Allowance for loan losses is a key due diligence issue

Investors targeting specialty lenders should take a close look

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Since the recent global financial crisis, many private equity groups and other strategic investors have invested in the specialty finance industry to bring solid returns to their funds. Companies and loan portfolios being acquired by such investors are often subject to significant financial due diligence. With increased scrutiny from outside parties during a potential transaction, it is vital to ensure that critical accounting policies of target specialty lenders fully comply with relevant accounting guidance and are documented properly.

The most critical accounting policy and management estimate for most specialty finance companies is the allowance for loan losses. There is a wide variety of guidance available on determing the allowance for loan losses, yet some specialty finance companies rely on requirements outlined by the senior lenders or suggestions from their external auditor to make that determination. Therefore, special scrutiny of that process is vital in any acquisition involving a specialty lender. It should be noted that an allowance for loan losses is not carried over by the acquirer on acquired loans under purchase accounting rules for both business combinations and asset acquisitions. There is separate guidance to address the post-acquisition accounting for credit losses on acquired loan portfolios that is beyond the scope of the discussion that follows.

Accounting guidance—homogeneous loans

The Financial Accounting Standards Board (FASB) Accounting Standards Codification Subtopic 450-20, *Loss Contingencies* (FASB ASC 450-20), provides basic guidance for the recognition of losses for homogeneous loans. This covers most of the loans that specialty finance companies originate and service. Homogeneous loans are groups of smaller balance loans with the same or similar characteristics. For example, a company that offers direct consumer loans and indirect auto loans would likely have two distinct homogeneous loan pools. For homogeneous loans, FASB ASC 450-20 requires the allowance to be recognized when loan losses are both probable at the financial statement date or the date the financial statements are available to be issued, and the losses are reasonably estimable (an incurred loss model).

For specialty finance companies serving near-prime or subprime borrowers, a loan loss typically becomes likely, or probable, when a customer loses their job or experiences some other type of financial hardship. With homogeneous pools of hundreds or thousands of individual loans, it is not practical to evaluate each borrower's financial situation on a loan-by-loan basis. As a result, management must estimate the amount of probable losses based on historical loss trends and other relevant factors.

Estimation process

In 2006, the federal agencies that regulate banks and credit unions collaborated to issue an Interagency Policy Statement on the Allowance for Loan and Lease Losses (Interagency Policy Statement). The Interagency Policy Statement indicates that management should consider "*all significant factors that affect the collectability of the portfolio as of the evaluation date*." The Interagency Policy Statement also states that the estimate should be properly supported and documented by the company. While the applicability of this guidance is limited to depository institutions supervised by these agencies, it reiterates key concepts of generally accepted accounting principles (GAAP) and serves as useful guidance in applying GAAP.

For SEC registrants, the Securities and Exchange Commission provides additional guidance with respect to the accounting for loan losses, including reemphasizing that a lender should "*develop and document a systematic methodology to determine its provision for loan losses and allowance for loan losses*." This guidance is included in the FASB codification at ASC 310-10-S99, and also makes reference to the AICPA Audit and Accounting Guide for Depository and Lending Institutions for additional guidance.

One key item in developing the allowance for loan losses is the determination of the appropriate historical loss period. The Interagency Policy Statement states that lenders generally "*should use at least an annualized or 12-month average net charge-off rate that will be applied*" to the homogeneous groups of loans being evaluated. This is also a common minimum allowance calculation required by lenders to the specialty finance industry. However, the Interagency Policy Statement also indicates that loans with effective lives shorter than 12 months "*may indicate that the estimated credit losses should be less than*" a trailing 12-month loss rate. As a result, the determination and documentation of the effective life of each homogeneous pool is a critical exercise.

While historical loss rates generally serve as the starting point for estimating the allowance on homogeneous loans, management should also consider qualitative factors that are likely to cause credit losses to differ from historical levels. Although not an all-encompassing list, the Interagency Policy Statement provides a list of qualitative factors to consider in estimating the allowance, including:

- Changes in lending policies and procedures, such as underwriting standards, collection, charge-off and recovery practices
- Changes in relevant economic and business conditions (international, national, regional and local)
- Changes in the nature and volume of the portfolio and the term of loans offered
- Changes in the company's delinquent and nonaccrual loans
- Changes in the value of collateral for secured loans (such as auto loans)
- Any concentrations of credit
- Other external factors, which may include competition, or legal and regulatory developments

Another potential factor specific to specialty finance companies could be trends in the use of loan modifications or refinancing. It is relatively common for specialty finance companies to provide modifications, such as payment deferments, to customers. If, however, the number of such modifications is trending upward, this could, in effect, decrease the delinquency rate. This qualitative change should be taken into consideration. Additionally, if there has been significant growth in the loan portfolio, the recent historical loss rate may be low, since losses on the more recent originations would not have occurred yet. Newly created specialty finance companies or companies without sufficient historical loss rates should use benchmark information or loss rates of other companies with similar types of loans to help establish initial allowance calculations until the company has sufficient loss rate information.

The changes in the allowance should be consistent with the changes in the factors that are considered significant in evaluating the collectability of the portfolio when taken as a whole. For example, if underwriting standards have been loosened, the relevant economic conditions are deteriorating and the level of delinquent loans is increasing, it would likely not make sense for the allowance for loan losses to decrease.

