Accounting for Purchased Loans

Easier said than done
About Sageworks

- Lending, Credit Risk and Portfolio Risk Solutions
- More than 1,100 financial institution clients
- Founded in 1998
- Thought leader for institutions and examiners
- Regularly featured in national and trade media
Learning Objectives

• Banking Landscape
• Accounting for Purchased Loans
• Key Challenges
• Day 1 vs. Day 2
• AS 310-20 / FAS 91 vs. ASC 310-30 / SOP 03-3
• Examples
Market Landscape

What are we seeing
Wave of M&A Activity
Number of Commercial Banks

Last 10 years

Source: Federal Financial Institutions Examination Council
Shaded areas indicate US recessions - 2014 research.stlouisfed.org
“Costs are higher. Capital requirements are higher...Revenue growth is slower, and your profit margin is slimmer. That’s driving smaller banks in the arms of larger banks, which are better positioned because they enjoy economies of scale.”

Tony Plath – Finance Professor at UNC Charlotte
Accounting for Purchased Loans
Accounting for Purchased Loans

- Additional accounting/regulatory complexities
- Regulations are not explicit
- Unique handling in the Allowance for Loan and Lease Losses (ALLL)
Key Challenges

• Understanding Day 1 vs. Day 2 accounting
• Determining the appropriate accounting standard to apply (ASC 310-20, ASC 310-30)
• Handling the complexities of each standard
• To pool or not to pool – that is the question
• Determining appropriate ALLL reserve levels
Day 1 vs. Day 2 Accounting
How are they different
“Day One” Accounting

• Often referred to as Fair Value Accounting or GAAP Purchase Accounting
• All acquired loans are initially measured at their fair value, which includes estimation of life-of-loan credit loss
• No longer is any associated ALLL carried over to acquirer’s balance sheet with loans
“Day Two” Accounting

• Accounting for the loans after the financial close date of the business combination

• Two prevailing standards to understand
  » ASC 310-20 / FAS 91
  » ASC 310-30 / SOP 03-3
Intro to ASC Standards

• ASC 310-20 / FAS 91
  » Non credit impaired
  » Recognizes income based on \textit{contractual} cash flows

• ASC 310-30 / SOP 03-3
  » Credit impaired
  » Recognizes income based on \textit{expected} cash flows
• Loans that are **not** considered “credit impaired” at the time of purchase

• Used when the contractually obligated principal and interest cash flows are expected to be received on an acquired loan

• The purchase discount or premium will generally be accreted (amortized) into income on a level yield over the expected life of the loan
ASC 310-20 / FAS 91

UPB = $100,000

- Interest Rate: $2,000
- Loss in Cash Flows: $3,000
- Initial Investment (Fair Value): $95,000

Accrete all discounts into income over expected life
• As a result of using contractual cash flows:
  » Should any credit losses be incurred on these loans subsequent to acquisition, a provision to the ALLL would be required

  » Remember there is no “carry over” of the ALLL recorded under this standard
### PURCHASED NON-IMPAIRED LOANS

**Today's Balances**

- **Total Balance of Purchased Non-Impaired Loans**: $243,381,016.00
- **Total Reserve Amount**: $1,690,679.77

**Break out subsegments/child pools**

**APPLY**  **EDIT LOSS RATES**

<table>
<thead>
<tr>
<th>Federal Call Code</th>
<th>Total Loan Balance</th>
<th>Loss Rate</th>
<th>Loss Reserve</th>
<th>Fair Value Premium / Discounts</th>
<th>Additional Allowance Required</th>
</tr>
</thead>
<tbody>
<tr>
<td>1a. Construction, land develop...</td>
<td>$81,420,450.00</td>
<td>1.9035%</td>
<td>$1,549,838.27</td>
<td>$-3,845,624.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>2a2. To other commercial banks...</td>
<td>$63,428,415.00</td>
<td>6.9934%</td>
<td>$4,435,802.77</td>
<td>$-2,745,123.00</td>
<td>$1,690,679.77</td>
</tr>
<tr>
<td>6. Loans to individuals for ho...</td>
<td>$96,532,151.00</td>
<td>1.2963%</td>
<td>$1,277,272.27</td>
<td>$-5,214,863.00</td>
<td>$0.00</td>
</tr>
<tr>
<td><strong>Total:</strong></td>
<td><strong>$243,381,016.00</strong></td>
<td><strong>$7,262,913.31</strong></td>
<td><strong>$11,805,610.00</strong></td>
<td><strong>$-16,906,679.77</strong></td>
<td><strong>$1,690,679.77</strong></td>
</tr>
</tbody>
</table>
• Considered “credit impaired” at time of purchase
• Uses the acquirer’s cash flow expected at acquisition as the benchmark for calculating the yield on the investment of the loan
• Loans that meet both of the following standards must be accounted for under this method:
  » The deterioration in credit quality occurred after origination.
  » Probable that the acquirer will be unable to collect all contractually obligated payments from the borrower.
• Additional complexities of ASC 310-20 / FAS 91
Accretable Yield vs. Non Accretable Difference

