Proposed Accounting Change Could Catch Lenders Unprepared

Results Released as Part of New Bank Executive Survey

By Michael Rapoport, WSJ.com, Updated Aug. 12, 2014 4:22 p.m. ET

A proposed accounting change expected to force banks to boost the amount of reserves they hold against soured loans could catch many small and midsize lenders unprepared, according to a new survey of bank executives.

More than half of the executives familiar with the Financial Accounting Standards Board's expected changes said they aren't planning to make significant modifications in their processes to cope with the changes until after they're completed, according to the survey from Sageworks, a financial-information company.

More than a third of the executives surveyed have little or no familiarity with the changes that FASB, which sets accounting rules for U.S. companies, hopes to finalize before the end of the year, according to the survey.

**The changes would require banks to book loan losses much more quickly than they do now and force them to dramatically increase their loan-loss reserves.**

Banks have some time to adapt. The expected FASB changes likely won't take effect until 2017 or 2018.

But banks should start preparing now because they'll need to amass a lot of data on their loans' performance to cope with the changes, and to make changes in their processes to store and use that data, Sageworks said. If they don't, the company said, the banks might not be able to assess and reserve for their loan losses as accurately.

With the changes, banks are "going to need a lot more granular data for individual loans," perhaps three or four years' worth of performance data, said Libby Bierman, a Sageworks analyst. "To get that data, banks need to start today."

There are "good reasons" many banks aren't yet prepared, said Donna Fisher, senior vice president of tax and accounting for the American Bankers Association. Notably, FASB has yet to make some decisions that could affect the final form of its new loan-accounting model, and the board needs to make sure all banks are on the same page in understanding what will be required of them, she said.

Also, "a lot of bankers are not focused on it," said James Kendrick, vice president of accounting and capital policy for the Independent Community Bankers of America. So much is happening now in banking regulation that banks have to address that many aren't paying much attention yet to the loan-accounting changes, he said.

Christine Klimek, a FASB spokeswoman, said the board is "considering the feedback" it's received in response to its loan-accounting proposal, and "will give banks and other lending institutions sufficient time to incorporate the changes."

FASB's changes, which the board has proposed and is working toward completing, are expected to require banks to record losses based on their future projections of loans going bad. **Currently, banks don't book loan losses until the losses have actually occurred, an approach many observers think led banks to be too slow in taking losses during the financial crisis. Under the new rule, banks will have to record upfront all losses expected over the lifetime of a loan.**

**The new method is expected to speed up the booking of losses and require banks to boost their loan-loss reserves significantly, possibly by as much as 50%, according to FASB and some industry estimates.**

**Global accounting rule-makers at the International Accounting Standards Board already have enacted a similar change for banks outside the U.S., beginning in 2018.**

**The IASB rule is softer, however, requiring to book upfront only those losses based on the probability that a loan will default in the next 12 months, not all lifetime losses.**

The survey, conducted for Sageworks by SourceMedia Research, polled 236 managers who deal with credit-risk management at banks and credit unions with between $250 million and $5 billion in assets. Of those surveyed, 37% had little or no familiarity with FASB's planned changes, though the proposal has been in the works and much-publicized over the past few years.

Sixty-five percent of those surveyed use spreadsheets to calculate their loan-loss reserves, as opposed to external or proprietary software or other methods. But Sageworks says that may not be sufficient to handle the massive amount of data banks will have to collect to accurately predict future losses under the new model, and many banks aren't yet acting to update their processes.

Of those surveyed, 34% plan to acquire new software to comply with the new requirements when they're completed. Another 21% say they'll acquire new software before the new model is enforced. Most of the other respondents either already have new software or don't know when they will acquire it.

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