CMS ADVISOR

CREDIT MANAGEMENT SERVICES

ASC 310-10 Calculations

This process can be tricky, but it is very important.

In the past five years, every community bank has become much more familiar with FASB 114, now ASC 310-10, analysis than they had ever been in the past, even though FASB 114 came into place in the early 1990's. Virtually every bank has at least one ASC 310-10 calculation on their books today. The methodology associated with this calculation has become something that is being closely scrutinized by regulators. ASC 310-10 allows the bank to perform the calculation using one of three methods.

> Using the proper ASC 310-10 calculation is vitally important to the accuracy of the final calculation.

First, the bank can calculate a potential reserve using a Present Value (PV) calculation. Second, the bank can utilize information that is readily observable in the marketplace. For instance, if the collateral is a home and the home next door with a similar floor plan recently sold. This method is the seldom utilized. Finally, the bank can use a Fair Market Value (FMV) calculation. The only caveat is that if the loan is considered "collateral dependent" then the bank is required to use the FMV method. A loan is considered to be collateral dependent when cash flow is insufficient to support the debt service and the primary source of repayment is from the liquidation of the collateral. If the loan is collateral dependent, it should also be placed on non-accrual status.

If the interest rate on the loan has not been modified, in most instances the PV calculation will generate a nominal reserve amount. In fact, we see many situations when the loan is deemed to be impaired where the calculation, whether PV or

Loan review: Is it necessary?

This question often arises with bankers, especially when economic times are good. The answer in all economic environments is a resounding "YES!!".

An independent loan review performed by a quality firm will identify weaknesses in internal loan grading and accrual status, provide insight to potential impairment issues, and give management a better understanding of the bank's loan portfolio compared to peer banks.

If you are not currently using an independent firm or you would like a 'fresh set of eyes' to review your portfolio, call CMS today.

You and your Board of Directors will be glad you did.

FMV, yields more value than the balance of the loan. Therefore, the reserve amount is zero. This is acceptable. However, some banks today have more loans with zero or nominal reserves associated with the ASC 310-10 portfolio than loans that have actual reserves. If that is the case with your bank, you should probably review your ASC 310-10 methodology. If the borrower does not have sufficient cash flow to cover their debt service, then the loan may be collateral dependent and therefore should be calculated using the FMV.

FMV's should only be calculated based on a current, reviewed valuation or appraisal. We see some calculations using 2- or even 3-year old appraisals. This is not acceptable. Valuations should be no more than 1-year old. Additionally, the methodology that your bank is using within the FMV is important. Some banks are simply taking a discount for closing/selling expenses that range from 6-12%. Other banks are also discounting the appraisal by a specific amount to account for market variance. Our recommendation is to review your recent historic sales of OREO properties compared to the current appraisals. If you have been experiencing a material difference in the two, you should consider adding that percentage difference to the discount in the FMV calculation.

Additionally, if you have deemed a loan to be collateral dependent and you have performed an ASC 310-10 calculation that shows there is a need for a specific reserve, in most instances, you should charge-off some or all of the calculated specific reserve at that time as opposed to simply reserving that amount. The OCC's BAAS dated June, 2012 allows for you to reserve the discounted amounts in your calculation. However, any shortfall between the valuation of the collateral and the bank book amount should be classified as Loss and charged off immediately.

If the loan is not considered collateral dependent, the Present Value (PV) calculation will typically be used to test for impairment. If, after performing the calculation, impairment does exist in the credit the bank is allowed to reserve for this amount as opposed to charging it off.

Using the proper ASC 310-10 calculation is vitally important to the accuracy of the final calculation. Many of our clients tell us that their regulators believe that although their total reserves may be sufficient, the amount that is being reserved for impaired loans is often believed to be too little. This is definitely an area that regulators appear to be focusing on in Safety and Soundness Exams today.

Some clients have gone so far as to place a reserve amount against loans that are tested for impairment but yield no impairment amount. While this practice may seem prudent, one must be careful because it can be construed as 'layering' which is prohibited in the ALLL regulatory guidance. We recommend that you contact your specific regulator for guidance if you choose to take this approach.

ASC 310 and 450 can be complicated. Great care should be taken by the bank to ensure the accuracy of implementation. Should you have questions or concerns when defining these areas for your Bank, please do not hesitate to call us.

Credit Management Services provides loan review services to banks throughout the western U.S. If you have a need for credit review or due diligence projects, call us first.

Brian Yarrington
CREDIT MANAGEMENT SERVICES
(714) 722-4066
creditmngmt.com