Impairment – Just the Facts

Just the Facts!

As with most guidance from FASB and especially under the new codification numbering system, understanding impairment is just as difficult as figuring out how much cash flow a borrower in default is going to pay you. Just when you think you got the right answer, the regulator steps in and wants you to do something different.

The purpose of this white paper is to sort out impairment issues with loans - what does GAAP say and what have the regulators said in policy statements or other written materials. Truth be told, the regulators tell us to follow GAAP, but where GAAP falls short on detail the regulators write a policy statement defining those seemingly missing principles; hence, the Interagency Policy Statement on the Allowance for Loan Losses. In addition, you have a bevy of other releases from the regulators, which encompass examiner's manuals, accounting manuals and other releases. You would think with all of these references there would be one easy common process to calculate the allowance reserve. However, in my twenty-five years of auditing and consulting with financial institutions and now selling software to calculate the allowance, I have found that there is an enormous variation in methods to calculate the allowance account. Obviously, every institution is different, but examiners make different requests based on size, complexity, risk and yes, sometimes just personal preference. On top of GAAP and the regulators, the auditors come in and make some more "recommendations". At the end of the day, you have similar institutions following a very different path to calculate an allowance reserve. What is an institution to do?

Over the years and more recently with the credit crisis, much attention has been placed on the estimation, but little emphasis has been made to bettering the process. At the end of the day, this is your best guess estimate of what you think you will charge off over some period in the future for the loans you have today. The new disclosures surrounding the Allowance for Credit Losses are no different. What does FASB really mean and how much should be disclosed?

We are in process of developing our next whitepaper on where FASB and the IASB are headed in changing the allowance calculation. While some of the process will remain consistent, much will change and there appears to be more rules that you will have to follow. Gone will be the days of "probable" and only using loss information available at the end of the period. The new standard will involve forecasting losses to the entire portfolio, over the next 12 months and over the average life. Probable will disappear and weighted averages will replace the current methodology. Well that's the next whitepaper, look out for it!

While this white paper may not answer all your questions, we hope to bring some sanity to what impairment really means.

Impairment Basics

The allowance account is created to establish an estimated loss for impairment of the loan portfolio. However, FASB gives you a lot of latitude, as they should, in determining how your institution measures impairment.

What is included in section 310-10 – Receivables?

Receivables, listed below, all fall under this basic allowance guidance.

- Trade accounts receivables
- Loans
- Loan Syndications
- Factoring arrangements
- Financing Receivables

The revised definition of financing receivables, as stipulated in ASU 2010-20 includes the following:

1. Trade accounts receivable
2. Loans
3. Notes receivable
4. Credit cards
5. Receivables relating to a lessor's right(s) to payment(s) from a lease other than an operating lease that should be recognized as assets in accordance with the following paragraphs:
    a. Paragraph 840-30-25-8 (for leveraged leases)
    b. Paragraph 840-30-25-7 (for direct financing leases)
    c. Paragraph 840-30-25-6 (for sales-type leases).

Some leases are now included in the definition of financing receivables. Therefore, leases can be considered for impairment under this definition. However, leases are still specifically excluded under section 310-10-35-13 (SFAS 114). And, under the revised TDR standard, modifications of lease agreements are not considered for TDR treatment.

Impairment Defined

We all know a loan is considered impaired when it is probable that the creditor will not collect all the principal and interest as scheduled in the loan agreement. FASB also states that the threshold for impairment is the same whether the creditor has many loans or only one.

This is where the guidance splits and we end up with what has historically been referred to as SFAS 5 and SFAS 114.

FASB's Take on SFAS 5 & SFAS 114 Loans

SFAS 5 Loans

Turns out, FASB doesn't say much regarding SFAS 5 loans. Section 450-20 thru 35 basically states that information available before the financials are issued indicates that the probable likelihood of future events will cause an asset to be impaired and that a loss can be reasonably estimated. FASB doesn't give guidance on how to estimate, just that you have to estimate. More over, they don't even give an example. So where does the historical loss experience come from? In 310-10-35-4 FASB provides the following guidance on impairment.

