ACCOUNTING FOR PURCHASED LOANS: WHAT TO KNOW IF YOU'RE CONSIDERING AN ACQUISITION

PRESENTED BY:

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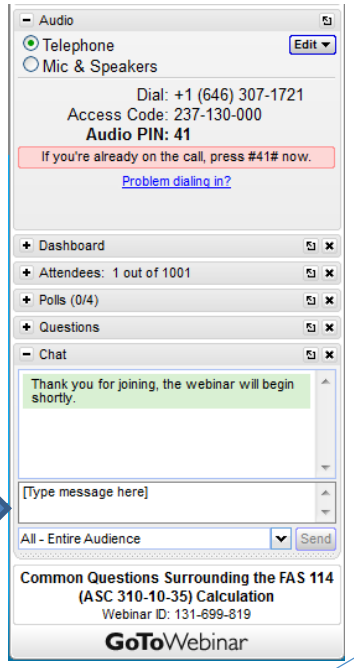
Questions

- A copy of the slides and webinar recording will be emailed to you following the webinar
- To ask a question during the webinar, enter it into the chat box in the GoToWebinar panel on right side of screen:
- Brief Q&A held at end of webinar



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- Financial information company that provides credit and risk management solutions to financial institutions
- Data and applications used by thousands of financial institutions and accounting firms across North America
- Awards
  - Named to Inc. 500 list of fastest growing privately held companies in the U.S.
  - Named to Deloitte's Technology Fast 500
  - NC Tech Awards: Excellence in Customer Service

Who will be speaking?

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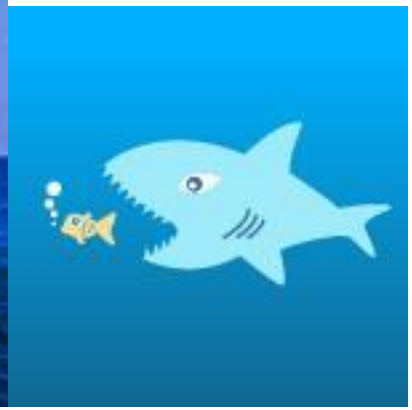
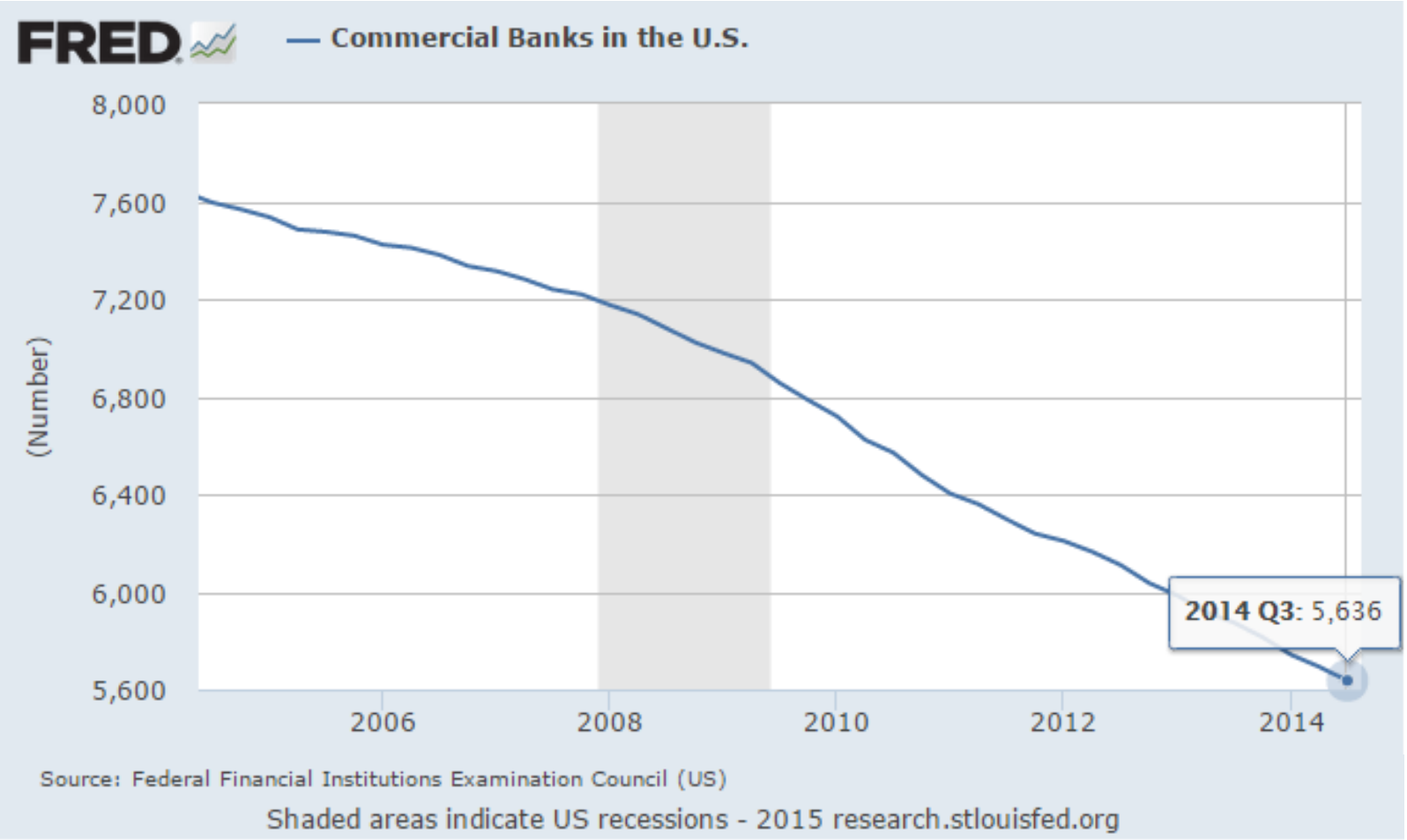
Learning Objectives

