

Challenges and Improvements in the FAS 114 Impaired Loans Reserve Calculation

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While defending the [FAS 5 \(ASC 450-20\) General Reserve calculations](#) tends to be most cited by financial institutions as presenting challenges in the estimation of the Allowance for Loan and Lease Losses (ALLL), there are also many inherent challenges in the calculation of FAS 114 (ASC 310-10-35) Specific Reserves. Some of the biggest challenges and areas for improvement are outlined below:

1. **Determining which loans should be evaluated under FAS 114 (ASC 310-10-35) versus under the Pooled Loans.**

Many financial institutions will start by using the criteria of separating out into FAS 114 (ASC 310-10-35) any loans that are risk rated Substandard or worse on the institution's risk rating system. One of the challenges inherent in this approach is that it is dependent on the institution having an effective risk rating methodology that is current and reflective of the level of risk on its loans. Bruce Vance from Advanced Bank Solutions says: "The primary challenge is the proper risk rating of loans, especially the identification of impaired loans... banking regulators are keenly focused on this area." To ensure the institution is not missing any loans that need to be evaluated individually, it should consider also looking at:

- a. All loans that have been labeled as a Troubled Debt Restructure (TDR). Most, if not all, of these loans should be evaluated under FAS 114 (ASC 310-10-35).
- b. All loans that are considered to be in non-accrual. The bank still may have some threshold (by dollar volume), but they will want to ensure that the appropriate loans in this category are being evaluated under FAS 114 (ASC 310-10-35), in case some of these are not picked up by the risk rating criteria.
- c. Loans that are at a certain level of delinquency (ie, Days Currently Past Due > 90, or loans that have reached certain delinquency levels a set number of times).

Looking at loans using these other criteria can ensure that no loans that should potentially be evaluated for impairment slip through the cracks.

Paradoxically, on the opposite end of the spectrum, one other potential pitfall of identifying loans for impairment is erring on the side of being too conservative. Vincent Van Nevel of Professional Bank Services, Inc. points out: "One of the biggest traps banks can fall into in the FAS 114 analysis is calculating impairment on loans that are really not impaired... For example, many banks are just being conservative and calculating potential 'exposure' on all substandard rated credits. Many of these credits may still be paying or modestly past due, but are not yet past due enough (90 days) to be considered impaired, nor are they truly collateral dependent. Once the regulators see the bank has an impairment calculated, they will require it to be nonaccrual and possibly a partial charge off." Whether erring to the side of being too conservative or not conservative enough in identifying loans for impairment, the bank needs to ensure it is using its risk rating system effectively and looking beyond it to other metrics like non-accrual status during this process.

2. Ensuring that loans are not double-counted for reserves under both FAS 5 (ASC 450-20) and FAS 114 (ASC 310-10-35).

This is relatively straightforward but it is sometimes overlooked. It is simply ensuring that loans that are being reserved for individually are not counted in the Pooled Reserve Analysis under FAS 5 (ASC 450-20).

3. Determining whether a loan that is being evaluated for impairment under FAS 114 (ASC 310-10-35) should be evaluated using the “Fair market value of collateral” or the “Present value of future cash flows.”

From a strict accounting standpoint, loans that are considered “collateral-dependent” should be evaluated under the “Fair market value of collateral.” The contentious aspect lies in determining whether a loan should be considered “collateral-dependent” or not. Again, from a strict accounting perspective, any loan that is still expected to be supported by repayment from the borrower should be evaluated under the “Present value of future cash flows.” At a minimum, most if not all Troubled Debt Restructures should be evaluated in this way, as these are loans in which the terms have been modified or restructured and re-payment of a portion of the outstanding principal is expected.

For other loans, the line may be more blurry. If the borrower is still expected to make payments, the strict accounting perspective may say that the financial institution should evaluate the loan under the “Present value of future cash flows.” However, regulators may be more apt to want to see the impairment under the “Fair market value of collateral” for any loan that would rely on the value of collateral for recovery in the event of default. In these instances where the decision isn’t black and white, the institution should clearly document why they have chosen the Valuation Method that they have for the loan in question (particularly if they are using the “Present value of future cash flows”). It may also make sense to evaluate what the impairment would be under either method, so that once a loan becomes considered collateral dependent (ie, the institution deems that the borrower will not be repaying the principal), the institution can quickly change their impairment analysis towards looking at the collateral as the support for the loan.

4. Using the appropriate and updated values for impairment analysis under either method.

For each valuation method, there are some key aspects that need to be examined and accounted for appropriately:

- a. Fair market value of collateral
 - i. This method should use collateral values from an appraisal that is as current as possible. If the appraisal is outdated, the appraisal value should be updated accordingly.
 - ii. If there are complexities around cross-collateralization or prior liens from other institutions, these need to be taken into account so that the institution is only including the appropriate equity value that could be used towards the loan in question.
 - iii. Appropriate assumptions need to be documented for any selling costs that will be incurred in the event of liquidation. To the greatest extent possible, these assumptions should be documented.
- b. Present value of future cash flows

- i. The institution needs to use the original contractual interest rate as the discount rate for the cash flows.
- ii. Ideally, the institution should set up a month-by-month analysis with the Expected Payment discounted appropriately for each month.
- iii. The institution should be wary of the “NPV” function in Excel, as this does not give an accurate Present Value unless appropriate adjustments are made to account for the appropriate timing of cash flows, particularly as it pertains to accounting for the “Total Recorded Investment” as a net outflow in the formula.

For both approaches, the institution needs to make sure it is taking into account all items that should be included in the Total Recorded Investment for the loan, including Outstanding Principal Balance, Accrued Interest, and Net Deferred Fees or Costs.

5. If a loan is evaluated for impairment and is found not to be impaired, then it should be moved back to its appropriate FAS 5 (ASC 450-20) pool and reserved for with other loans of a similar risk.

This would refer to a loan that may be on the border of being impaired but upon analysis, it is found that the payments that are expected from the borrower would be expected to cover the entire remaining outstanding balance. In this instance, the loan is not impaired, and the loan should be reserved for along with its appropriate FAS 5 (ASC 450-20) pool. The other instance of this would be a TDR, upon a sufficient period of repayment as expected, at which time the TDR should be evaluated with the appropriate FAS 5 (ASC 450-20) pool.

Although the actual FAS 114 (ASC 310-10-35) calculations can be relatively simple, there are several areas where a bank can be criticized by regulators or auditors if they are not following FASB methodology or appropriately documenting their assumptions. It is imperative that a financial institution set clear loan policies for how they are making their assumptions on these items and that they clearly implement and document them in their ALLL estimation.

About Mike Lubansky: Mike Lubansky is Senior Financial Analyst and Product Manager at [Sageworks](#) where he oversees product development, market research, and implementation in the financial institutions market. Mr. Lubansky has a background in both the financial and consumer industries. Before joining Sageworks in 2009, Mr. Lubansky served as Research Analyst for the Cherry Hills Fund and as Financial Analyst for Humana. Prior to that, Lubansky spent time as Specialty Account Manager for Pfizer and District Manager for consumer products marketing firm, Vector Marketing. Mr. Lubansky received his MBA with concentrations in Finance and Entrepreneurship from the University of North Carolina-Chapel Hill and his BA in American Studies from Yale University. He is also a CFA Level 2 candidate.

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