June 12–14
Pacific Grove, California
nativecdficonvening.org

2018 Native CDFI Capital Access Convening

Bringing Native CDFIs, Funders, and Investors Together to Bring Capital to Native Communities

Nitty Gritty of the Loan Loss Reserve

Pacific Grove, California

Your Presenters:

- Emily Trump, First Nations Oweesta
- Lisa Wagner, Bluestem Consulting

We'll Answer These 3 Questions about LLR:

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

<u>Accrued LLR</u> vs. <u>Cash/Liquidity Reserve</u>

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

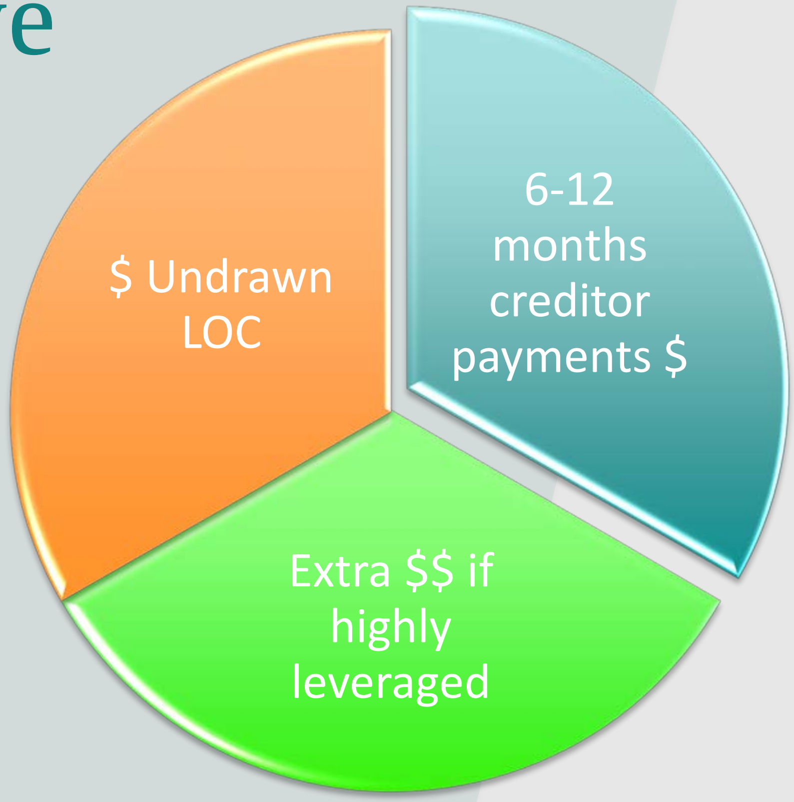
➢ *Expected scenario*

- A cushion against *<u>possible</u>* future losses
- Cash in the bank

➢ *Worst case scenario*

➢ *So you can repay your funders*

Determining Lending Cash Reserve



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

Determining Accrued LLR

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

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) Credit score > 720	2%
B Sound	0-1 late payment in last 12 months Consistent profitability (DSCR) Credit score 675-720, or declining	5%
C Adequate	1-2 late payments in last 12 months Breaking even, inconsistent revenue (DSCR) Credit score 600-675, or declining	10%
D Sub-standard	3 late payments in last 12 months Unprofitable/declining revenue (DSCR) Credit score < 600, or declining	30%-50%
F Doubtful	4+ late payments in last 12 months Unprofitable, declining (DSCR) Credit score < 600, or declining	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	$50,000	D	40%	$20,000
Total:	*$350,000*		*9.4%*	*$33,000*

- **When do you make adjustments?**

Accrued LLR – Accounts Affected

Balance Sheet October 31, 2017	
Loans rec	350,000
LLR (contra)	(33,000)
Net loans rec	317,000
Other Assets	50,000
Total Assets	*367,000*
Total Liabilities	*200,000*
Net Assets	***167,000***

Income Statement Jan-Oct 2017	
Total income	*150,000*
Payroll	100,000
Interest expense	5,000
Provision for losses	10,000
Total Expenses	*115,000*
Net Income	***35,000***

Example LLR Calculation

	October 31, 2017			December 31, 2017		
Loan #	**Loan Balance**	**Risk Rating /LLR %**	**LLR $$**	**Loan Balance**	**Risk Rating /LLR %**	**LLR $$**
1	$50,000	C/10%	**$5,000**	$50,000	F/100%	**$50,000**
2	$100,000	B/5%	**$5,000**	$98,000	B/5%	**$4,900**
3	$150,000	A/2%	**$3,000**	$140,000	A/2%	**$2,800**
4	$50,000	D/40%	**$20,000**	$40,000	D/30%	**$12,000**
5				$200,000	B/5%	**$10,000**
Total	***$350,000***	***9.4%***	***$33,000***	***$528,000***	***15.1%***	***$79,700***

Accrued LLR – Making an Adjustment

Balance Sheet October 31, 2017	
Loans rec	350,000
LLR (contra)	(33,000)
Net loans rec	317,000
Other Assets	50,000
Total Assets	367,000
Total Liabilities	200,000
Net Assets	***167,000***

Balance Sheet December 31, 2017	
Loans rec	528,000
LLR (contra)	(79,700)
Net loans rec	448,300
Other Assets	50,000
Total Assets	498,300
Total Liabilities	200,000
Net Assets	***298,300***

- **LLR *grows* by $46,700; and…**

Accrued LLR –Adjustment

Income Stmt Jan 1-Oct 31, 2017	
Total income	*150,000*
Other expenses	105,000
Provision for losses	10,000
Total Expenses	*115,000*
Net Income	***35,000***

Income Stmt Jan 1-Dec 31, 2017	
Total income	*150,000*
Other expenses	105,000
Provision for losses	56,700
Total Expenses	*161,700*
Net Income	***(11,700)***

- **Provision for loss *increases* by $46,700**

What if there is a loss of $50K?

Balance Sheet
December 31, 2016

Loans rec	528,000
LLR (contra)	(79,700)
Net loans rec	448,300
Other Assets	50,000
Total Assets	498,300
Total Liabilities	200,000
Net Assets	***298,300***

Balance Sheet
January 1, 2017

Loans rec	478,000
LLR (contra)	(29,700)
Net loans rec	448,300
Other Assets	50,000
Total Assets	498,300
Total Liabilities	200,000
Net Assets	***298,300***

- **L/R *decreases* by $50K; LLR *shrinks* (increases) by $50K**

MYTH #2:

OVER-RESERVING STRENGTHENS YOUR CDFI

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%

LLR Financial Impacts

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

MYTH #3:

UNDER-RESERVING STRENGTHENS YOUR CDFI

LLR Policy Should Include:

How	Who	When
• Initial risk rating is determined • Adjustments to the rating are determined • Loan loss provision amounts per risk rating	• Approves policy (BOD) • Prepares risk ratings • Approves LLR allocations • Enters LLR allocations	• Initial risk rating is determined (upon closing / disbursement) • Adjustments are made (at least quarterly) • Policy / rating system is reviewed (at least annually)

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 <u>**or**</u> over reserve, be prudent
- Evaluate the system