- Banking landscape
- Accounting for purchased loans: Implications and regulations
- Key challenges
- Day 1 vs. Day 2 accounting
- ASC 310-20 / FAS 91 vs. ASC 310-30 / SOP 03-3
- Examples

Banking Landscape: a Wave of M&A



Number of Commercial Banks – Past 10 yrs



M&A Activity

"Costs are higher. Capital requirements are higher… Revenue growth is slower and your profit margin is slimmer. That's driving smaller banks into the arms of larger banks, which are better positioned because they enjoy economies of scale."

Tony Plath – Finance Professor UNC-Charlotte

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(s) to apply (eg., ASC 310-20, ASC 310-30)
- Handling the complexities of each standard
- To pool or not to pool – that is the question
- Determining the appropriate ALLL reserve levels

“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
  - ASC 310-20 (FAS 91)
  - ASC 310-30 (SOP 03-3)

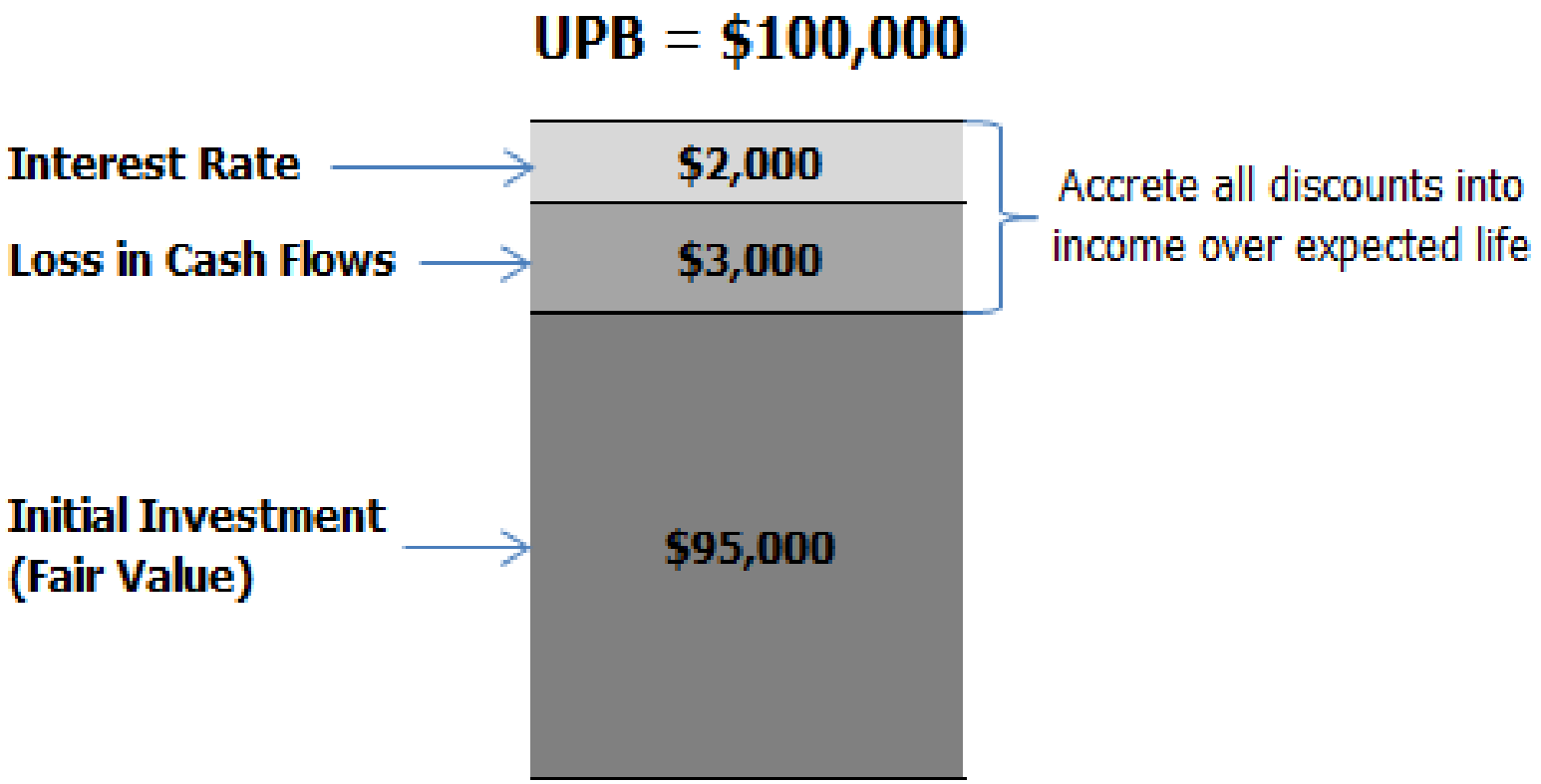
An Introduction to the Standards

- ASC 310-20 / FAS 91
  - Non-Credit Impaired
  - Recognizes income based on contractual cash flows
- ASC 310-30 / SOP 03-3
  - Credit Impaired
  - Recognizes income based on expected cash flows

ASC 310-20 (FAS 91)

- Loans that are <u>not</u> 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)



ASC 310-20 (FAS 91) ALLL

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

ASC 310-20 (FAS 91) ALLL Example

FAS 91 (ASC 310-20) Loans

February 2014 - Balances

Total Balance of FAS 91 (ASC 310-20) Pooled Loans:	$ 17,082,011.13
Total Reserve Amount:	$ 16,648.90