- Loans are initially recorded at purchase price (fair value)
- Accretable Yield = the amount of expected cash flows that exceed the initial investment in the loan
  » Recognized as interest income on a level yield basis over the life of the loan
- Non Accretable Difference = the excess of total contractual cash flows over the cash flows expected to be received at origination
ASC 310-30 / SOP 03-3 Example

Contractual Cash Flows → $100,000

Expected Cash Flows → $80,000

Initial Investment (Fair Value) → $65,000

Non-Accretable Difference (Contractual CF’s > Expected CF’s)

Accretible Yield (Expected CF’s > Cost)
Accretable Yield vs. Non Accretable Difference

- Not a one-time conclusion
  - Must be reviewed periodically for differences between actual cash flows and previous forecasts
- Remaining cash flows must be reforecast
- If expected cash flows improve, it is recognized through an increase in the accretion rate
- If expected cash flows decrease, it is recognized through a provision to the ALLL
Improvements in Cash Flow Expectations

Components of Acquired Loan Balances

<table>
<thead>
<tr>
<th>Contractual Cash Flows</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-Accratable Difference</td>
<td>Expected Cash Flows</td>
</tr>
<tr>
<td>Accratable Yield</td>
<td>Accratable Yield</td>
</tr>
<tr>
<td>Recorded Investment</td>
<td>Recorded Investment</td>
</tr>
</tbody>
</table>

Original | Revalued w/ Improvement
ASC 310-30 / SOP 03-3 Pooling

• To pool or not to pool – that is the question

• Can pool together loans of common risk characteristics:
  » Similar credit risk or risk rating
  » One or more prominent risk characteristics

• Must document and substantiate

• Pooled loans must have been acquired together or within the same fiscal quarter
  » Can be treated as a single asset
As a result of using expected cash flows:

» Decreases in expected cash flows are recognized as a provision to the ALLL

» Again, remember there is no “carry over” of the ALLL recorded under this standard

» Three valuation methods
  1. Collateral
  2. Expected Cash Flow
  3. Cost Recovery
## Collateral Method:

### PURCHASED IMPAIRED LOAN ANALYSIS - FAIR MARKET VALUE OF COLLATERAL

#### LOAN INFORMATION

<table>
<thead>
<tr>
<th>Customer Name</th>
<th>Loan Number</th>
<th>Book Balance</th>
<th>Accrued Interest</th>
<th>Net Deferred Fees &amp; Costs</th>
<th>Unamortized Premium / Discount</th>
<th>Total Recorded Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Acer</td>
<td>SOP Collateral Example</td>
<td>$2,250,000.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$1,600,000.00</td>
</tr>
</tbody>
</table>

#### Fair Value

- Value: $650,000.00

### SHARED COLLATERAL

<table>
<thead>
<tr>
<th>Related Documents</th>
<th>Collateral</th>
<th>Appraisal Value</th>
<th>Appraisal Adjustment</th>
<th>Current Value</th>
<th>Prior Liens</th>
<th>Equity</th>
<th>Selling Costs</th>
<th>Fair Value</th>
<th>Appraisal Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>Building</td>
<td>$1,550,000.00</td>
<td>$1,519,000.00</td>
<td>$202,023.47</td>
<td>$1,316,976.53</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Total:**
- $1,550,000.00
- $1,519,000.00
- $1,316,976.53
Expected Cash Flow Method

