Significant ALLL Guidance

Supervisory Guidance

Interagency Policy Statement on the ALLL, December 13, 2006 (SR 06-17)

- Nature and purpose of the ALLL
- An appropriate ALLL covers estimated credits losses on:
  - Individually evaluated impaired loans
  - Loans evaluated within groups—similar risk characteristics
  - Adjustments for relevant qualitative and environmental factors
- The ALLL does not apply to:
  - Loans carried at fair value
  - Loans held for sale
  - Off-balance sheet credit exposures
  - General or unspecified business risks
- Management responsibilities:
  - Develop, maintain, and document a comprehensive, systematic, and consistently applied ALLL process
  - Document analysis of loan portfolio
  - Conduct effective loan review
  - Charge-off promptly
  - Maintain appropriate ALLL level
- Board responsibilities:
  - Oversee management's significant judgments and estimates
- Examiner responsibilities:
  - Evaluate Board oversight
  - Evaluate loan review process
  - Evaluate ALLL methodology
  - Review documentation support
  - Review level
  - Evaluate reasonableness

Policy Statement on ALLL Methodologies and Documentation for Banks and Savings Institutions, July 2, 2001 (SR 01-17)

- Documentation guidance on:
  - Policies and procedures
  - Methodology
  - ALLL under FAS 114
  - ALLL under FAS 5
  - Consolidation of ALLL balance
  - Validation of the methodology
- Technical Q&As:
  - Measuring and supporting FAS 114 estimates
  - Measuring impairment for collateral dependent loans
  - Measuring impairment for loans with collateral protection
  - Adjusting loss rates applied to groups of loans
  - Estimating losses under FAS 5 for loans initially individually reviewed and determined not to be impaired
  - Documenting the reported ALLL
- Application of GAAP
  - Description of applicable GAAP
  - Interaction of FAS 114 and loans with a split classification
  - Inappropriate layering of losses
- ALLL level must conform to GAAP
- Similar SEC guidance in SAB 102

Joint Interagency Letter on the Loan Loss Allowance, July 26, 1999 IPS (SR 99-22)

- Statement by the Federal Reserve, the other banking agencies, and the SEC regarding the ALLL
- Appropriate loss estimates rely upon management judgments and are inevitably imprecise
- Loss estimates should consider all available information existing as of the evaluation date
- Prudent, conservative but not excessive loss estimates are appropriate
- Appropriate to estimate loss within a range and select best estimate at the high end of the range
- Appropriate to have unallocated allowances, with appropriate support

GAAP Guidance

FAS 114, Accounting by Creditors for Impairment of a Loan, May 1993

- Identify loans for individual loss evaluation (i.e., homogeneous loans are reviewed in groups—see FAS 5)
- For impaired loans, measure impairment:
  - Present value of expected cash flow, at the loan's effective interest rate, or
  - Observable market price of the loan, or
  - Fair value, less costs to sell, of collateral (if collateral dependent, Call Report Instructions require using this method)
- For individually reviewed loans that were not impaired:
  - Estimate loss based upon rates associated for loans with similar characteristics (i.e., in a FAS 5 group)

FAS 5, Accounting for Contingencies, March 1975

- Estimate loss for groups of loans with similar risk characteristics
- Record provisions when the estimate of loss is probable and estimable
- Generally, banks base loss rates on historical information, updated for current conditions

EITF D-80, Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio, May 19–20, 1999

- Includes FASB staff's *Viewpoints* article, which:
  - Discusses the interaction, measurement guidance, disclosure requirements, and documentation requirements of FAS 5 and FAS 114
- Includes a letter from the FRB to supervised banking organizations, which mirrors points made in SR 99-22

SOP 03-3, Accounting for Certain Loans or Debt Securities in a Transfer, December 2003

- Requires identification of all impaired loans prior to purchase and purchased impaired loans to be recorded at expected (fair) value with no ALLL at transfer
- Allows interest accrual only with reasonable expectation of timing and collectibility of cash flows
- When the volume of purchased impaired loans is significant, the ALLL ratios, used to evaluate level appropriateness and charge/recovery history, will be distorted

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List of Common Terminology

Allowance for Loan and Lease Losses (ALLL)

A valuation account established to recognize estimated loan impairment before probable losses on individual loans have been confirmed resulting in a subsequent charge-off or write-down. The ALLL is an accounting estimate of probable but unconfirmed asset impairment that had occurred in the loan portfolio as of the financial statement date. All confirmed losses must be charged off.