Edit FAS 91 Loss Rates

Loan Type Code	Total Loan Balance	Loss Rate	Loss Reserve	Fair Value Premium / Discounts	Additional Allowance Required
1-4 FAMILY FIRST MORTGAGE (1)	$ 1,939,080.26	4.1700%	$ 80,859.65	$ -75,000.00	$ 5,859.65
1-4 FAMILY JUNIOR MORTGAGE (1)	$ 10,122,430.87	4.3300%	$ 438,301.26	$ -427,512.00	$ 10,789.26
AGRICULTURE (NON-RE) (1)	$ 5,020,500.00	5.6500%	$ 283,658.25	$ -594,231.00	$ 0.00
Total:	$ 17,082,011.13		$ 802,819.15	$ -1,096,743.00	$ 16,648.90

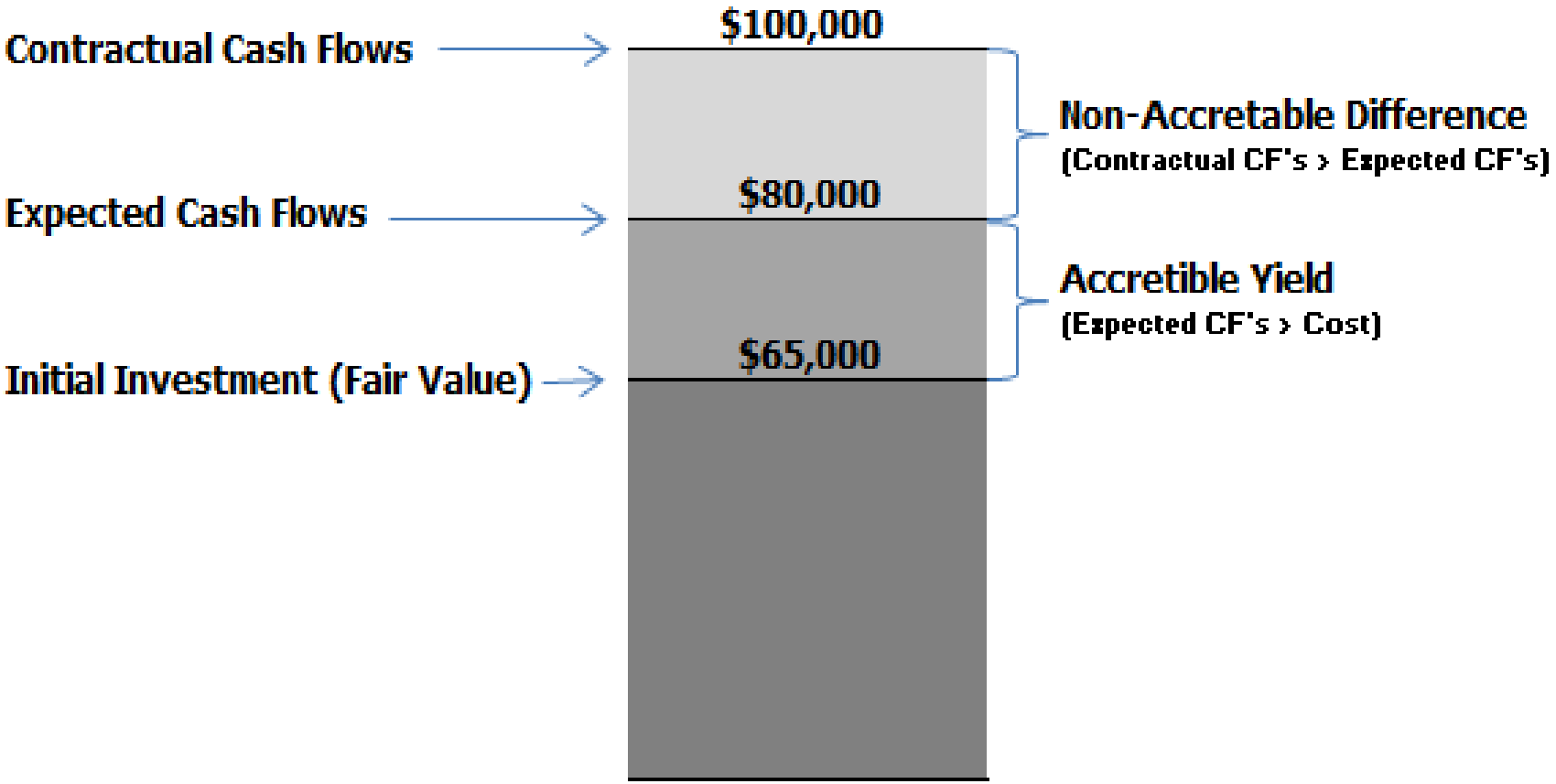
ASC 310-30 (SOP 03-3)

