Confusion Remembering The Loan Loss Reserve

by Steve Brown

Sometimes you can stare at something for a long time and not know which way to go. Sometimes you may lose your keys and not remember where you left them. In banking, as the industry ages, many working in it may have forgotten that the loan loss reserve is designed to rise and fall as conditions merit and based on the rules around its calculation.

Banks have certainly stuffed money into their loan loss allowance (ALLL) over the last few years. Given a conservative bent, many community bankers are admittedly having a hard time feeling good about releasing it. Truth is, accounting rules indicate a reduction in ALLL balances might be appropriate now, simply because the calculation is based on relatively near-term history. Banks had big losses in 2008 - 2010, but the last several years, their loss experience has diminished significantly. Now that most troubled assets are already off the books, things are looking pretty solid. Given the standard for calculation uses a near-term look back, all indications would point to the idea that banks can keep lower reserves now than in the last few years.

Before anyone goes too crazy though, consider that there is a problem with using only recent history. The biggest problem is that near-term history doesn't encompass an entire economic cycle. Banks' loss history right now is looking a lot like 2006 or 2007 when reserves were at a credit cycle low, and we all know how that turned out when things got really bad.

Today, the economic recovery is still anemic in many places, but by most historical measures regarding its duration, it is looking rather long in the tooth. With more than 5Ys of positive GDP growth, the US is moving into the historical upper end of economic expansionary cycles, in terms of its length. It's also broadly expected that the Fed will begin raising short term rates sometime in 2015. While no one knows exactly when or by how much rates may climb, prime-based loans and short-term LIBOR based loans have been at a low level for so long, borrowers are likely to be surprised by an increase.

Surprise is one thing, but inability to pay is another. The risk is that if stronger economic expansion does not accompany higher short term rates, borrowers may well not be able to keep up with their loan payments and another nasty credit cycle could result. Given that backdrop, one must pause when considering whether it is a great idea to reduce allowances right now.

Even if we ignore the length of the economic expansion, there is another element waiting in the wings. FASB is still ironing out the last details on the current expected credit loss model (CECL), but it is coming. Calculating a forward looking model that measures risk throughout the life of a loan will be a stretch for many banks, simply because loan grading systems are not that granular and many banks don't value repayment ability separately in loan grades. However, everyone in the end will need to develop methods and comply with the rule, because GAAP doesn't care about size of entity. So, if banks end up reducing allowances based on their current loss experience but later CECL calculations show their allowance levels to be too low, then allowances will have to be built up once more.

Banks can prepare for CECL by gathering more granular data on their loans, developing more robust ALLL calculation methods and by keeping watch on all the impending rules. For those who would rather spend staff time on other pursuits, PCBB has a time-tested ALLL service which has helped numerous banks, plus it has been reviewed in bank exams across the country. Give us a call if you'd like more information on getting this chore off your plate.

Whether calculating ALLL internally or through an outside provider, banks should tread carefully before reducing their ALLL as a result of near-term trends. Remembering this will help your bank both now and in the future.

BANK NEWS

M&A

BB&T ($184B, NC) will acquire Susquehanna Bank ($18.3B, PA) for approximately $2.5B in cash (30%) and stock (70%) or about 1.7x tangible book. The move will add 245 branches to BB&T's footprint when completed.

M&A

Inland Bank & Trust ($1.0B, IL) will acquire College Savings Bank ($500mm, NJ) for about $30mm.

Fined

Regulators have ordered the first six banks to pay about $4.3B in fines related to a global investigation into the rigging of foreign exchange benchmarks. The banks and their respective fines are the following: Citibank ($1B), JPMorgan ($1B), UBS ($800mm), RBS ($625mm), HSBC ($600mm) and Bank of America ($250mm).

IT Spending

Celent projects US banks will spend $51B on technology in 2014 and 4% more annually in 2015 and 2016. An estimated 25% of this spending will go toward new technology investments.

Free Checking

A survey by Moebs Services finds 61% of all financial institutions offer free checking vs. 82% at the high water mark in 2009. Interestingly, only about 27% of banks with assets >$10B offer free checking.

SARs

The Financial Crimes Enforcement Network (FinCEN) indicates that for the year ended Apr 2014, about 34% of FBI investigations into drug trafficking or organized crime were the result of SARs filed by banks.

Strange

A survey by Bank Director finds 40% of bank executives say their pay is not tied to financial performance.

More Digital

PNC Bank reports 47% of customers use non-branch channels today vs. 38% one year ago (a 24% increase).