Confirmed Loss

A loss is considered confirmed when information, which is available before the financial statements are issued, indicates that as of the financial statement date a loan, or portion thereof, will become uncollectible. At the time a loan, or portion thereof, is considered a confirmed loss, the confirmed balance must be charged off. Generally, this definition is consistent with the financial institution supervisors' classification category of "loss."

Debt Restructuring

According to FAS 5, a debt restructuring is a modification of loan terms. Such a modification is not necessarily a troubled debt restructuring even if the borrower is experiencing some financial difficulties. In general, a borrower that can obtain funds from sources other than the existing financial institution at market interest rates at or near those for nontroubled debt is not involved in a troubled debt restructuring.

Directional Consistency

The provisions for the ALLL and credit quality indicators (e.g., past due and nonaccrual) should move in the same direction. As credit quality declines, provision levels within financial reports should indicate that incurred loan losses have increased. This should also be the case for rate of change.

Loan Impairment

According to FAS 114, a loan is impaired when, based on current information and events, it is probable that a financial institution will be unable to collect all amounts due according to the contractual terms of the loan agreement. "All amounts due according to the contractual terms" means that both the contractual interest payments and the contractual principal payments of a loan will be collected as scheduled in the loan agreement. However, an insignificant delay or insignificant shortfall in amount of payments on a loan does not mean that the loan is impaired.

Loss Contingency

An existing condition, situation, or set of circumstances that involves uncertainty as to probable loss that will be resolved when one or more future events occur or fail to occur. An estimated loss (or expense) from a loss contingency (for example, pending litigation or provisions for loan losses) must be accrued by a charge to income if it is probable that an asset has been impaired or a liability incurred as of the report date and the amount of the loss can be reasonably estimated.

Troubled Debt Restructuring

According to FAS 15, a restructuring of a debt constitutes a troubled debt restructuring if the financial institution for economic or legal reasons related to the borrower's financial difficulties grants a concession to the borrower that it would not otherwise consider. That concession either stems from an agreement between the financial institution and the borrower or is imposed by law or a court. A troubled debt restructuring may include, but is not necessarily limited to, one or a combination of the following:

- Transfer from the borrower to the financial institution of receivables from third parties, real estate, or other assets to satisfy fully or partially a debt.
- Issuance or other granting of an equity interest to the financial institution by the borrower to satisfy fully or partially a debt unless the equity interest is granted pursuant to existing terms for converting the debt into an equity interest.
- Modification of terms of a debt, such as reduction of the stated interest rate for the remaining original life of the debt.

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Examination Steps to Take When Evaluating the ALLL

Step One

An assessment of the institution's ALLL policy, methodology, and controls to determine compliance with supervisory guidance and generally accepted accounting principles (GAAP)

Step 1(a)

Ensure that the board of directors approved the policy and methodology at least annually and when changes were made.

Step 1(b)

Review policy for adequacy based on an understanding of bank's lending risk profile.

Step 1(c)

Determine if ALLL policy and methodology address the standards established in supervisory guidance. If not in writing, ensure management is committed to developing a written policy that includes a description of the methodology within a specified time frame.

Step 1(d)

Determine if the ALLL methodology is consistent with GAAP. Review whether adjustments have been considered and incorporated for qualitative or environmental factors.

Step 1(e)

Determine if management has written documentation that supports its ALLL methodology, including a summary or consolidation of the ALLL balance as well as any periodic adjustments to the ALLL process or balance.