The process for determining the allowance for loan losses should be consistent, yet flexible, to consider new trends that may impact the collectability of the portfolio.

In terms of consistency, for example, consider a specialty finance company that has historically used a trailing 12-month loss rate for the starting point of its allowance calculation. It would not make sense in a subsequent period to change to a shorter period loss rate without supporting analysis that provides justification for the change.

To understand the need for flexibility, consider how specialty finance companies had to react to events as loan losses increased during the financial crisis in late 2008 and early 2009. Certain key changes, such as sudden spikes in gasoline prices or unemployment, may not have been anticipated as relevant factors before the crisis. Clearly, such events need to be considered going forward for companies who hold portfolios that would be impacted by these events.

The questions and answers to the Interagency Policy Statement also indicate that when loans included in homogeneous pools are modified in a troubled debt restructuring (TDR), such loans should be removed from the homogeneous pools and individually evaluated for impairment, which is the emphasis of the section that follows.

Accounting guidance—loans individually evaluated

FASB ASC Subsection 310-10-35 and related implementation guidance at ASC 310-10-55 provides guidance for accounting for an allowance for loan losses for specific loans that are evaluated individually for impairment. This generally excludes large groups of smaller balance homogeneous loans, which are collectively evaluated for impairment as discussed above. However, as is also noted above, loans within a homogeneous pool that are determined to be TDRs should be evaluated individually for impairment. Since most specialty finance companies hold only smaller-balance homogeneous loans, loans evaluated individually may be limited to TDRs. A TDR is a loan for which a creditor grants a concession to a borrower who is experiencing financial difficulties, for economic or legal reasons that it would not otherwise consider. A common TDR for most specialty finance companies is a customer who files for Chapter 13 bankruptcy and has a court-approved plan that reduces the interest rate, lengthens the term of the loan or reduces the principal amount of the loan. If a specialty finance company provides any concessions to borrowers, generally in order to recover as much principal as possible, such concessions should be evaluated under FASB ASC 310-40 to determine if they are TDRs.

Once TDRs and other individually evaluated impaired loans have been identified, the impairment and resulting allowance is generally calculated by estimating the cash flows that will be collected from the modified loan agreement, and computing the present value using the original contractual interest rate and comparing this present value to the loan's carrying amount.[1] For example, if a $1,000 loan that bore interest at 10 percent and had a remaining term of 12 months was modified to reduce the interest rate to 5 percent and extend the term to 24 months, the impairment would be $49, regardless of whether management expected to collect the full $1,000. For companies charging higher interest rates, the impact of TDRs can be much more dramatic, with impairment rates of 30 percent or greater for accounts with confirmed Chapter 13 bankruptcy plans. FASB ASC 310-10-35-21 allows the impairment for groups of individually impaired loans with similar risk characteristics (such as accounts in Chapter 13 bankruptcy) to be measured in aggregate using average historical statistics.

Forthcoming changes to accounting guidance

Final guidance is expected to be issued by the FASB in late 2015 or early 2016 that will change the accounting requirements that specialty lenders follow in determining their allowance for loan losses. Under the proposed new guidance, specialty lenders will need to recognize an allowance for expected loan losses throughout the life of the loan on the day a loan is originated (referred to as CECL), instead of following an incurred loss model. The federal agencies that issued the Interagency Policy Statement referenced above plan to collaborate to issue revised guidance after the CECL accounting guidance is issued by FASB.

Although the CECL requirements are not expected to apply until at least 2018, specialty lenders should begin evaluating their processes and tools to determine if they are capturing all of the information that will be necessary to prepare forecasts of future loan losses that will be required by the CECL guidance.

Visit the FASB website for further detail on CECL.

Summary

Specialty finance companies should employ a systematic approach to determine the allowance for loan losses as follows:

- Disaggregate the loan portfolio into appropriate homogeneous pools
- Calculate and document the rationale to support the appropriate historical loss rate and period for each homogeneous pool
- Evaluate all relevant qualitative factors that may impact the collectability of the portfolio
- Determine whether any TDRs exist and calculate any necessary impairment specific to TDRs
- Take an overall look at the allowance and verify its movement is directionally consistent with all factors taken as a whole

Potential investors in specialty finance companies should carefully consider if the allowance for loan losses is properly determined by the specialty finance company, in accordance with GAAP, which will provide more meaningful comparisons to other companies in the industry during the due diligence and evaluation phases. Additionally, maintaining and documenting a consistent approach will prove to be valuable to specialty finance companies that are seeking to be acquired when external parties come in to evaluate the allowance for loan losses. Potential investors should also consider the current capabilities that specialty finance companies have to capture and analyze all of the data that will be necessary to prepare forecasts of future loan losses that will be required by the forthcoming CECL accounting guidance.

1 ASC 310-10-35-22, as a practical expedient, permits the use of observable market prices or the fair value of collateral (for collateral dependent loans) to be used to measure impairment. Generally, collateral-dependent loans would be real estate loans. For loans for which foreclosure is probable, ASC 310-10-35-32 requires impairment to be measured based on the fair value of the collateral.

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