DRIVING ALLL AROUND THE ORANGE CONES

by Steve Brown

We don't know about you, but in our younger years we found it fun every once in a while to slowly weave around orange cones at construction sites when no one was looking. Our goal was to try to keep the cones standing as we went on down the road, while getting as close as possible because it was dad's car. Sometimes we were successful and other times we were not. Calculating the Allowance for Loan and Lease Losses (ALLL) can be sort of like driving around caution cones, but here are some key things to know and understand from the regulatory perspective we picked up from regulatory guidance and in various conversations with bankers all over the country.

In general, ALLL begins with loss events, which are events that have occurred and impair the value of a loan. Loss events lead banks to set up reserves, even when an exact loss cannot be specifically identified. In short, when a bank deems a loss event to be probable, it should trigger a reserve.

A chargeoff, on the other hand, occurs when credit losses are deemed uncollectible - probable that the bank will be unable to collect given facts and circumstances as of the evaluation date. This results once a confirming event occurs, which on a real estate loan could be an appraisal or other valuation that reflects a shortfall between the value of the collateral and the book value of the loan (or a deficiency balance following the sale of collateral).

Under FAS 114, loans are impaired when it is probable the bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. To determine whether a loan should be reviewed for impairment under FAS 114, banks should set criteria that can include: materiality; regulatory exam reports; internally generated reports (past due, overdrafts, loans to insiders, borrower exposure, historical loss experience by loan type, etc.); loan files lacking current financial data on the borrower/guarantor; loans secured by collateral that is not readily marketable; loans to borrowers in industries experiencing economic stress; documentation/compliance exception reports; and borrowers experiencing operating losses, inadequate cashflow or business interruptions. All of these sources and others can help banks identify loans for individual impairment analysis under FAS 114.

When measuring for impairment under FAS 114, banks need to thoroughly document the analysis that resulted in the impairment decision; determination of impairment method used; valuation assumptions; calculations; supporting rationale for adjustments to appraised values; sales costs and even quality, expertise and independence of the appraisal. Each of these factors can be utilized during the documentation phase.

One nuance that banks should be aware of (given the current market especially) is that while groups of small balance loans of similar nature can not be collectively evaluated for impairment under FAS 114 (would be handled under FAS 5), they can be grouped if they were modified in a troubled debt restructuring according to regulatory guidance. The key across the board when it comes to evaluating loans for individual impairment is to have a method and process for identifying loans based on normal review procedures and on individual facts and circumstances.

Finally, it is critical to understand that regulatory criticism of a loan does not always indicate the existence of an inherent loss. While loans classified "doubtful" have an inherent loss; that is not necessarily the case with "substandard" credits. Loans classified as substandard may be inadequately protected by the paying capacity of the borrower or the collateral and losses may occur if weaknesses are not corrected, this is only a potential loss.

Given its importance, we'll cover more of this issue tomorrow. The credit crisis has made it clear that bankers will have to slow down because industry streets are torn up all over the place and heavy construction is underway in the industry.

BANK NEWS

M&A

Savings Bank ($753mm, CA) agreed to purchase Bank of Willets ($132mm, CA) for an undisclosed sum. In total, the bank will operate 11 branches.

Branch M&A

Salisbury Bancorp Inc ($560mm, CT) will acquire one of Webster Bank's ($17.2B, CT) branches for an undisclosed value. The deal includes nearly $17mm in deposits and $4mm in loans.

US vs World

In stark opposition to the International Accounting Standards Board (IASB), the Financial Accounting Standards Board (FASB) has submitted a proposal that would force banks to mark-to-market all loans (IASB allows banks to value loans at amortized cost).

FRB Economic Projection

A Federal Reserve economic report we came across indicates "financial markets are improving," the housing sector "looks to be stabilizing," and that the easing of the financial crisis will "allow a modest recovery to ensue in he 3rd quarter (of 2009)."

FDIC

Analysis finds the FDIC had nearly $27B of assets in liquidation as of the end of July.