Step 1(f)

Determine the adequacy of controls around the ALLL estimation process by reviewing the appropriate documentation, board oversight, loan grading process, and the independent review and validation process of the ALLL (e.g., internal or external audit and loan review).

Step Two

An assessment of the appropriateness of the recorded level of the ALLL by evaluating the process used to calculate the ALLL estimate.

See summary of the process for determining the loss estimate under FAS 5, FAS 114, and the interaction of FAS 5 and FAS 114. Review for completeness, directionally consistency, red flags, consistency with industry standards, and reasonableness of the ALLL level.

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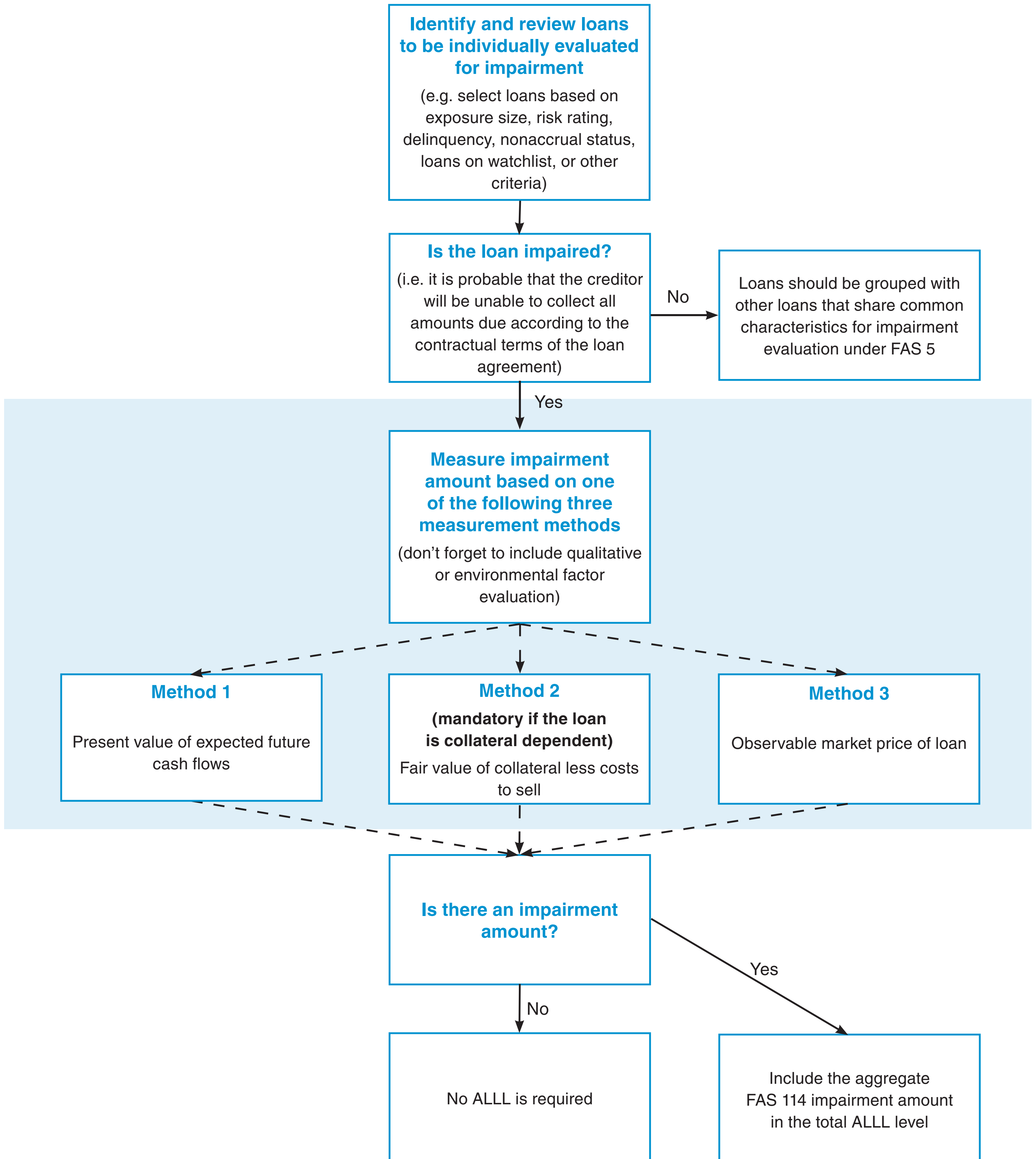
FAS 114

