



Portfolio Management: The Ins and Outs of Loan Loss Reserve

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We'll Answer These 3 Questions about Loan Loss Reserve:

1. What is it?
 2. How and when is it calculated?
 3. Why is it important – what are the real world impacts?
- And we'll debunk the 3 biggest myths about LLR!!!

MYTH #1:

ACCRUED LLR SHOULD EQUAL YOUR CASH LLR



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Accrued LLR



- A valuation reserve maintained to cover losses that are *probable* and *reasonably estimated* on the date of the evaluation
- Shows the "true" value of the asset on the BS
- An accounting adjustment

➤ *Expected scenario*



vs.

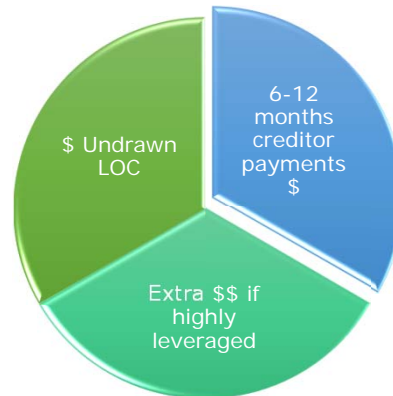
Cash/Liquidity Reserve



- A cushion against *possible* future losses
- Cash in the bank
- *Worst case scenario*
- *So you can repay your funders*

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Determining Cash (Liquidity) Reserve



- At a minimum needs to meet funder covenants
- Does not include operating liquidity reserve



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Determining Accrued LLR

- Amount of loss *reasonably estimated*
- Risk rating - New vs. seasoned
- Individual loans vs. portfolio segments
- Consider credit protections (collateral, loan guarantees)



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Example LLR Allocation – Existing Loans

Risk Rating	Rating Criteria Consider Financial, Security, Environmental, Management, Risk Trends	LLR Allocation
A Strong	No late payments Consistent, growing profitability (DSCR) LTV < 90% Industry strong	2%
B Sound	0-1 late payment in last 12 months Consistent profitability (DSCR) LTV 70%-90% Industry strong	5%
C Adequate	1-2 late payments in last 12 months Breaking even, inconsistent revenue (DSCR) LTV 90%-100% Industry neutral, uncertain	10%
D Sub-standard	3 late payments in last 12 months Unprofitable/declining revenue (DSCR) LTV > 100% Industry neutral to unfavorable	30%-50%
F Doubtful	4+ late payments in last 12 months Unprofitable, declining (DSCR) LTV > 100% Industry highly unfavorable	50%-100%

Example LLR Calculation

Loan #	Loan Balance	Risk Rating	LLR %	LLR Amount
1	\$50,000	C	10%	\$5,000
2	\$100,000	B	5%	\$5,000
3	\$150,000	A	2%	\$3,000
4	<u>\$50,000</u>	D	40%	<u>\$20,000</u>
Total:	<i>\$350,000</i>		<i>9.4%</i>	<i>\$33,000</i>

➤ When do you make adjustments?



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Accrued LLR – Accounts Affected

Balance Sheet November 30, 2016		Income Statement YTD thru Nov 30, 2016	
Cash	400,000	Interest & fees	50,000
Loans rec	350,000	Grant income	<u>100,000</u>
LLR (contra)	<u>(33,000)</u>	Total income	150,000
Net loans rec	317,000	Payroll	100,000
Other Assets	<u>50,000</u>	Interest expense	5,000
Total Assets	767,000	Provision for losses	<u>10,000</u>
Total Liabilities	400,000	Total Expenses	115,000
Net Assets	367,000	Net Income	35,000



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Example LLR Calculation

Loan #	December 31, 2015			November 30, 2015		
	Loan Balance	Risk Rating /LLR %	LLR \$\$	Loan Balance	Risk Rating /LLR %	LLR \$\$
1	\$50,000	D/50%	\$25,000	\$50,000	C/10%	\$5,000
2	\$98,000	B/5%	\$4,900	\$100,000	B/5%	\$5,000
3	\$140,000	A/2%	\$2,800	\$150,000	A/2%	\$3,000
4	\$40,000	D/30%	\$12,000	<u>\$50,000</u>	D/40%	<u>\$20,000</u>
5	<u>\$200,000</u>	B/5%	<u>\$10,000</u>			
Total	\$528,000	10.4%	\$54,700	\$350,000	9.4%	\$33,000

➤ Increased LLR of \$21,700



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Accrued LLR – Making an Adjustment

Balance Sheet November 30, 2016		Balance Sheet December 31, 2016	
Cash	400,000	Cash	222,000
Loans rec	350,000	Loans rec	528,000
LLR (contra)	<u>(33,000)</u>	LLR (contra)	<u>(54,700)</u>
Net loans rec	317,000	Net loans rec	473,300
Other Assets	<u>50,000</u>	Other Assets	<u>50,000</u>
Total Assets	767,000	Total Assets	745,300
Total Liabilities	400,000	Total Liabilities	400,000
Net Assets	367,000	Net Assets	345,300

➤ LLR grows by \$21,700; and...