- 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 in 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 over 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

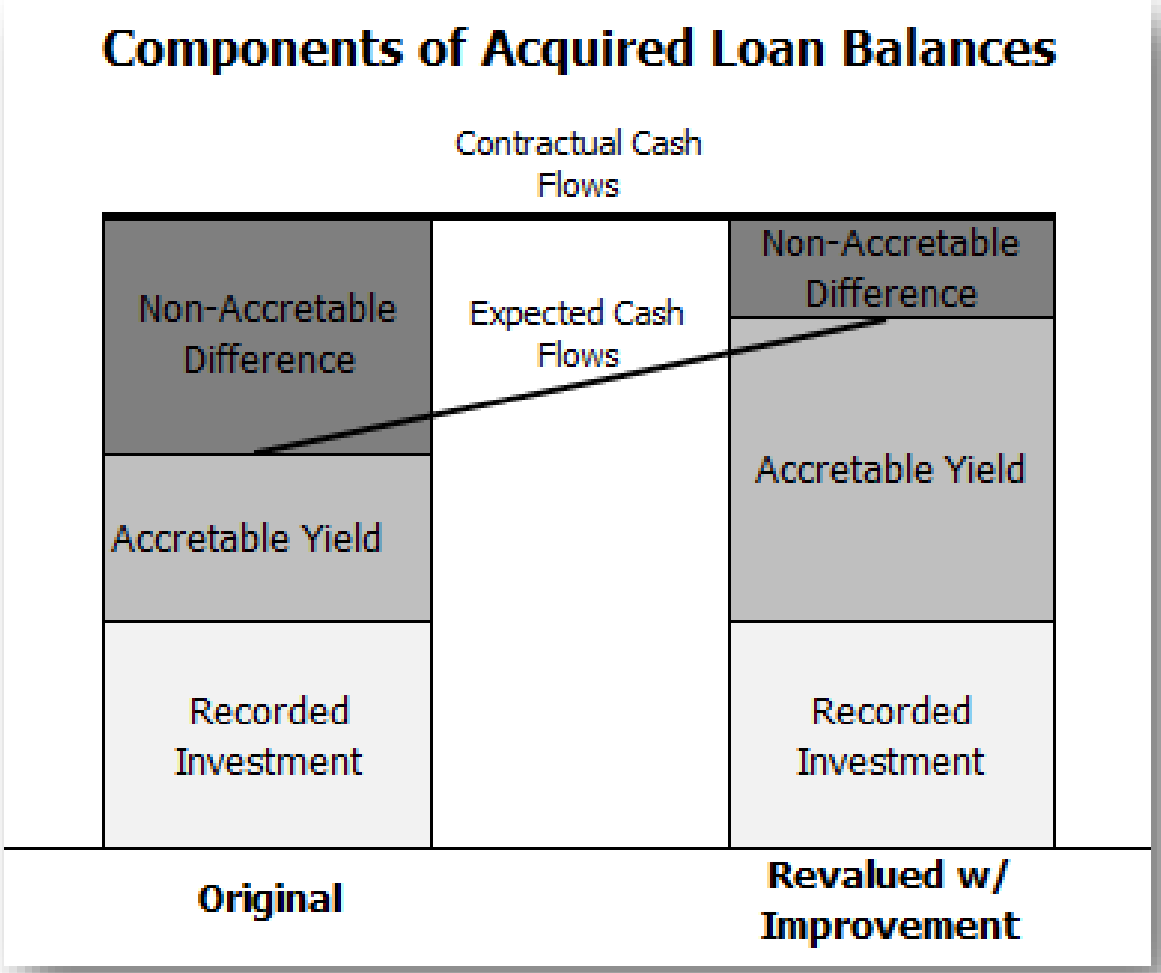
ASC 310-30 (SOP 03-3) Example



Accretable Yield vs. Non-Accretable Difference

- Not a one-time conclusion
- 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

