CMS ADVISOR

CREDIT MANAGEMENT SERVICES

LOAN RESERVES VS CHARGE-OFFS

A complex decision.

Banks are required to hold reserves on virtually all of the loans in their lending portfolio, whether it is a FASB 5 reserve on a loan in the Pass-graded pool or a FASB 114 specific reserve on an impaired loan. Banks are reserving, in many cases, more than they ever have in history. One of the unique things associated with this issue is when to charge-off a loan. As we go from bank to bank on a weekly basis, we are seeing many situations where bankers are complacent with reserving for loans. They are not specifically considering whether a loan deserves a partial charge-off as long as the loan has a reserve associated with it. Most often, the bank is reserving an appropriate amount. The question becomes "When do we partially charge-off a loan as opposed to just reserving for it"? Unfortunately, some banks are not considering this question at all. It is appropriate to charge-off a portion of the loan when it becomes apparent that the bank is going to experience a loss.

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A perfect example is one that we see often. The bank has a real estate secured loan in which they have filed a Notice of Default to begin the foreclosure process. For the purpose of this example, assume that the loan amount is $500,000. The bank obtains a new appraisal on the collateral property with an "As-Is" value of $400,000. The appraisal clearly shows a deficiency of $100,000. The bank has performed a FASB 114 reserve analysis in which they use an expected sales/closing expense of 10% of the appraised amount or $40,000. The bank is showing a reserve amount of $140,000. The bank has taken no charge-off but is reserving according to their methodology for the risk associated with the loan. Clearly, the bank realizes that there is an

LOAN REVIEW: IS IT NECESSARY?

This question often arises with bankers, especially when 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, 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 will be glad you did.

expected loss which should trigger a charge-off. However, we have visited many banks who have become comfortable with reserves and are not acknowledging charge-offs when the loss is apparent. Many of these banks are content to take the charge-off when the collateral property has sold and the exact loss is defined. Unfortunately, this does not conform to the required regulation. The bank is required to acknowledge the anticipated charge-off at the time that it is clear that a loss exists. So in the example above, the bank should take a $100,000 charge-off at the time they review and accept the appraisal showing a collateral value of $400,000. Additionally, the bank should reserve the $40,000 that they expect to be the closing expenses associated with dispensing of the property.

This is a challenge for many bankers to accept. No one likes to accept a charge-off. However, properly reserving for a defined loss is not accurate, nor acceptable to your regulators. Bankers should rationally review their reserved assets and determine if it is clear that a loss is imminent. If so, a charge-off is most likely appropriate.

By not taking a charge-off timely, the bank creates a situation where the historical losses associated with the FASB 5 pool of loans may no longer be accurate. The bank could then inadvertently be under-reserving in the historic loss section because they have not been recognizing historic losses timely and accurately.

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