> ***"It is usually difficult, even with hindsight, to identify any single event that made a particular loan uncollectible. However, the concept in GAAP is that impairment of receivables shall be recognized when, based on all available information, it is probable that a loss has been incurred based on past events and conditions existing at the date of the financial statements.***
>
> ***Losses shall not be recognized before it is probable that they have been incurred, even though it may be probable based on past experience that losses will be incurred in the future. It is inappropriate to consider possible or expected future trends that may lead to additional losses. Recognition of losses shall not be deferred to periods after the period in which the losses have been incurred."***

Voilà, we have historical losses being used to guide us in our evaluation of future events. The discouraging part is that in the new standard FASB is developing jointly with the IASB, there is not much more than what you see here. So it appears, in some form, historical loss is here to stay. We have seen historical losses being calculated in a variety of ways and even weighted averages used over periods of time. Since FASB gave no direction here, the use of various calculation methods and periods vary from institution to institution.

What is clear in the regulator's releases is that the institution should have support as to why their method is right for their risk and portfolio.

What Constitutes SFAS 5 Loans?

- Large groups of smaller balance loans – the newly defined segments and classes
- Loans that are not identified for evaluation. This encompasses loans which are specifically excluded from SFAS 114 such as leases or types of loans where there may only be a few or possibly just one in the portfolio.
- Loans that are evaluated but are not considered impaired. These are loans that were evaluated to go into the SFAS 114 category, but were excluded because they were deemed not impaired. For example, let's say you define loans to be evaluated for SFAS 114 status as all loans on your watch list. If there are 10 loans on the watch list and 6 are deemed impaired and 4 are not deemed impaired, then the 6 that are impaired go forward to be measured for impairment

under SFAS 114. (We will discuss how to measure impairment below). The 4 deemed not impaired are simply kept in the SFAS 5 pool they belong in by segment and class.

SFAS 114 Loans

FASB's guidance for SFAS 114 loans is much more specific. The guidance does not simply list material loans, it requires you to identify where and what types of loans should be considered for evaluation. For instance, loans that meet one of the following characteristics need to be evaluated further.

a. A specific materiality criterion, such as loans with a current balance of greater than 1 million.
b. Loans specifically identified by regulators in their reports of examination. This could be due to lack of documentation or other errors in underwriting, as well as borrower financial changes.
c. Internally generated listings such as watch lists, past due reports, overdraft listings, and listings of loans to insiders. That's right, you can include all past due loans as impaired and evaluate separately.
d. Management reports of total loan amounts by borrower.
e. Historical loss experience by type of loan. If you had a certain class of loans that had historically high charge-offs, you could evaluate the loans separately.
f. Loan files lacking current financial data related to borrowers and guarantors. This may come through internally developed reviews or examiner/auditor reports
g. Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions. Generally, this is what put the loan on the watch list to begin with.
h. Loans secured by collateral that are not readily marketable or that are susceptible to deterioration in realizable value. In today's market this could include real-estate loans in distressed areas, for example vacation rentals.
i. Loans to borrowers in industries or countries experiencing economic instability.
j. Loan documentation and compliance exception reports.

SFAS 114 Step-by-Step

When determining which loans are in SFAS 114 and which are in SFAS 5 pools, consider these key steps:

1. Identification
2. Evaluation of Impairment
3. Measurement of Impairment

Step 1: Identification

Using the SFAS 114 Guidance listed above (a thru j), determine whether the loans are part of the group that you've identified for evaluation.

Step 2: Evaluation

If Identified Yes: If the loan is part of the group identified, then ask the impairment question; "Is it probable that the creditor will not collect all principal and interest as scheduled in the loan agreement for each individual loan?" (We will not be discussing immaterial or insignificant delays or shortfalls

because FASB scopes those out.) If it is probable, then the loan moves to the next phase of measurement. Remember, probable means *"somewhere higher than more likely than not"* – other than this definition there is no guidance specified. Make sure to set a standard and be consistent.

If Identified No: If the loan is not impaired, then you must ask the question; "Are there specific characteristics of the loan indicating that it is probable that there would be an incurred loss in a group of loans with those characteristics?" In other words, does this loan fit into one of the pools (segments/classes) that are being evaluated under SFAS 5?

If yes then*,* move the loan back to the SFAS 5 pool.

