

2011 NACUSAC Annual Conference – Seattle, WA

Accounting for the Allowance for Loan Losses and Troubled Debt Restructurings

Presented by:

Michael E. Richards, CPA
Richards & Associates

Saturday, June 11, 2011 – 8:30-10:00am

2

Allowance for Loan Losses

- Allowance for Loan and Lease Losses (ALLL), originally referred to as the reserve for bad debts, is a valuation reserve established and maintained by charges against a credit union's operating income. It is an estimate of uncollectible amounts used to reduce the book value of loans and leases to the amount that a credit union expects to collect.

3

ALLL Accounting Guidance

- FASB ASC 450-20 (*formerly SFAS #5, Accounting for Contingencies*)
- FASB ASC 310-10-35 (*formerly SFAS #114, Accounting by Creditors for Impairment of a Loan*)
- Accounting Standards Update #2010-20 July 2010, *Disclosures about the Credit Quality and Financing Receivables and the Allowance for Credit Losses*

4

Summary of ALLL Accounting Guidance

- Loan losses should be recognized when both of the following conditions are met:
 - It is probably that the loan is impaired (that is loan payments or other assets to be received in settlement of the loan are less than its recorded book balance)
 - The loss can be reasonably estimated

5

Summary of ALLL Accounting Guidance - *continued*

- Allowance for Loan and Lease Losses should include the following components
 - Allowance for certain identified or impaired loans
 - Allowance related to classified loans
 - Allowance relating to loans that are evaluated in pools such as consumer and real estate loans
 - General allowance for other loan losses inherent in the portfolio

6

Summary of ALLL Accounting Guidance - *continued*

- A loan is considered impaired if it is probable that the lender will be unable to collect all amounts due under the contractual terms of the loan agreement
- Non accrual loans (delinquent more than ninety days) are generally considered impaired

7

Summary of ALLL Accounting Guidance - *continued*

- If impaired one of following methods used to determine amount of loan loss
 - Fair value of collateral
 - Expected cash flows
 - Aggregate collection experience
 - Market value of the loan

8

Fair Value of Collateral

- Loan loss is the amount needed to reduce the recorded loan balance to the fair value of the collateral
 - Must be used when foreclosure is probable
 - Also used for collateral dependent loans, those for which the collateral is the sole source of repayment
 - Selling costs should be factored in when foreclosure is probable

9

Expected Cash Flows

- Loan loss is the amount needed to reduce the recorded loan balance to expected cash flows to be received, discounted at the effective rate of the loan

10

Aggregate Collection Experience

- Loans with similar risk characteristics are aggregated and historical data is used to determine the loan loss for that group

Market Value of the Loan

- Loan losses are determined based on the market value of the loan, if there is an observable market value for the loan. Such market values are usually unavailable and this method is rarely used by credit unions

New ALLL Disclosure Requirements

- Accounting Standards Update #2010-20, *Disclosure about the Credit Quality of Financing Receivables and the Allowance for Credit Losses*
 - Significantly expands the existing disclosure requirements
 - Intended to provide more information about the credit union's exposure to credit losses and how the allowance for loan losses relates to that exposure

13

New ALLL Disclosure Requirements

- *continued*

- The focus of the ASU is additional disclosure of:
 - The nature of credit risk
 - How credit risk is analyzed and assessed in arriving at the allowance for loan losses and
 - Changes and reasons for those changes in the allowance for loan losses

14

New ALLL Disclosure Requirements

- *continued*

- Disclosure information needs to be provided at the portfolio segment level. Additionally existing disclosures will need to be presented in more detail including:
 - A schedule of activity in the allowance for loan losses from the beginning of the period to the end of the period on a portfolio segment basis
 - The nonaccrual state of loans by class
 - Impaired loans by class

15

New ALLL Disclosure Requirements

- *continued*

- New disclosures about loans will need to be presented:
 - Credit quality indicators for loans at the end of the reporting period by class
 - The aging of past due loans at the end of the reporting period by class
 - The nature and extent of troubled debt restructurings that occurred during the period by class and their effect on the allowance for loan losses

16

New ALLL Disclosure Requirements

- *continued*

- New disclosures about loans will need to be presented (*continued*)
 - The nature and extent of loans modified as a result of troubled debt restructurings within the previous twelve months that defaulted during the reporting period by class and their effect on the allowance for loan losses
 - Significant purchases and sales of financing receivables during the reporting period disaggregated by portfolio segment

