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ASU 2010-20 Whitepaper – Series 1

General – Allowance for Credit Loss Disclosures

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General Policy and Risk Assessment Issues

Overriding all of the following is an underlying theme that management must ensure that controls are in place to develop, assess, account for and obtain approvals for the policies, methodologies and allowance estimation calculations. These controls not only involve initial policies and processes, but also changes to those policies and processes. Change management is more important because you must disclose the changes and the effects on the allowance estimation.

The following should be specifically addressed in the accounting and risk management policies:

- Defining segments and related classes of loans: Specifically, the policies should address the specific risk characteristics of each segment and class of loans. This is important, because this assessment will be disclosed and should tie directly to the loss estimation calculation. These policies should be approved and updated annually. Modifications made to support changes in the credit risk analysis or methodology used in estimating the allowance account must be documented. The reasons for the change should also be documented since disclosures require the rationale for the change. Remember, all this has to be disclosed in detail by segment and by class.

    - This is an important process since there are many requirements which require detailed disclosure by segment or class. If you dive too deep into your portfolio, you may find that your disclosures are becoming enormous. A few thoughts to consider in determining segments and classes.

    - You can have only segments and no classes. However, if you make this assessment, make sure your policies, methodology and calculations support the conclusion.
    - You may find it difficult to not have classes. For example, in residential real estate lending, you may have 30 year fixed mortgages, 15 year variable mortgages and home equity lines of credit with 5 year terms. Your risk assessments, credit policies and other risk factors could be different for all three. In this case you probably have 3 classes.

- Defining Historical loss periods and other economic factors by segment:

  - Historical losses: The policies and risk assessments should specifically address the methodology used in determining specific historical loss periods by segment. Even though the Standard only calls for disclosure by segment, you may still want to calculate your allowance by class if risk assessments are substantially different between classes within the same segment. Examples of Historical loss period rationale would be:

    - The average life of the loans in the segment
    - The average period from origination to default or charge-off
    - Levels of and trends in past due/delinquencies and impaired loans
    - Levels of and trends in charge-offs and recoveries
    - Migration analysis of the loan portfolio
    - Trends in volume and terms of loans
    - Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices
    - Experience, ability, and depth of lending management and other relevant staff

    This rationale should be supported by documentation. Remember, the rationale for a change has to be disclosed, so having specific reasoning for the loss period will be important if a change is made.

    We are aware that some institutions modify the historical loss periods for additional risks. We believe this type of process is not as effective as adding leading indicators of risk to your allowance calculation as separate loss items. If you decide to use a modified historical loss approach, make sure you keep documentation as to the changes and rationale for the change. Remember, the allowance increases and decreases should correlate with the applicable risks by segment or class. Our general recommendation is to not change the loss period unless the underlying risks supporting the initial assessment for the loss period have changed. Therefore, simply having more losses in a current period may not lead to a change in the historical loss period. Management should look to other factors such as those listed in the next section for applying additional loss estimations.

- Other Economic Factors: The Standard requires disclosure of these factors used in determining the loss estimation. Specifically, what risk factors either caused the losses or could cause losses to the respective segment. Once again, even though the Standard only calls for disclosure by segment, calculating by class should be considered if risk assessments as substantially different between classes within the same segment. These additional factors should be added separately to the loss calculation so the effects of the risks and loss estimations are tracked separately. These factors, such as those based on economic conditions, should rise and fall as the risks increase and decrease (leading indicators). We believe this process tracks well with the interagency policy statement. In our opinion, using the approach of modifying your historical loss periods or percentages for economic or other conditions, could lead to major methodology changes from period to period, especially if the periods are similar to our current credit conditions.

- Currently, FASB and the Regulators want loan loss reserves to be more predictive by using leading economic indicators. The other key factor to consider is that FASB wants to remove the "Probable" requirement theory from the allowance estimation process based on the new exposure draft on financial instruments. That portion of the draft appears to be supported by the users and the regulators. The moral of this story may be to add leading risk indicators to your allowance calculation.

- Because of the new requirement to disclose methodology changes and rationale as well as the quantitative effect of the change, developing a methodology that is robust and reacts to credit risks is more important than ever. Without a robust process, you may have to disclose changes on an ongoing basis.

- Other Factors - The Standard requires discussion of the characteristics by each segment.