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Accrued LLR – Making an Adjustment

Income Stmt Jan 1-Nov 30, 2016		Income Stmt Jan 1-Dec 31, 2016	
Interest & fees	50,000	Interest & fees	50,000
Grant income	<u>100,000</u>	Grant income	<u>100,000</u>
Total income	150,000	Total income	150,000
Payroll	100,000	Payroll	100,000
Interest expense	5,000	Interest expense	5,000
Provision for losses	<u>10,000</u>	Provision for losses	<u>31,700</u>
Total Expenses	115,000	Total Expenses	136,700
Net Income	35,000	Net Income	13,300

➤ Provision for loss increases by \$21,700



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What if there is a loss of \$50K?

Balance Sheet December 31, 2016		Balance Sheet January 1, 2017	
Cash	222,000	Cash	222,000
Loans rec	528,000	Loans rec	478,000
LLR (contra)	<u>(54,700)</u>	LLR (contra)	<u>(4,700)</u>
Net loans rec	473,300	Net loans rec	473,300
Other Assets	<u>50,000</u>	Other Assets	<u>50,000</u>
Total Assets	745,300	Total Assets	745,300
Total Liabilities	400,000	Total Liabilities	400,000
Net Assets	345,300	Net Assets	345,300

➤ L/R decreases by \$50K

➤ LLR shrinks (increases) by \$50K



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Replenishing the LLR

Balance Sheet January 1, 2017 Before replenish		Balance Sheet January 1, 2017 After replenish	
Cash	222,000	Cash	222,000
Loans rec	478,000	Loans rec	478,000
LLR (contra)	<u>(4,700)</u>	LLR (contra)	<u>(29,700)</u>
Net loans rec	473,300	Net loans rec	448,300
Other Assets	<u>50,000</u>	Other Assets	<u>50,000</u>
Total Assets	745,300	Total Assets	720,300
Total Liabilities	400,000	Total Liabilities	400,000
Net Assets	345,300	Net Assets	320,300

➤ LLR grows (decreases) by \$25K; and...



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Replenishing the LLR

Income Stmt Jan 1 2017 Before replenish		Income Stmt Jan 1 2017 After replenish	
Interest & fees	5,000	Interest & fees	5,000
Grant income	<u>10,000</u>	Grant income	<u>10,000</u>
Total income	15,000	Total income	15,000
Payroll	5,000	Payroll	5,000
Interest expense	5,000	Interest expense	5,000
Provision for losses	<u>0</u>	Provision for losses	<u>25,000</u>
Total Expenses	10,000	Total Expenses	35,000
Net Income	5,000	Net Income	(20,000)



➤ Provision for loss *increases* by \$25K

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MYTH #2:

**OVER-RESERVING
STRENGTHENS YOUR
CDFI**



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Determining LLR

- Ideally LLR will equal actual losses over time...you can be *slightly* more conservative

Year	Total (L/R)	L/R 90+ days	Delinq %	Actual loan losses	Loan loss %	\$ LLR	LLR %
2011	\$1,177,389	\$4,897	0.4%	\$4,429	0.4%	\$288,006	24.5%
2012	\$1,268,684	\$4,084	0.3%	\$6,848	0.5%	\$236,388	18.6%
2013	\$1,340,752	\$170,440	12.7%	\$19,561	1.5%	\$308,465	23.0%
2014	\$1,156,046	\$51,590	4.5%	\$9,296	0.8%	\$306,789	25.5%



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LLR Financial Impacts

- Total Assets
- Net Asset Ratio
- Net Income
- Self-sufficiency ratio
- Operating liquidity ratio



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MYTH #3:

UNDER-RESERVING STRENGTHENS YOUR CDFI



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LLR Policy Should Include:

How	Who	When
<ul style="list-style-type: none"> • Initial risk rating is determined • Adjustments to the rating are determined • Loan loss provision amounts per risk rating 	<ul style="list-style-type: none"> • Approves policy (BOD) • Prepares risk ratings • Approves LLR allocations • Enters LLR allocations 	<ul style="list-style-type: none"> • Initial risk rating is determined (upon closing / disbursement) • Adjustments are made (at least quarterly) • Policy / rating system is reviewed (at least annually)



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Parting Thoughts

- Educate your Board and loan committee
- Set up a system that makes sense for your market and loan products
- Put it into written policy
- Make sure you are following your policy!
- Don't under or over reserve, be prudent
- Evaluate the system



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