If no, is the loan fully secured by collateral? If it is fully secured, then the loan is out of the analysis and no allowance would be recorded. If it's not fully secure by collateral it may be possible that you have a separate segment or class you need to recognize and prepare a methodology to analyze. In general this would be unlikely, but not impossible. FASB clearly shows in the diagram in section 310-10-55-1 this possibility.

Step 3: Measurement

If the loan is deemed impaired, measure impairment under one of the following methods:

> *Method 1* – Present value of the cash flows discounted at the loans effective interest rate.
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> *Method 2* – Fair value of collateral for loans that are collateral dependent: In section 310-40-55-13 FASB uses an example of a real estate loan as a collateral dependent loan, but does not specifically define collateral dependent loans. However, the regulators have defined it as follows:
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>> ***Collateral dependent loans: A loan is considered "collateral dependent" when the repayment of the debt will be provided solely by the underlying collateral, and there are no other available and reliable sources of repayment.***
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> *Method 3* (generally only done at larger institutions) – In 310-10-35-21, FASB states "Some impaired loans have risk characteristics that are unique to an individual borrower, and the creditor shall apply the measurement methods described in paragraphs 310-30-30-2; 310-10-35-22 through 35-28; and 310-10-35-37 on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. A creditor may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans."

What about TDR's?

We have all heard the saying, "Once a TDR, always a TDR." In my honest opinion, I think it is more properly stated as "Once a TDR, always an Impaired Loan." This is important because of the financial statement disclosures for impairment, as well as for the call report. So, where do these pesky TDR's belong?

TDR's and Financial Statements

For financial statement purposes, all TDR's are impaired whether they are in the SFAS 114 part of the allowance or the SFAS 5.

As a point of reference, FASB addresses TDR's in two ways.

1. When a loan qualifies for TDR treatment (Section 310-40)
2. Impairment Guidance (Section 310-10)

Under section 310-40 FASB clearly defines when a loan should be considered a TDR. There is no guidance in this section on how to apply allowance methodology to TDR's except that you must use the original loan rate in a discounted cash flow analysis for fair value. In addition, section 310-40 specifically states once a loan is determined to be a TDR then the loan is an impaired loan and will be impaired until repaid or written off. Restructuring does not cause the loan to be a new loan. Hence my new saying "Once a TDR, always an Impaired Loan."

Since TDR's are by definition, impaired loans, where do we look for guidance? FASB refers you directly to 310-10 for impaired loans. To be clear, 310-40 does not discuss or set standards for how to establish allowances for TDR's. Section 310-10 does this for all impaired loans.

The use in the standard as discussed above for measurement of impaired loans evaluated and identified as impaired, requires the use of present value of the total expected cash flows to determine a fair value of the loan for measurement purposes. Therefore, FASB requires you to make an estimate of cash flows and an estimate of timing of cash flows, to estimate the reserve needed. Simply put, you make an estimate and an estimate to make an estimate - nothing can go wrong there!

However, as previously mentioned, you can use collateral value to estimate the loss on collateral dependent loans. Upon reading all the examples in the guidance, if a loan's primary source of repayment is the collateral, then it is collateral dependent.

Therefore, a TDR is generally considered impaired forever. TDR disclosures would be required on these loans until they are repaid or charged-off. FASB does give some guidance as to when a TDR can be removed from disclosure requirements.

For GAAP purposes - Not all TDR's have to be disclosed

A loan modified, as a TDR does not have to be disclosed as such, 310-10-50-15(a) (Impaired allowance with and without allowances) and 310-10-50-15(c) (impaired disclosure of average recorded investment) in years after the restructuring if both of the following conditions exist:

1. The restructuring agreement specifies an interest rate equal to or greater than the rate that the creditor was willing to accept at the time of the restructuring for a new loan with comparable risk. (This usually is not the case)
2. The loan is not impaired based on the terms specified by the restructuring agreement. (the loan is now performing)

In reality, few loans will ever leave TDR disclosure status.

TDR's and Call Reports

For call report purposes, it depends. Generally, TDR's are labeled as such based on GAAP guidance. However, when a TDR is performing for some period of time and under certain circumstances, the regulators will allow you to move the TDR's that are performing to accrual status in the call reports.

