PLANTING SUSTAINABLE LOAN LOSS RESERVES

by Steve Brown

You may not have known it, but Americans throw away 40% of the food we buy each year, according to analysis by the Natural Resources Defense Council. That amounts to about $165B annually chucked into the trash or about $2,275 for a family of four. The study also found unsold fruits and vegetables in grocery stores account for a large portion of the wasted food. We waste a lot of things as humans, but one thing bankers won't waste is the loan loss reserve (ALLL). That is why it is important to note the Financial Accounting Standards Board (FASB) recently released an exposure draft for a new impairment model for financial assets. This represents the 3rd release for comment on this topic.

Current methodology recognizes a credit loss when it is probable that it will occur or when the loss has taken place. This creates the limitations of untimely impairment and excessive complexity across institutions. That is why in 2011, FASB developed the 3-bucket model.

Under the 3-bucket model, a bank would recognize impairment at a reporting period if the loss is expected to occur within the following 12 months or if a significant deterioration in credit quality has taken place. Otherwise, a loan would be placed in Bucket 1 and no impairment loss would be needed at that time.

The 3rd proposal seeks to solve some limitations identified in this 3-bucket methodology. First, it appears unclear how transfers among the buckets would work. Next, certain comments FASB received highlighted that credit losses would be underestimated or recognized late by limiting the analysis to 12 months. This time, the proposal seeks to replace the 3-bucket methodology with a Current Expected Credit Loss (CECL) model.

When measuring the ALLL, management reviews past events and current conditions to determine the impairment. Under CECL, management would incorporate neither a worst case, nor a best case scenario. Instead, an estimate is made of the specific cash flows that the bank does not expect to collect for the remaining life of the loan, by incorporating forward looking information. The new CECL model reinforces the use of forecasts that should be supportable and have a clear rationale.

To explain the latest proposal we use an example. Suppose you hold a loan in your books as of 12/31/12 with a maturity date of 12/31/18. The borrower has been making payments on time from inception and has not shown signs of credit deterioration.

However, as of 12/31/12, the borrower provides updated forecasted cash flows and a liquidity deterioration surfaces beginning 12/31/16. Under the original 3-bucket model, your bank would not be required to record any changes in ALLL because the potential deterioration in credit quality is expected to occur beyond the 12 months following your impairment analysis.

Conversely, under the proposed CECL model, management must consider recognizing the forecasted loan deterioration from 12/31/16 to maturity. As such, the impairment amount and whether a loss should be booked will need to consider additional information. Assuming that all information confirms expectations that the projected cash flows are accurate, your bank would need to reflect an impairment loss as of 12/31/12 (for the fair value of the uncollectible payments from 12/31/16 to 12/31/2018).

As you may infer from this example, some banks expect impairment charges to increase overall and for subjectivity to increase (given a murky future that can change as time progresses). The key features in the CECL model are the recognition of the time value of money (such as the discounted cash flows calculated at the loan effective rate) and the expectation to make the bank's impairment process more robust (by adding supportable forward looking data).

Comments to FASB on the CECL proposal are due on April 30, 2013 and we will continue to update you as more information becomes available. As always, you may contact our impairment experts for a complete and detailed walkthrough of this process.

BANK NEWS

4Q Earnings

Wells Fargo was the first major bank to report earnings, saying quarterly net income reached $5.1B, up 24% from 4Q 2011. On a YOY basis, revenue was $21.9B (+7%); ROA reached 1.46% (+17%); ROE hit 13.35% (+12%); ALLL was 2.19% (-14%); efficiency ratio was 58.8% (-3%); average loans were $787.2B (+2%); average deposits were $928.8B (+7%) and NIM was 3.56% (-8%).

M&A

Royal Business Bank ($627mm, CA) will acquire Los Angeles National Bank ($199mm, CA) for an undisclosed cash sum. The transaction is the 3rd for Royal since Nov. 2008.

Large Layoffs

American Express followed other major financial entities by announcing a plan to lay off 5,400 employees (4% to 6%). AMEX said it is adjusting to an uneven economic recovery and is seeking to improve efficiencies.

Exploring Options

Hanmi Financial ($2.8B, CA) has hired an investment bank to help it explore options that include a possible business combination, merger of equals or sale.

Auditors Charged

The SEC has charged two KPMG LLP employees with failing to uncover problems at failed bank TierOne (NE). The SEC claims auditors did not look closely enough at loan loss reserves, ignored red flags and relied on outdated appraisals, as TierOne hid millions of dollars in losses and eventually failed. This is the first time the SEC has taken action against auditors related to the financial crisis.

IRS Reminder

The IRS is reminding companies to start withholding 6.2% from employee paychecks for Social Security taxes, up from 4.2% in 2012 and 2011. The reminder was sent out following the fiscal cliff agreement.