Asset Quality

Off-site & On-site Analysis

Bank Analysis and Examination School
Objectives

- Use a UBPR to gather asset quality information
- Evaluate asset quality through level and trend of adverse classifications
- Determine an asset quality rating
- Evaluate the adequacy of the allowance for loan losses
- Assess the impact of asset quality on earnings and capital
- Understand the roles of management and regulators.
Off-Site Analysis of UBPR

What to look for when analyzing asset quality:

- **Asset Mix of Balance Sheet**
  - Percentages of total assets in loans and securities and other assets

- **Past Due, Noncurrent, and Restructured Loans and Leases**
  - Total delinquencies by type of loan
  - Noncurrent loans to gross loans by type
  - Restructured loans as a percentage of total loans by type of loan
Off-Site Analysis of UBPR-Cont’d

- Net loan losses by type of loans
  - In which loan category is there excessive losses?
- Recoveries to prior period losses
- Earnings coverage of net losses
- ALLL to total loans
- ALLL to net losses
- Noncurrent loans to gross loans
- Noncurrent loans to ALLL
The UBPR is an Off-Site Tool

- We can use it to assist in off-site evaluation of important ratios, ALLL adequacy, and effectiveness of bank’s internal rating system.
- Designed to supplement examination procedures. NOT designed to replace on-site inspections.
Other Assets

- Investment Securities
- Other Real Estate Owned
- Off-Balance Sheet Items
  - Commercial and Standby Letters of Credit
  - Unfunded Loan Commitments
  - Lines of Credit
Core Principle 8: Adequacy of the loan loss reserve

A reserve set aside to absorb incurred loan losses

The linkage between asset quality and earnings and capital

A relatively subjective measure and a process often leading to debate
Asset Quality Classification Ratios

- **Total Classifications Ratio (TCR):**
  - Total classified assets as a percentage of Tier 1 Capital + ALLL

- **Weighted Classification Ratio (WCR):**
  - Loss @ 100%
  - Doubtful @ 50%
  - Substandard @ 20%
  - As a percentage of Tier 1 Capital + ALLL
Asset Quality Rating

- **Rating**
  - 1  0 to 5%
  - 2  5% to 15%
  - 3  15% to 30%
  - 4  30% to 50%
  - 5  Over 50%

There may be extenuating circumstances which may cause the examiner to deviate from the rating guidelines.
Other Asset Quality Factors

- Effectiveness of risk management
- Effectiveness of board oversight
- Adequacy of policies and procedures
- Quality of internal controls
- Assessment of management information systems (MIS)
- Concentrations of credit
- Economic conditions
Accounting for the Loan Loss Reserve

- **Specific reserve vs. General reserve**
  - *specific reserve is for an identified loss*
  - *general reserve is for incurred losses*
FASB 114 – Reserve for Impaired Loans

- Identify loans for individual loss evaluation.
- Three impairment measurement standards
  - Present value of expected cash flow, at the loan’s effective interest rate.
  - Observable market price of the loan
  - Fair value of collateral less selling cost
FASB 5 – Reserve for Homogenous Loan Pools

- Estimate loss for group of loans with similar credit characteristics

- Generally, banks base loss rates on historic information, adjusted for current conditions
Environmental Factors

- Changes in underwriting standards
- Increased turnover of lending staff
- Economic conditions
- Quality of loan review
Application of FAS 5 and FAS 114 to a Loan Portfolio

Segregate portfolio into loans within the scope of FAS 114 and FAS 5

**FAS 114**
- Review individual loans for impairment under FAS 114
  - Is the loan determined to be impaired?
    - Yes: Determine the amount of impairment for each loan using one of the three valuation methods
    - No: Transfer the loan to a loan group with similar characteristics to be reviewed under FAS 5

**FAS 5**
- Review groups of loans to estimate loss under FAS 5
  - Determine the amount of loss estimate for each loan group based on loss history and other environmental factors

Summarize the ALLL computed under FAS 114 and FAS 5 and compare it to existing ALLL amount to determine if provisions are needed
Key Guidance

- www.federalreserve.gov/boarddocs/srletters/

- SR 06-17
  - Application of FASB 114
  - Importance of documentation to support management’s judgment
  - ALLL estimate should consider all available information.
Impact on Earnings and Capital

- **Earnings**
  - Additional provisions required
  - Nonaccrual assets reduce interest income

- **Capital**
  - High losses erode capital levels
### Example: ALLL Adequacy Test (Part 1)

<table>
<thead>
<tr>
<th>Amount</th>
<th>Est. Loss</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total Loans</strong></td>
<td>200,000</td>
</tr>
<tr>
<td>- Substandard</td>
<td>4,200 @ 15% = 630</td>
</tr>
<tr>
<td>- Doubtful</td>
<td>550 @ 50% = 275</td>
</tr>
<tr>
<td>- Loss</td>
<td>250 @ 100% = 250</td>
</tr>
</tbody>
</table>

**Loans, net of classifications:** 195,000 @ 0.65% = 1,268

**Required ALLL = 2,423**
ALLL Adequacy Test (Part 2)

\[
\text{ALLL} \quad 2,000 \\
- \text{Required Reserve} \quad 2,423 \\
\text{Excess/(Deficiency)} \quad (423)
\]

Note: Examiners would require the $250 loss to be charged-off.

The bank must increase its loan loss reserves by $423.
Regulatory Oversight

- Select a sample of loans to assess:
  - loan grading system
  - effectiveness of internal credit review

- Review and assess the adequacy of internal models

- Ultimately, determine the adequacy of the loan loss reserve
  - If not adequate, require management to increase provisions
Asset Quality Write-up Outline

- Conclusions and Rating with support
- Classified and Special Mention Assets
- Past Due Loans and Net Loan Losses
- LLR Adequacy and Methodology
- Adequacy of the Loan Policy
- Adequacy of Loan Policy, Administration, and Loan Review
- Investment Portfolio Composition and Policy Adequacy
- Quality of OFF Balance Sheet Items

Remember Level, Trend, Peer and WHY!!!
Questions???