

# The Provision for Credit Losses & the Allowance for Loan Losses

How Much Do *You* Expect to Lose?



# This Lesson: VERY Specific to Banks

This is about a key accounting topic for banks and financial institutions. It's only important in that industry.

So if you are not interested in banks, you don't have to watch this (unless you really want to...).

# Lesson Outline:

- **Part 1:** Allowance for Loan Losses vs. Regulatory Capital
- **Part 2:** Loan Loss Accounting on the Financial Statements
- **Part 3:** Example Scenarios to Illustrate the Mechanics
- **Part 4:** How Regulatory Capital and the Allowance for LLs are Linked



Assets	
Cash and balances at central banks	238.1
Loans and advances to banks	26.0
Loans and advances to customers	2,673.8
Derivative financial assets	2.1
Property, plant and equipment	47.5
Intangible assets	51.5
Deferred tax asset	10.6
Other assets	7.5
<b>Total assets</b>	<b>3,057.1</b>



# Business Model of Commercial Banks

- **Banks:** Collect money from customers (deposits), and then lend it to people who need money (loans)
- They **expect** to lose something on these loans because people and companies **default** and are unable to pay back their loans
- But there are two categories: **expected losses** and **unexpected losses** (e.g., a random disaster happens and everyone in a certain region of the country loses everything)
- **This Tutorial:** All about **expected losses** and how *unexpected losses* eventually turn into expected losses



# Expectations Matter!

- **Poker Scenario:** If you bet a lot with no real hand, you should expect to lose everything... and plan accordingly!



- **But:** What happens if you have a Straight Flush and you then do the same thing? Now you expect to win... or at least not lose much



- **But Then:** You keep playing, and it turns out someone else has a Royal Flush – you lose everything you bet! Oops.



- **First Scenario:** Allowance for Loan Losses – *Expected* Losses



- **Second Scenario:** Regulatory Capital – *Unexpected* Losses



# Allowance for Loan Losses on the Statements

- **Balance Sheet:** The Allowance is a contra-asset that's netted against Gross Loans to calculate Net Loans
  - **Additions:** The Provision for Credit Losses will *increase* this reserve, making the contra-asset *more negative*
  - **Subtractions:** Net Charge-Offs (loans actually going bad) will *reduce* this reserve, making the contra-asset *less negative*



- **Income Statement:** The Provision for Credit Losses is an expense that reduces Pre-Tax Income and Net Income, but Net Charge-Offs do not appear... *directly*
  - This is *technically* true, but it's a bit misleading – more on this one later



- **Cash Flow Statement:** The Provision for CLs is a non-cash add-back; you also record Loan Additions here



# Example Scenarios to Illustrate the Mechanics

- **Scenario #1:** Bank expects to lose an ADDITIONAL \$10 on its Loans
- **Scenario #2:** Bank adds \$100 in Loans, and expects to lose \$5 on them
- **Scenario #3:** Now the bank actually loses \$5 and records the charge-off
- **Scenario #4:** ...but now, there's a recovery of \$2! Due to collateral, or the borrowers suddenly repaying some of the loan
- **Scenario #5:** The Allowance is \$10, but there's a Gross Charge-Off of \$20 – what happens? How can this possibly work?

# Key Points – How Loan Loss Accounting Works

- **Point #1:** Yes, technically only the Provision for CLs affects the IS...



- **Point #2:** BUT, in reality, companies are always adjusting this and have to increase it if a huge charge-off is coming up



- **Point #3:** So... charge-offs do impact the IS, just indirectly



- **Point #4:** On the BS, only the Provision for CLs and Loan Additions affect Net Loans; Net Charge-Offs affect both Gross Loans and the Allowance for LLs, so they cancel each other out!

$$\frac{\cancel{3}}{5} \times \frac{\cancel{2}}{\cancel{3}} \times \frac{1}{\cancel{2}} = \frac{1}{5}$$

- **Point #5:** Recoveries increase the ALL because of the default possibility





# Regulatory Capital and Loan Losses

- **So...** you know that Regulatory Capital is for “unexpected losses,” while the Allowance for LLs is for “expected losses”
- But how exactly does Regulatory Capital “absorb” losses?
- **Answer:** Because when an *unexpected loss* occurs, banks have to increase their Allowance for Loan Losses
- **How:** They do this by increasing the Provision for CLs, which reduces Net Income since it appears on the Income Statement
- **And:** That reduced Net Income reduces Shareholders’ Equity



# Regulatory Capital and Loan Losses

- So **Regulatory Capital** “absorbs losses” by ensuring that Equity stays above a certain level, even if Net Income falls...
- And a dramatic drop in Net Income, most likely, would come from *unexpected losses*...
- Since a bank has to record *Provisions for Credit Losses* when these unexpected losses occur and it doesn't have the required reserves
- **Impact:** The capital ratios fall when this happens – as they should!
- **Tier 1 Capital:** This is why it's “Going Concern Capital”



# Recap and Summary

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