

Allowance for loan losses is a key due diligence issue

Investors targeting specialty lenders should take a close look

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In recent years, 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 properly documented. In addition, guidance that will soon become effective may have a significant impact on the allowance for loan losses for specialty finance companies.

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 determining the allowance for loan losses, yet some specialty finance companies rely on requirements outlined by the senior lenders 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 the accounting rules for business combinations or 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 in this white paper.

Legacy accounting guidance—homogeneous loans

The Financial Accounting Standards Board (FASB) Accounting Standards Codification (ASC) Subtopic 450-20, *Loss Contingencies*, 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, 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 on a collective or pool basis based on historical loss trends and other relevant factors.

Legacy 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 U.S. generally accepted accounting principles (GAAP) and serves as useful guidance for specialty lenders in applying U.S. GAAP.

For registrants of the Securities and Exchange Commission (SEC), the SEC 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 ASC 310-10-S99, and also makes reference to the AICPA’s Audit and Accounting Guide for *Depository and Lending Institutions: Banks and Savings Institutions, Credit Unions, Finance Companies, and Mortgage Companies* for additional guidance.

One key element of developing the allowance for loan losses under the incurred loss model 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 refinancings. 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, because 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 internal loss rate information.

The changes in the allowance should be consistent with the changes in the factors that are considered significant in evaluating the collectibility 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 collectibility of the portfolio. 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 needed to be considered going forward for companies who held 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.

Legacy accounting guidance—loans individually evaluated

A loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to contractual terms of the loan agreement. A TDR is a type of impaired loan in which the creditor, for economic or legal reasons related to the debtor's financial difficulties, grants a concession to the debtor that it would not otherwise consider.

ASC 310-10-35 and related implementation guidance starting 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 earlier. However, loans within a homogeneous pool that are determined to be TDRs should be individually evaluated for impairment except under certain circumstances in which aggregation of impaired loans that share common risk characteristics is acceptable. Because 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, which it would not otherwise consider, to a borrower who is experiencing financial difficulties for economic or legal reasons. 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 and (or) reduces the principal amount of the loan. If a specialty finance company provides any concessions to borrowers, whether voluntarily or court mandated, generally to recover as much principal as possible, such concessions should be evaluated under ASC 310-40, *Receivables: Troubled Debt Restructurings by Creditors*, 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

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.

at 10% and had a remaining term of 12 months was modified to reduce the interest rate to 5% 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% 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 the aggregate using average historical statistics.

New accounting guidance

In 2016, the FASB issued Accounting Standards Update (ASU) 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, which applies to all entities and most financial assets that are not measured at fair value through net income. With the issuance of ASU 2016-13, the impairment guidance formerly contained in ASC 320-10-35 was eliminated and ASC Topic 326 was created. For lending institutions, this is arguably the most significant fundamental accounting change the industry has ever faced.

ASC 326 is effective for public business entities that meet the definition of an SEC filer, excluding entities eligible to be smaller reporting companies (SRC) as defined by the SEC, for fiscal years, and interim periods within those fiscal years, beginning after December 15, 2019 (e.g., January 1, 2020 for a calendar year SEC filer not eligible to be a SRC). For all other entities, ASC 326 is effective for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years (e.g., January 1, 2023 for a calendar year private company).

The underlying premise of ASC 326-20, *Financial Instruments—Credit Losses – Measured at Amortized Cost*, which provides guidance on the current expected credit losses model (herein referred to as CECL), is that the allowance for credit losses should reflect management's current estimate of credit losses that are expected to occur over the remaining life of a financial asset. There are no specific methods or approaches that are required to be applied in estimating expected credit losses; however, examples of methods that are specifically referenced in ASC 326-20 and other industry literature include:

- Discounted cash flow (DCF)
- Loss-rate
- Roll-rate
- Probability-of-default
- Aging schedule
- Weighted-average remaining maturity (WARM method)

While it is expected that the methods used to estimate expected losses and the approaches taken related to the preceding list of methods will vary from entity to entity, there are certain underlying requirements of ASC 326-20 that need to be met. Those requirements include, but are not limited to:

- Relevant available information should be considered when estimating expected losses, including information related to the borrower's creditworthiness, changes in lending strategies, underwriting practices and the current and forecasted direction of the economic and business environment.
- Credit losses should be measured on a collective or pool basis when similar risk characteristics exist. Risk characteristics upon which the portfolio is aggregated should be consistent with the entity's policies for evaluating the credit risk characteristics of its financial assets.
- The allowance should be based on estimated credit losses over the contractual term of the financial asset, with consideration given to estimated prepayments and recoveries. ASC 326-20-30-6 indicates

that the contractual term should not be extended for expected extensions, renewals and modifications, unless the entity has a reasonable expectation at the reporting date that it will execute a TDR with the borrower, or there are extension or renewal options that are not unconditionally cancellable by the creditor (i.e., the borrower has a right to extend the maturity date or renew the loan that is either unconditional or conditional on events such as compliance with debt covenants that are beyond the creditor's control).

- Discounts that will be accreted into interest income should not be offset against expected credit losses when determining the amount of allowance to be recorded. This is in contrast to the practice under legacy guidance where certain entities assert that no allowance is necessary if the unamortized discount at the measurement date exceeds the amount of allowance that was otherwise computed.
- In addition to adjusting historical loss ratios for current conditions, the entity is also required to adjust for reasonable and supportable forecasts related to future conditions that would impact the collectibility of the financial assets over their contractual term.

ASC 326-20 acknowledges that estimating expected credit losses is highly judgmental and illustrates this in ASC 326-20-55-6 by providing the following list of judgments that entities may need to make in the estimation process:

- a. The definition of default for default-based statistics
- b. The approach to measuring the historical loss amount for loss-rate statistics, including whether the amount is simply based on the amortized cost amount written off and whether there should be adjustments to historical credit losses (if any) to reflect the entity's policies for recognizing accrued interest
- c. The definition of default for default-based statistics
- d. The approach to determine the appropriate historical period for estimating expected credit loss statistics
- e. The approach to adjusting historical credit loss experience to reflect current conditions and reasonable and supportable forecasts that are different from conditions existing in the historical period
- f. The methods of utilizing historical experience
- g. The method of adjusting loss statistics for recoveries
- h. How expected prepayments affect the estimate of expected credit losses
- i. How the entity plans to revert to historical credit loss information for periods beyond which the entity is able to make or obtain reasonable and supportable forecasts of expected credit losses
- j. The assessment of whether a financial asset exhibits risk characteristics similar to other financial assets.

Specialty lenders should be determining the method to use in estimating expected credit losses and gathering the information that will be necessary to prepare forecasts of future loan losses that will be required by the CECL guidance.

Visit our [Current Expected Credit Loss \(CECL\) Resource Center](#) for further information on CECL.

In 2019, the FASB issued ASU 2019-05, *Financial Instruments—Credit Losses (Topic 326): Targeted Transition Relief*, which provides an option for entities with certain financial instruments to irrevocably elect the fair value option on an instrument-by-instrument basis upon adoption of CECL. The fair value alternative option does not apply to held-to-maturity debt securities.

Summary

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 U.S. 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 in specialty finance companies that are not SEC filers (or that are SEC filers that are eligible to be SRCs) should also consider the current capabilities the companies have to capture and analyze all of the data that will be necessary to prepare forecasts of future loan losses required by the CECL accounting guidance. These specialty finance companies should start the analysis of the CECL model as early as possible to avoid unanticipated impacts.

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