    - Credit Risk Assessments – this would include the specific risks associated with each segment and class. These risks generally fall into the following categories:

        - Financial Risk Factors of the Borrower: These risk factors include company cash flow and financial ratios such as leverage, liquidity and profitability as well as FICO scores for consumer loans.

        - Industry Specific Risks (companies only): These factors include such items as industry sales data, concentration risks, specific industry risk factors as well as environmental factors and laws affecting the industry.

        - National and Local Economic Factors : these include factors such as unemployment rates, occupancy rate, foreclosure rates, Industrial production and GDP.

        - Market based risks (public companies only): these factors include stock price history and rank as well as default and cash flow issues.

- Approved charge off policies by segment. These policies have risen in importance due to control and disclosure issues. You will now have to disclose the past due/delinquent status of the loan portfolio by class. The policies should also address why a loan would not be written off in accordance with the policies. If you disclose the aging of significant loans past due more than the policy period, you may need to disclose the reasoning as to why those past due loans were not charged off. We will discuss this more with our discussion on Credit Quality Disclosures.

- Define specifically what causes impairment by segment in your policies. Since you now must track the movement of loans between individually and collectively impaired categories, it will be important to define when a loan is impaired by segment type.

Process Implementation issues:

- General Disclosure requirements now include a disclosure by segment of the following:

    - Allowance Beginning Balance by segment
    - Amounts provisioned by segment
    - Charge-offs or write downs by segment
    - Recoveries by segment
    - Allowance Ending Balance by segment

    Fundamental to this is management must develop a tracking system which allocates all the variables. Currently, many institutions have not tracked the allowance by segment or class. The first step would be to allocate the allowance to the specific segments and classes. Gone are the days of applying a single number or using an unallocated amount. ***Remember everything is allocated***. Most companies will need to develop a more detailed tracking system. (Don't forget about review and approval of the process and the calculations)

- Developing a tracking system for all changes in methodology and risk assessments as well as new segments or classes. Management must define what constitutes a change in methodology or policy. For example, changing a historical loss period would be considered a change in methodology. (Don't forget controls)

- Develop a method to track the quantitative effects of changes in methods and policies. You must now disclose the effects of changes in your allowance that were caused by management modifying one or more of the variables used in the allowance calculation. (Don't forget controls)

- Develop a method to track all SFAS 114 loans and TDR's by Segment. This information is part of the disclosure required for segments.

- Develop a method to track any acquired loans by segment and specifically identify those with deteriorated credit quality.

Definitions:

A portfolio segment is the level at which a creditor develops and documents a systematic methodology for determining its allowance, such as by type of loan, industry or risk rate (for example, auto, real estate, commercial or unsecured loans). Most companies and financial institutions are familiar with portfolio segments as this is the level that is more than likely being reported in their financial statements.

A class of loan is generally a disaggregation of a portfolio segment. The principal determination of a class should be based on the initial measurement attribute and secondarily by the level the entity uses when assessing and monitoring risk and the performance of the portfolio, such as by type of borrower, type of loan or type of collateral (for example, if a segment has been defined as auto loans then a class could include new, used or indirect auto loans).

A measurement attribute is a level at which a creditor develops a credit risk profile, such as by creditworthiness category or internally assigned grade (for example, pass, special mention or substandard assigned to the loans within the portfolio).

WE BELIEVE WE HAVE THE SOLUTION - ARCSys has been following this Update since it was issued as an Exposure Draft and has created specialized accounting Software (Software as a Service (SaaS)) to comply with SFAS 5, SFAS 114 and ASU 2010-20. Our software, ACL Calculator, will effortlessly automate the entire allowance calculation process including disclosures; rendering spreadsheets obsolete. ACL Calculator handles everything;

- Historical losses and calculations by segment or class,
- Additional risks calculations for economical, political, industry and environmental credit risks by segment or class.
- SFAS 114 evaluation for fair value and present value calculations
- Troubled Debt Restructurings,
- Detailed calculation reports and edit reports
- Full financial statement disclosures,
- And much more!

CONCLUSION - The ACL Calculator is proprietary software designed to offer you peace of mind regarding SFAS 5 and 114 requirements and the new update standard ASU 2010-20 disclosure changes. It is comprehensive, customizable, all-encompassing software that will drastically minimize the workload required to adhere to the new Standard.

Best of all, It is software developed by accountants for accountants! We provide **Innovative Solutions in a Regulated World.**