> ***The FDIC policy statement states the following in question 8 of the policy discussion:***
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> ***Question #8***
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> ***If a borrower is current under the modified terms of a restructured troubled loan, how should the loan be reported in the bank Reports of Condition and Income (Call Report), the Thrift Financial Report (TFR) and the NCUA 5300 Call Report (5300)?***
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> ***Answer:***
>
> ***Call Report:***
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> ***For regulatory reporting purposes on the bank Call Report, a loan that has been formally restructured so as to be reasonably assured of repayment and of performance according to its modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the loan are supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must remain in nonaccrual status.***
>
> ***The evaluation of the borrower's financial condition and prospects must include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. Each loan that has undergone a troubled debt restructuring (except a loan secured by a 1-4 family residential property and a loan to an individual for household,***

family, and other personal expenditures) must be reported as a restructured loan in Schedule RC-C or Schedule RC-N, as appropriate, depending on whether the borrower is in compliance with the loan's modified terms. However, a restructured loan that yields a market rate and on which the borrower is in compliance with the loan's modified terms need not continue to be reported as a troubled debt restructuring in calendar years after the year in which the restructuring took place.

TFR:

For regulatory reporting purposes on the TFR, a savings association may remove a restructured troubled loan from nonaccrual status when it is (1) reasonably assured of repayment and is performing according to the modified terms, and (2) the restructured loan is well secured and collection of principal and interest under the revised terms is probable. To determine probability of collection, the savings association must consider the borrower's sustained historical repayment performance for a reasonable period of time. This determination may take into account performance prior to restructuring the loan. A sustained period of repayment performance generally would equal a minimum of six months and would involve payments of cash or cash equivalents.

Loans that have undergone troubled debt restructurings (TDRs) should generally be reported as a TDR (on Schedule VA if in compliance with the restructured terms or on Schedule PD if past due or nonaccrual) until the loans are paid off. However, a restructured loan that is in compliance with its modified terms and yields a market rate at the time of restructuring need not continue to be reported as a TDR beyond the first year after the restructuring.

5300:

For regulatory reporting purposes on the 5300, credit unions should report troubled debt restructured loans (as defined in GAAP) as delinquent consistent with the original loan contract terms until the borrower/member has demonstrated an ability to make timely and consecutive monthly payments over a six-month period consistent with the restructured terms. Likewise, such loans may not be returned to full accrual status until the six-month consecutive payment requirement is met.

What makes these estimates so difficult?

The hard part of this whole calculation is estimating losses based on the past and projecting cash flows for present value calculations. No matter what FASB says, this is an estimate built on estimates. And whether we are forecasting (another estimate) or using the past to guide us, it is still an estimate. When estimating projected cash flows for SFAS 114 present value calculations, you are estimating what you will receive and when you will receive it. Even when a loan has been modified, you are still estimating when you use the new payment stream for a present value calculation. You hopefully believe that is true, but it is still an estimate.

So why are we surprised when estimates are wrong? I am sure there will be models developed and people in companies really believing in their process, but when a crisis hits like the one we just went through, they will most assuredly all fall apart. Just like what happened in the past two years. Only a very few had the foresight to see the process unfolding until it was too late. Or maybe some could see it coming and didn't want to take the hit by increasing the allowance ahead of time. But what is going to change this, better modeling. Modeling is only as good as the information it is fed and the basis on which it is developed.

So the questions remain!

1. How do you really understand the risk in your portfolio?
2. How do different companies come to similar conclusions?
3. How do we know that those conclusions are right?
4. What happens when opinions differ?
5. How can you please the regulators, the auditors and the CEO at one time?

Good Luck!

Your Solution - The ACL Calculator

Whether it is Impairment or any other complex component of the allowance calculation, ARCSys has the solution to help you meet the standards with assurance and effortlessly automates the entire allowance calculation process including disclosures – rendering your spreadsheets obsolete.

ACL Calculator handles everything:

- Detailed disclosure reports that calculate every required disclosure for you
- Historical losses and calculations by segment or class
- Additional risk calculations for economical, political, industry and environmental credit risks by segment or class
- SFAS 114 evaluation for fair value of collateral and present value calculations
- Troubled Debt Restructurings
- Detailed calculation reports and edit reports
- And much more!

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 and 2011-02 disclosure and accounting changes. It is comprehensive, customizable, all-encompassing software that drastically minimizes the workload required to adhere to the new standard.

Best of all, it is software developed by accountants for accountants!

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