Improvement in Cash Flow Expectations: Example



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 ratings
  - One or more prominent risk rating characteristics
- Must document and substantiate
- Pooled loans must have been acquired together, or within the same fiscal quarter
  - Can then be treated as a single asset

ASC 310-30 (SOP 03-3) ALLL

As a result of using expected cash flows:

- Decreases in expected cash flows are recognize with a provision to the ALLL
- Again, remember there is no “carry over” of the ALLL recorded under this standard
- Three (3) valuation methods:
  - Collateral
  - Expected cash flow
  - Cost recovery

ASC 310-30 (SOP 03-3) ALLL Example

Collateral Method:

SOP 03-3 (ASC 310-30) Impairment Analysis - Fair Market Value of Collateral

Today's Balances

Loan Information

Customer Name	Loan Number	Current Balance	Accrued Interest	Net Deferred Fees & Costs	Unamortized Premium / Discount	Fair Value Premium / Discount	Total Recorded Investment
Mitel	118109514	$ 105,115.39	$ 0.00	$ 0.00	$ 0.00	$ -7,851.00	$ 97,264.39

Save

Shared Collateral

Attached Documents	Collateral	Appraisal Value	Appraisal Adjustment	Current Value	Prior Liens	Equity	Selling Costs	Fair Value	Appraisal Date	Expand All
0	Single family reside...	$ 200,000.00	0.00%	$ 200,000.00	$0.00	$200,000.00	$0.00	$ 200,000.00	07/10/2006	Expand
Total:		$ 200,000.00		$ 200,000.00				$ 200,000.00		

ASC 310-30 (SOP 03-3) ALLL Example

Expected Cash Flow Method:

Loan Information

Customer Name:	Blackhawk
Loan Number:	5000020965
Carrying Amount (Fair Value):	$4,000,000.00
Remaining Term (Months):	5
Expected Payment:	$ 1,165,134.00
Calculated Yield Rate:	14.0000%

Generate Cash Flows

Loan Schedule

Payment Date	Expected Payment	Present Value
3/31/2014	$ 1,165,134.00	$ 1,022,047.43
4/30/2014	$ 1,165,134.00	$ 896,532.88
5/31/2014	$ 1,165,134.00	$ 786,432.40
6/30/2014	$ 1,165,134.00	$ 689,853.02
7/31/2014	$ 1,165,134.00	$ 605,134.27

Carrying value = Current Balance + Fair Value Premium/Discount integrated/entered for the loan

Accretable Yield based on the carrying value (above) and expected payments (below)

ASC 310-30 (SOP 03-3) ALLL Example

Expected Cash Flow Method:

Loan Information

Customer Name:	Blackhawk
Loan Number:	5000020965
Remaining Cash to be Collected:	$5,825,670.00
Cash Collected to Date:	$0.00
Write Downs & Allowances:	$0.00
Yield Accreted to Date:	$0.00
Remaining Accretable Yield:	$1,825,670.00