Carrying value = Current Balance + Fair Value

Integrated or entered for the loan

Accretable Yield based on the carrying value and expected payments
## Expected Cash Flow Method

### Loan Information

- **Customer Name:** SAMPLE BORROWER
- **Loan Number:** 725589005A
- **Carrying Amount:** $2,270,297.26
- **Remaining Cash to be Collected:** $2,589,228.44
- **Cash Collected to Date:** $0.00
- **Write Downs & Allowances:** $0.00
- **Yield Accreted to Date:** $0.00
- **Remaining Accrivable Yield:** $318,931.18

### Loan Schedule

<table>
<thead>
<tr>
<th>Payment Date</th>
<th>Yield %</th>
<th>Beginning Carrying Amount</th>
<th>Cash Flows</th>
<th>Interest Income</th>
<th>Ending Carrying Amount</th>
<th>Allowance Entry</th>
<th>Total Allowance</th>
</tr>
</thead>
</table>
## Purchased Impaired Loan Analysis - Cost Recovery Method

**Today's Balances**

**Customer Name:** Rock City  
**Loan Number:** SOP Cost Recovery

<table>
<thead>
<tr>
<th>Payment Date</th>
<th>Beginning Carrying Amount</th>
<th>Cash Flows</th>
<th>Adjustments</th>
<th>Ending Carrying Amount</th>
<th>Interest Income</th>
</tr>
</thead>
<tbody>
<tr>
<td>2/28/2014</td>
<td>$50,000.00</td>
<td>$10,000.00</td>
<td>$0.00</td>
<td>$40,000.00</td>
<td>$0.00</td>
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<tr>
<td>3/31/2014</td>
<td>$40,000.00</td>
<td>$15,000.00</td>
<td>$0.00</td>
<td>$25,000.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>4/30/2014</td>
<td>$25,000.00</td>
<td>$14,000.00</td>
<td>$0.00</td>
<td>$11,000.00</td>
<td>$0.00</td>
</tr>
<tr>
<td>5/31/2014</td>
<td>$11,000.00</td>
<td>$15,000.00</td>
<td>$0.00</td>
<td>$0.00</td>
<td>$4,000.00</td>
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<tr>
<td><strong>Total:</strong></td>
<td><strong>$54,000.00</strong></td>
<td><strong>$0.00</strong></td>
<td></td>
<td><strong>$4,000.00</strong></td>
<td></td>
</tr>
</tbody>
</table>

**Reserve Amount:** $75,000.00
### ALLOWANCE FOR LOAN AND LEASE LOSSES BALANCES AND RESERVES

<table>
<thead>
<tr>
<th></th>
<th>Balances</th>
<th>Reserves</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>Individually Analyzed Loans:</td>
<td>$53,814,446.00</td>
<td>$53,814,446.00</td>
<td></td>
</tr>
<tr>
<td>Pooled Loans:</td>
<td>$373,189,789.57</td>
<td>$14,138,258.54</td>
<td></td>
</tr>
<tr>
<td><strong>Purchased Impaired Loans:</strong></td>
<td>$30,404,241.36</td>
<td>$615,558.45</td>
<td></td>
</tr>
<tr>
<td><strong>Purchased Non-Impaired Loans:</strong></td>
<td>$243,381,016.00</td>
<td>$1,690,679.77</td>
<td></td>
</tr>
<tr>
<td><strong>Total Loans:</strong></td>
<td>$700,789,492.93</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Other Reserves:</strong></td>
<td>$0.00</td>
<td></td>
<td></td>
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<tr>
<td><strong>Total ALLL Reserve:</strong></td>
<td>$70,258,942.76</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Items to Remember

• Increase in M&A activity
• With acquisitions, increase in regulation and accounting requirements
• Purchased accounting introduces added complexities
• Day 1 vs. Day 2 accounting
• ASC 310-20 / FAS 91 vs. ASC 310-30 / SOP 03-3
Additional Resources

**BEST PRACTICES & NEWS**

**WEBINARS**

- [www.Sageworks.com](http://www.Sageworks.com) > Resources
- Monthly, complimentary webinars on the ALLL and CECL

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[Image: ALLL.com by Sageworks]
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