another form of capital charge for banks at a time when Basel III and Dodd-Frank have mandated higher capital. Nevertheless, another 25 basis points to 50 basis points of reserves will not cause the system to lock up and may give investors more comfort the next time the credit cycle turns.

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