ALLL Regulatory Guidance

- SEC's Staff Accounting Bulletin #102, *Selected Loan Loss Allowance Methodology and Documentation Issues*
- FFIEC Interagency Policy Statement, *Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions*

ALLL Regulatory Guidance - *continued*

- NCUA Interpretive Ruling and Policy Statement #02-3, *Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions*
- NCUA Letter to Credit Unions #03-CU-01, *Loan Charge-off Guidance*

Summary of ALLL Regulatory Guidance

- Board of Directors required to have policies and procedures to ensure adequate funding of the allowance for loan losses
- ALLL process must be:
 - Appropriate
 - Systematic
 - Consistently applied
 - Incorporate management's best judgment about the credit quality of the loan portfolio

Summary of ALLL Regulatory Guidance - *continued*

- Method must cover:
 - Estimated credit losses on individually evaluated loans determined to be impaired
 - Estimated credit losses inherent in the remainder of the loan and lease portfolio
- Describes the objectives and elements of an effective loan review system, including a sound credit grading system

Troubled Debt Restructurings

- A troubled debt restructuring (TDR) occurs when the creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor that it would not otherwise consider.

TDR Accounting Guidance

- FASB ASC 470-60-15-9 (formerly SFAS #15 *Accounting by Debtors and Creditors for Troubled Debt Restructurings*)
- FASB ASC 360-10-35 (formerly SFAS #144, *Accounting for the Impairment or Disposal of Long-Lived Assets*)
- Accounting Standards Update #2011-02 April 2011, *A Creditor's Determination of Whether a Restructuring is a Troubled Debt Restructuring*

23

Summary of TDR Accounting Guidance

- A TDR occurs when both of the following conditions exist:
 - The debtor is experiencing financial difficulty
 - The creditor has granted a concession

24

Summary of TDR Accounting Guidance

- *continued*

- When is a debtor experiencing financial difficulty:
 - Debtor is in default of one or more debts
 - Debtor is in the process of filing bankruptcy
 - For business loans there are significant concerns about the debtor's ability to continue as a going concern
 - The debtor's projected cash flows are insufficient to service the debt according to the terms of the agreement
 - The debtor is unable to borrow funds at market interest rates from other creditors

25

Summary of TDR Accounting Guidance

- *continued*

- When is a debtor not experiencing financial difficulty:
 - Debtor is current on the existing loan payments
 - The debtor can obtain funds from a new creditor at existing market interest rates to repay the current loan
 - The creditor restructures the loan exclusively due to:
 - A decrease in the existing market rates
 - An increase in the creditworthiness of the debtor

26

Summary of TDR Accounting Guidance

- *continued*

- When has the creditor granted a concession:
 - Extending the payment due dates
 - Lowering the contractual interest rate
 - Reducing accrued interest
 - Reducing the debt's face or maturity amount
- A concession does not exist if the lower borrowing rate is due solely because of other factors such as the debtor granting additional collateral or guarantees

NCUA Disclosure Requirements

- NCUA requires the following disclosure in the appropriate sections of the 5300 Call Reports
 - TDRs disclosed as delinquent consistent with the original loan contractual terms until the borrower has demonstrated an ability to make timely and consecutive payments over a six-month period consistent with the restructured terms
 - TDRs may not be returned to full accrual status until the six-month consecutive payment requirement is met.

NCUA Disclosure Requirements

- *continued*

- NCUA requires the following disclosure in the appropriate sections of the 5300 Call Reports
 - Total number and amount of modified 1st mortgage real estate loans
 - Total number and amount of modified other real estate loans/lines of credit
 - Total number and amount of modified real estate loans also reported as business loans
 - Total number and amount of modified consumer loans not secured by real estate

29

NCUA Disclosure Requirements

- *continued*

- NCUA requires the following disclosure in the appropriate sections of the 5300 Call Reports
 - Total number and amount of modified business loans not secured by real estate
 - Total amount of loans charged off due to bankruptcy
 - Number of members filing bankruptcy
 - Real estate loans foreclosed

30


NCUA Disclosure Requirements

- *continued*

- NCUA requires the following disclosure in the appropriate sections of the 5300 Call Reports
 - Beginning and ending balance in the allowance for loan losses
 - Provision for loan losses (expense)
 - Total amount of charged off loans
 - Total amount of recoveries from previously charged off loans

31

Q & A



32

About the Presenter

Michael E. Richards, CPA
Managing Partner

RICHARDS & ASSOCIATES, CPAs
21520 Yorba Linda Blvd, #G-516
Yorba Linda, CA 92887
877.572.0473

mrichards@richardscpas.com

