Preparing for Current Expected Credit Loss

In 2008, following the most recent financial 'crisis,' focus turned to forcing higher reserves for credit losses in healthier periods. To do so, regulators have embraced the concept of Expected Loss ("EL") as a means to recognize the risks in lending portfolios by setting aside loss reserves that would deal with the inherent volatility of credit portfolios.

Under the proposed rules (FASB 825-15), reserves must be set aside in the current year for probable losses in future years extending to the contractual life of the asset. This is in contrast to current accounting rules to set aside reserves when problems become apparent (for example through late payments, covenant breaches, renegotiation requests, Chapter filings, etc.).

EL is a complex calculation even when there is no long-term forecast involved. The probability of default ("PD") has to be estimated as a numeric value or range; the exposure at default ("EAD") has to be estimated where the borrower has drawing rights or when the loan amortizes; and the final recovery amount, loss given default ("LGD"), has to be estimated. Not only are these estimations difficult, they have to be backed up by historical performance data before both regulators and auditors can accept them.

Unfortunately, throughout the EL calculation it is all too easy to impose conservatism with the probable, indeed the almost certain outcome being that of inaccuracy.

In order to prevent the possible excesses of conservatism, a financial institution must show facts and data that prove that there are better estimates to use in the EL calculation. These facts and data have one overarching need, they must have historical proof using data with statistically valid sample sizes from several years, including years of an economic downturn.

The challenge is to provide data that will allow a reliable estimate. Realistically, most banks either do not have that data or they do not have enough of it to provide a statistically meaningful answer. Moreover, even if they do have the data, it may not have been collected through a full economic cycle, as required by the proposed rules. Everyone needs a loss database or access to such a database. Keeping good records will bring valuable results.

All too often the law of unintended consequences comes along and bites back. Examples abound in many fields. However in the case of Expected Loss it seems possible that a radical change in accounting, prompted by regulatory rather than commercial pressure, can actually bring some tangible benefits, rather than simply add to the regulatory and administrative burden.

Lenders will be able to recognize the dynamics of the business and, in doing so, prove that the risk is well understood and its inherent volatility better controlled. If this is done well using data and measures that are available, the conversations with accountants and regulators will focus on practical and logical outcomes rather than prescriptive conservatism.