Allowance for Loan Losses – A Practical Approach

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Accounting Standards Guidance

• FASB Guidance
  – July 2010, the FASB issued Accounting Standards Update 2010-20, which is incorporated in ASC 310-10-50
  
  – FASB 5 – (ASC 450 – Contingencies)

  – FASB 114 - ASC 310 Accounting by Creditors for Impairment of a Loan

  – TDR Guidance (ASC 310-40)
NCUA Guidance

• Two Main NCUA Documents that Rule

  – IRPS 02-3 Allowance for Loan and Lease Losses Methodologies and Documentation

IRPS 02-3 Allowance for Loan and Lease Losses Methodologies and Documentation

• Policy –
  – greater emphasis on board involvement
  – Pooling of homogenous loans and individual impairment
  – Management oversight and loss summarization
  – Validation of the data internally

• Establish a Methodology
  – Discussion of the internal processes to be used in preparing the ALLL estimate
  – Pooling Calculation
  – Consider all aspects that affect your allowance estimate

• Validation Process

• Other Factors
  – Conditions that would affect the accuracy of the ALLL Balance
Key Aspects related to Allowance Practices:

- Acknowledges that the process involves a high degree of management judgment and results in a range of estimated losses.
- Should be Prudent, conservative, but not excessive. (includes when will an ALLL balance estimate is at high end of range)
- Process is inevitably imprecise
- An “Unallocated” portion is appropriate when it reflects an estimate of probable losses.
NCUA Joint Accounting Bulletin 2006 – Interagency Policy Statement on Allowance for Loan and Lease Losses

• Key Aspects related to Allowance Practices:
  – ALLL estimate should be based on comprehensive, well-documented and consistently applied analysis of the loan portfolio, and
  – ALLL should take into account all available information existing as of the financial statement date, including environment factors, such as industry, geographical, economic and political factors.
1- The institution’s process for determining an appropriate level for the ALLL is based on a **comprehensive, well-documented, and consistently applied analysis** of its loan portfolio. The analysis should consider all significant factors that affect the collectibility of the portfolio and should support the credit losses estimated by this process.

2- The institution has an effective loan review system and controls (including an **effective loan classification or credit grading system**) that identify, monitor, and address asset quality problems in an **accurate and timely manner**. To be effective, the institution’s loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.

3- The **institution has adequate data capture and reporting systems** to supply the information necessary to support and document its estimate of an appropriate ALLL.
4- The institution evaluates any loss estimation models before they are employed and modifies the models’ assumptions, as needed, to ensure that the resulting loss estimates are consistent with GAAP. To demonstrate this consistency, the institution should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with the models or other estimation tools. The institution should also document and support any adjustments made to the models or to the output of the models in determining the estimated credit losses.

5- The institution promptly charges off loans, or portions of loans, that available information confirms to be uncollectible.
Management Responsibilities

6- The institution **periodically validates the ALLL methodology**. This validation process should include procedures for a review, by a party who is independent of the institution’s credit approval and ALLL estimation processes, of the ALLL methodology and its application in order to confirm its effectiveness. A party who is independent of these processes could be the internal audit staff, a risk management unit of the institution, an external auditor (subject to applicable auditor independence standards), or another contracted third party from outside the institution. **One party need not perform the entire analysis** as the validation can be divided among various independent parties.
Board of Directors’ Oversight Responsibilities

- Reviewing management’s assessment and justification that the loan review system is sound and appropriate for the size and complexity of the institution.
- Reviewing management’s assessment and justification for the amounts estimated and reported each period for the PLLL and the ALLL.
- Requiring management to periodically validate and, when appropriate, revise the ALLL methodology.
Qualitative and Environmental Factors

• Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses.

• Changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments.

• Changes in the nature and volume of the portfolio and in the terms of loans.
Qualitative and Environmental Factors

- Changes in the experience, ability, and depth of lending management and other relevant staff.
- Changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans.
- Changes in the quality of the institution’s loan review system.
- Changes in the value of underlying collateral for collateral-dependent loans.
Qualitative and Environmental Factors

• The existence and effect of any concentrations of credit, and changes in the level of such concentrations.

• The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution’s existing portfolio.
Responsibilities of Examiners

• Examiners should assess the credit quality of an institution’s loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of the reported ALLL in the institution’s regulatory reports. In their review and classification or grading of the loan portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the appropriateness of the ALLL, examiners should:
Responsibilities of Examiners

• Consider the **effectiveness of board oversight** as well as the quality of the institution’s loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution’s **loan review function and credit grading system**. Typically, this will involve testing a sample of the institution’s loans. The sample size generally varies and will depend on the nature or purpose of the examination.
Responsibilities of Examiners

• Evaluate the institution’s ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management’s assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management’s best estimate within the range. In making these evaluations, examiners should ensure that the institution’s historical loss experience and all significant qualitative or environmental factors that affect the collectibility of the portfolio (including changes in the quality of the institution’s loan review function and the other factors previously discussed) have been appropriately considered and that management has appropriately applied GAAP, including FAS 114 and FAS 5.
Responsibilities of Examiners

• Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances this may include a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner’s knowledge of the collectibility of loans at the institution and its current environment.