Statement 114 provides guidance on loss estimation for loans that are identified for individual evaluation



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FAS 5

FAS 5 provides guidance on loss estimation for groups of smaller or homogeneous loans

Segment loan portfolio by identifying risk characteristics that are common to groups of loans

(Include loans selected for review under FAS 114 and determined **NOT** to be impaired. Exclude loans selected for evaluation under FAS 114 determined to be impaired and measured for impairment.)

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Estimate loss on groups of loans based on loss history and environmental or qualitative factors.

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Loss history

Loss history should be long enough to capture sufficient loss data. (e.g., three years)

If no loss history

(e.g., new products or de novo)
Estimate based or other relevant industry standards only until sufficient loss history developed

Environmental or qualitative factors

(e.g., underwriting standards, staff experience, credit concentration, business conditions, political and regulatory conditions, local and national economic trends)

↓

Determine the amount or appropriate point within a range of loss for each segment which should include an estimate of loss for qualitative or environmental factors.

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Include the aggregate FAS 5 estimate of loss in the total ALLL level.

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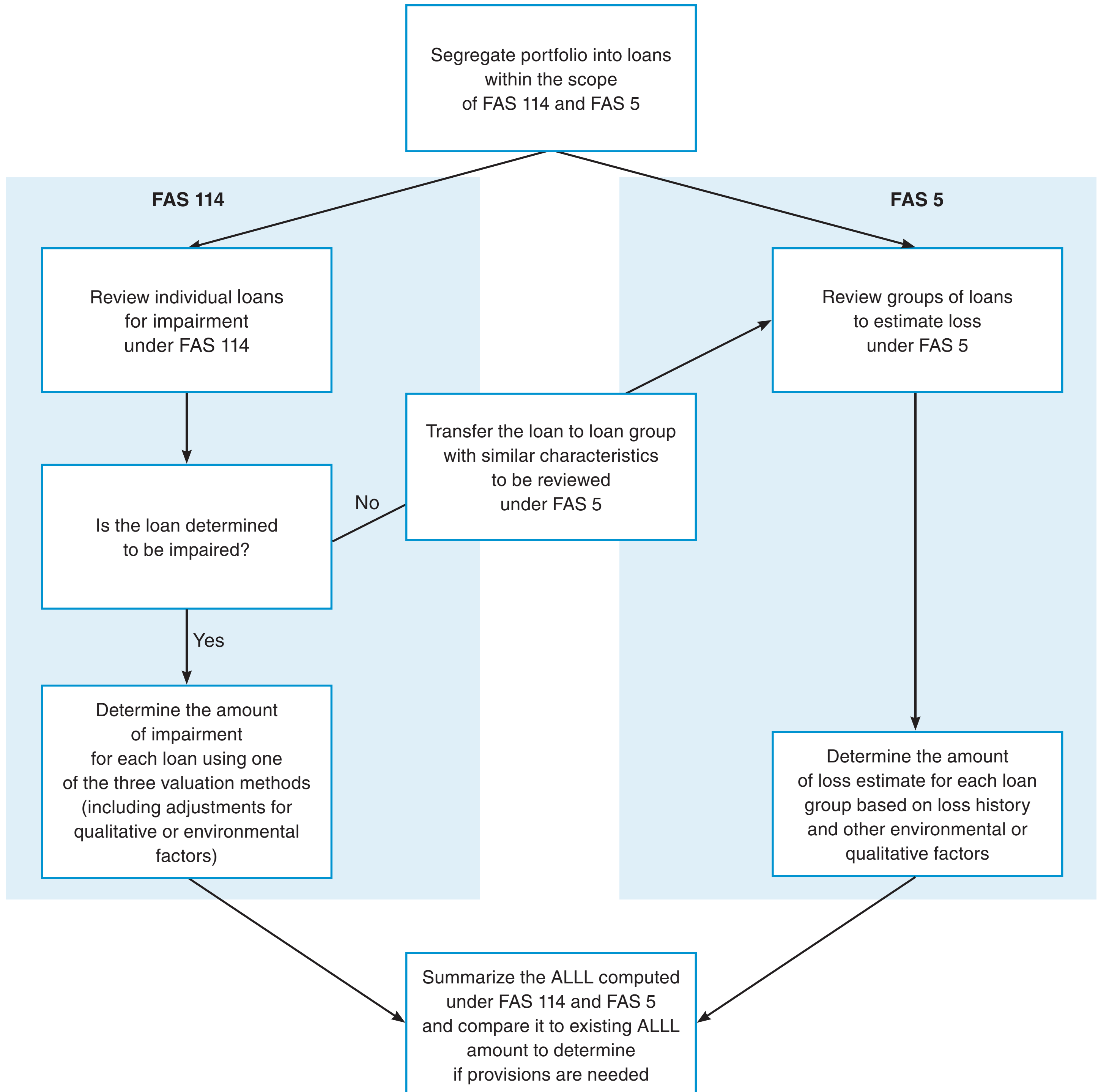
Interaction of FAS 114 and FAS 5