Review / Edit Cash Flow Schedule

Loan Schedule

Payment Date	Yield %	Beginning Carrying Amount	Cash Flows	Interest Income	Ending Carrying Amount	Allowance Entry	Total Allowance
3/31/2014	14.0000%	$ 4,000,000.00	$ 1,165,134.00	$ 559,999.73	$ 3,394,865.73	$ 0.00	$ 0.00
4/30/2014	14.0000%	$ 3,394,865.73	$ 1,165,134.00	$ 475,280.98	$ 2,705,012.71	$ 0.00	$ 0.00
5/31/2014	14.0000%	$ 2,705,012.71	$ 1,165,134.00	$ 378,701.60	$ 1,918,580.31	$ 0.00	$ 0.00
6/30/2014	14.0000%	$ 1,918,580.31	$ 1,165,134.00	$ 268,601.12	$ 1,022,047.43	$ 0.00	$ 0.00
7/31/2014	14.0000%	$ 1,022,047.43	$ 1,165,134.00	$ 143,086.57	$ 0.00	$ 0.00	$ 0.00

ASC 310-30 (SOP 03-3) ALLL Example

Expected Cash Flow Method:

Loan Information

Customer Name:	CV Test 04.12.2014
Loan Number:	CV Test 04.12.14
Remaining Cash to be Collected:	$24,500.00
Cash Collected to Date:	$9,300.00
Write Downs & Allowances:	$0.00
Yield Accreted to Date:	$487.88
Remaining Accretable Yield:	$3,312.12

Review / Edit Cash Flow Schedule

Loan Schedule

Payment Date	Yield %	Beginning Carrying Amount	Cash Flows	Interest Income	Ending Carrying Amount	Allowance Entry	Total Allowance
10/31/2014	0.6007%	$ 30,000.00	$ 3,100.00	$ 180.20	$ 27,080.20	$ 0.00	$ 0.00
11/30/2014	0.6007%	$ 27,080.20	$ 3,100.00	$ 162.66	$ 24,142.86	$ 0.00	$ 0.00
12/31/2014	0.6007%	$ 24,142.86	$ 3,100.00	$ 145.02	$ 21,187.88	$ 0.00	$ 0.00
1/31/2015	3.7688%	$ 21,187.88	$ 3,500.00	$ 798.52	$ 18,486.40	$ 0.00	$ 0.00
2/28/2015	3.7688%	$ 18,486.40	$ 3,500.00	$ 696.71	$ 15,683.11	$ 0.00	$ 0.00
3/31/2015	3.7688%	$ 15,683.11	$ 3,500.00	$ 591.06	$ 12,774.17	$ 0.00	$ 0.00
4/30/2015	3.7688%	$ 12,774.17	$ 3,500.00	$ 481.43	$ 9,755.60	$ 0.00	$ 0.00
5/31/2015	3.7688%	$ 9,755.60	$ 3,500.00	$ 367.67	$ 6,623.27	$ 0.00	$ 0.00
6/30/2015	3.7688%	$ 6,623.27	$ 3,500.00	$ 249.62	$ 3,372.88	$ 0.00	$ 0.00
7/31/2015	3.7688%	$ 3,372.88	$ 3,500.00	$ 127.12	$ 0.00	$ 0.00	$ 0.00

ASC 310-30 (SOP 03-3) ALLL Example

Expected Cash Flow Method:

Loan Information

Customer Name:	Blackhawk
Loan Number:	5000020965
Remaining Cash to be Collected:	$3,195,402.00
Cash Collected to Date:	$2,330,268.00
Write Downs & Allowances:	$232,163.23
Yield Accreted to Date:	$1,035,280.71
Remaining Accretable Yield:	$722,552.52

Review / Edit Cash Flow Schedule

Loan Schedule

Payment Date	Yield %	Beginning Carrying Amount	Cash Flows	Interest Income	Ending Carrying Amount	Allowance Entry	Total Allowance
3/31/2014	14.0000%	$ 4,000,000.00	$ 1,165,134.00	$ 559,999.73	$ 3,394,865.73	$ 0.00	$ 0.00
4/30/2014	14.0000%	$ 3,394,865.73	$ 1,165,134.00	$ 475,280.98	$ 2,705,012.71	$ 232,163.23	$ 232,163.23
5/31/2014	14.0000%	$ 2,472,849.48	$ 1,065,134.00	$ 346,198.76	$ 1,753,914.25	$ 0.00	$ 232,163.23
6/30/2014	14.0000%	$ 1,753,914.25	$ 1,065,134.00	$ 245,547.88	$ 934,328.12	$ 0.00	$ 232,163.23
7/31/2014	14.0000%	$ 934,328.12	$ 1,065,134.00	$ 130,805.88	$ 0.00	$ 0.00	$ 232,163.23