• Review the ALLL amount reported in the institution’s regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance reported in the financial statements. Inquire about reasons for any material differences between the results of the institution’s ALLL analyses and the institution’s reported ALLL to determine whether the differences can be satisfactorily explained.
Responsibilities of Examiners

– Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.
– Review the interest and fee income accounts associated with the lending process to ensure that the institution’s net income is not materially misstated.
Responsibilities of Examiners

Therefore, examiners should generally accept management’s estimates when they assess the appropriateness of the institution’s reported ALLL, and not seek adjustments to the ALLL, when management has:

– Maintained effective loan review systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner.

– Analyzed all significant qualitative or environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner.

– Established an acceptable ALLL evaluation process for both individual loans and groups of loans that meets the GAAP requirements for an appropriate ALLL.

– Incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.
Build an Acceptable Approach to the ALLL

• 4 Key Steps to Preparing an Appropriate ALLL Estimation Process
  – Establish an appropriate Pooling Process (FAS 5)
  – Establish an appropriate Individual Identification Process (FAS 114)
  – Establish an appropriate Qualitative and Environmental Analysis Process
  – Prepare a final Management & Discussion Analysis (MD&A)
Step 1 – Pooling Process (key areas)

- Establish appropriate pools of homogenous loan types
  - Determine amount of historical loss data to use (1, 2, or 3 years, other)
  - Could be different historical time periods for different pools
- Pooling is a good start, but it is only a start
- ALLL (under GAAP) is intended to be a representation of losses existing in the loan portfolio. This has generally been interpreted to mean a 1-year funding (i.e. it funds one year of losses)
Step 2 - Individual Identification (FAS 114)

- **Definition of Impaired Loan**
  - Generally, Large balance non-homogenous loans, which may include
    - Commercial and MBL loans
    - Large balance residential real estate
    - Participation Loans
    - Other loans that may not be able to be pooled. Perhaps there may not be enough historical data available to pool a loan type and the overall balance of that loan type is not significant.

- Includes Modified loans and Troubled-Debt Restructurings (TDRs)

- Consideration of PV of future cash flows and collateral dependency issues
Step 3 - Qualitative & Environmental

- How well are the considerations of Q&E documented
- Most credit union management groups have many discussions about the condition of their loan portfolio.
- Not all of these discussions get reduced to writing.
- The larger the credit union, the more diverse the loan portfolio, the more detailed the Q&E analysis should be.
- If not reduced the writing, you will have far greater exposure to examiner scrutiny of the ALLL process (If not in writing, is the analysis really being done).
- Q&E analysis is where most credit unions have opportunity to control the examiner process the most.
- Use of Charts, graphs, local economic data are a significant area to support conclusions. Make sure that they do support your analysis.
Step 3 - Qualitative & Environmental

• Generally speaking, after the pooling and individual impairment analysis is completed, what you are really trying decide with Q&E is:

• “What is happening in the loan portfolio (good or bad) that is currently not being measured (or taken into account) by the analysis already performed?
Step 4 – Management Discussion & Analysis (MD&A)

- Pull all of the pieces together.
- In the end, it should be supportive, not distract from the final assessment (estimate).
- Document should stand on its own (board, management and examiners should not need to go to other sources to support your allowance conclusions.)
Why Go Through the Agony of Such a Structured Process

• Formalization of the process assures greater understanding of factors affecting this most significant estimate in the financial statements.

• When performing risk management processes, ALLL has significant impact on the credit unions financial statements.

• If an examiner doesn’t feel the credit union analysis of ALLL is complete, they might start drawing their own conclusions about adequacy of the estimate that don’t make sense in your credit union. This is what you are trying to avoid.
Why Go Through the Agony of Such a Structured Process

• “Limit the playing field” by “cutting the examiner off at the pass” with a comprehensive allowance process.
• If your credit union has gone through the process and responded to all of the Joint Bulletin 2006 examiners guidance areas, it lets examiners know that you are playing by the rules. Therefore, they will play by the rules and examiner personal preferences will have a smaller chance of driving the discussion.
Sample Allowance MD&A
Table of Contents

• Policy & Management Philosophy
• Methodology and Procedures
  • Describe your process
  • Where and how is the data derived
  • How is the data used to arrive at the estimate
  • These are the steps and procedures you go through each time you prepare the ALLL Estimate (NOTE: A complete methodology will yield an appropriate estimate, regardless of good or bad economy – all factors will be considered each time the estimate is prepared)
Sample Allowance MD&A

Table of Contents

• Summary of the Analysis and Final Allowance Estimate
  • Pooling Analysis
  • Individual Impairment Analysis
  • Qualitative & Environmental Factors
  • Other Considerations
  • Required Allowance for Loan & Lease Loss Estimate Total

• Analysis of Pools by Loan Type (Include the calculations, charts and graphs)
  • Individual Pools (pool breakout)
  • Credit scoring (grading analysis) considerations
  • Collateral quality considerations
  • Allowance balance required from pooling estimate
Sample Allowance MD&A

Table of Contents

• Individual Impairment Analysis (Include the schedules of individual loans, collateral values and other factors impacting individual loan balances)
  • Schedule of Individually Evaluated Loans
  • Modified & TDR Loans
    » Present Value of Cash Flows Analysis
    » Analysis of Collateral Dependent Loans
• Allowance balance required from individual impairment analysis
Sample Allowance MD&A
Table of Contents

- Qualitative & Environmental Factors
  - Discussion of the 9 Q&E Factors in the 2006 Joint Bulletin
  - Supporting charts, graphs, and other analysis
  - Can/should include discussions of internal and external factors that impact the loans.

- Externally
  - Employment outlook and business conditions (SEG group economic drivers) that affect loan collectibility
  - Real estate values, automobile market values, and other collateral considerations,
  - Competition from other institutions, legal and regulatory impact on the portfolio.
Sample Allowance MD&A
Table of Contents

• Internally
  • FICO Migration Analysis
  • Real Estate Values in your portfolio (geographic analysis)
  • Broker Price Opinions (BPO) and Automated Valuation Models (AVMs)
  • Other credit quality indicators
What’s coming next on Credit Loss Accounting Standards

• Proposed Accounting Standards Update
  – Financial Instruments – Credit Losses
    • (Subtopic 825-15)
    • Part of a bigger revamp of ASC 825 on Financial Instruments
  – This is out as an Exposure Draft – Comment deadline extended to May 31, 2013.
Proposed Accounting Standards Update

• Applies to Financial Assets not accounted for at Fair Value
  – Loans, debt securities, trade receivables, lease receivables, loan commitments, reinsurance receivables and other receivables that represent contractual rights to receive cash
Proposed Accounting Standards Update

• Incurred Loss vs. Expected Loss Model
  – Incurred Loss Model
    • FAS 5 (ASC 450) Probable assessment
    • Not taking losses until “probable” threshold is reached.
Proposed Accounting Standards Update - Expected Loss Model

• Expected Loss Model
  • Broader range of information to be considered:
    – Based on relevant information about past events, including historical losses, current conditions as well as reasonable and supportable forecasts affecting collectibility.

• Time Value of Money (Discounted Cash Flows)

• Multiple measurement approaches can be used, such as loss rate methods, roll-rate methods, probability of default methods and provision matrices using loss factors.
Proposed Accounting Standards Update – Expected Loss Model

- Removes the existing “probable” threshold
- Focus on Current Estimate of Contractual Cash Flows not expected to be collected at the reporting date.
- Process should always reflect both possibilities of “credit loss” and “no credit loss” results
- Prohibit estimating credit losses “solely on the basis of most likely outcome”
- Recognized as an allowance, or contra-asset, not a direct write-down of the amortized cost.
Proposed Accounting Standards Update – Expected Loss Model

• Income statement would reflect credit deterioration (or improvement)

• If measuring a financial asset at fair value, entity may choose to not recognize credit losses if both conditions exist.
  – Fair value of asset is greater than amortized cost
  – Expected credit losses on financial asset are insignificant

• FASB believes entities can leverage current risk monitoring systems to implement proposed approach. Inputs used to make an estimate may need to change.
Proposed Accounting Standards Update – Expected Loss Model

– The proposed amendments would broaden the information that an entity is required to consider in developing its credit loss estimate. Specifically,

• require that an entity’s estimate be based on relevant information about past events, including historical loss experience with similar assets, current conditions, and reasonable and supportable forecasts that affect the expected collectibility of the financial assets’ remaining contractual cash flows.
Proposed Accounting Standards Update – Expected Loss Model

• As a result, an entity would consider quantitative and qualitative factors specific to the borrower, including the entity’s current evaluation of the borrower’s creditworthiness. An entity also would consider general economic conditions and an evaluation of both the current point in, and the forecasted direction of, the economic cycle (for example, as evidenced by changes in issuer or industry-wide underwriting standards).
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