ASC 310-30 (SOP 03-3) ALLL Example

Cost Recovery Method:

Customer Name: Northwest

Loan Number: 118102576

Payment Date	Beginning Carrying Amount	Cash Flows	Adjustments	Ending Carrying Amount	Interest Income
2/28/2014	$ 102,521.07	$ 25,000.00	$ 0.00	$ 77,521.07	$ 0.00
3/31/2014	$ 77,521.07	$ 27,500.00	$ 0.00	$ 50,021.07	$ 0.00
4/30/2014	$ 50,021.07	$ 27,500.00	$ 0.00	$ 22,521.07	$ 0.00
5/31/2014	$ 22,521.07	$ 27,500.00	$ 0.00	$ 0.00	$ 4,978.93
Total:		$ 107,500.00	$ 0.00		$ 4,978.93

Reserve Amount: $ 0.00

ALLL (Example)

Allowance for Loan and Lease Losses Balances and Reserves

	Balances	Reserves	Comments
FAS 114 (ASC 310-10-35) Loans:	$ 2,957,364.56	$ 779,594.89	
FAS 5 (ASC 450-20) Loans:	$ 376,463,999.20	$ 19,464,408.58	
SOP 03-3 (ASC 310-30) Loans:	$ 2,823,730.23	$ 0.00	
FAS 91 (ASC 310-20) Loans:	$ 17,082,011.13	$ 16,648.90	
Total Loans:	$ 399,327,105.12		
Unallocated Reserves:		$ 800,000.00	
Total ALLL Reserve:		$ 21,060,652.37	

OCC Declaration on Mark Split

Facts Bank A acquires Bank B in a transaction accounted for under the acquisition method in accordance with ASC 805. The loan portfolio acquired includes both impaired and non-impaired loans. Bank A accounts for the impaired loans as PCI loans in accordance with ASC 310-30 and accounts for all non-impaired loans in accordance with ASC 310-20. For the acquired non-impaired loans, Bank A bifurcates the acquisition fair value mark into a credit portion and a non-credit portion when estimating the ALLL needed in subsequent periods.

Question 10

Is it proper for Bank A to bifurcate the fair value mark on the acquired non-impaired loans into a credit portion and a non-credit portion when estimating the ALLL in subsequent periods?

Staff Response

No. ASC 310-20 does not support such bifurcation between the two components. The entire discount is accreted into interest income, or premium amortized, over the remaining lives of the loans. However, the accretion or amortization related to an individual loan should cease if that loan is placed on nonaccrual. The unamortized discount or premium is part of the recorded investment in the loan against which the need for the ALLL is evaluated.

Items to Remember

+Increase in M&A Activity

+With acquisitions, increase in accounting / regulatory requirements

+Purchased accounting introduces additional complexities

+Day 1 vs. Day 2 Accounting

+ASC 310-20 (FAS 91) vs. ASC 310-30 (SOP 03-3)

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Resources

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- **www.sageworksanalyst.com**
- Whitepapers, webinars, thought leadership

ALLL.com by sageworks

- The destination website for the ALLL calculation
- Latest news, peer discussions, industry expert opinions

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- ALLL Forum for Bankers
- Commercial Credit Risk Professionals

Resources (cont'd)

- CECL Webinar
- Fill out form, we'll email you invite when guidance passed
- **Web.sageworks.com/CECL/**

- 2015 Annual Risk Management Summit (ALLL + ST)
- Chicago, IL Sept 23 – 25
- **Sageworks.com/Summit**

- Brief survey following webinar: topics for upcoming webinars? Speaker feedback?

Questions?