FAS 114 provides guidance on loss estimation and disclosure for individually reviewed loans that are considered impaired. FAS 5 provides guidance on loss estimation for groups of smaller or homogeneous loans.



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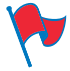 Red Flags: Inappropriate Loan Loss Estimation Practices

Flag	Correction
The ALLL is determined based on budgeted amounts or target statistics or ratios (e.g., substandard, doubtful) without relevant documentation to support those amounts.	The determination of the ALLL should • Be based on management's current judgments about the credit quality of the loan portfolio • Consider all known relevant internal and external factors that affect loan collectibility as of the evaluation date It is inappropriate to use a standard (or generic) percentage as the sole determinant for the amount reported as the ALLL on the balance sheet.
Management applies an overall adjustment to bring the ALLL to a predetermined percentage of total loans.	An institution should not default to a peer ratio or a standard percentage after determining an appropriate level of ALLL under its methodology. In certain circumstances, an institution may rely on peer data to assist in the estimation of the ALLL. These circumstances are limited, should be short term, and apply mostly to de novo institutions or institutions offering new products or entering a new market.
Overall adjustments to the ALLL are not directionally consistent with the underlying factor(s). For example, regional unemployment rates are trending downward, capacity utilization numbers are increasing, and consumer confidence levels are increasingly positive yet the unallocated adjustment based on these factors has stayed the same for the past several quarters.	Any adjustments should be based on relevant qualitative or environmental factors that represent increases or decreases from prior experience. A static level of adjustment that ignores these changes in credit risk would not be directionally consistent.
Management frequently revises its overall methodology.	Management should not revise the ALLL methodology without sufficient justification and documentation. Frequent revisions to an institution's methodology may signal many irregularities. One concern may be that an assessment of directional consistency may be untrackable and underlying trends may be camouflaged by frequent changes in the overall methodology.
The bank's loss estimation measurement under FAS 114 is based on financial information that was borrower prepared without consideration of the borrower's lack of objectivity.	Management should institute a process that exercises appropriate skepticism of borrower prepared data.
A bank has a loan facility to a customer for $500M, of which $300M is outstanding. Management uses the total facility amount, not the outstanding balance, as the basis for its FAS 5 analysis.	Management should not include amounts for off balance sheet exposures such as loan commitments in the ALLL. To the extent that management establishes a valuation allowance for such exposures, it should be recorded as an "other liability."
Loans (within the scope of FAS 114) identified separately for evaluation and determined to be impaired have not been segregated from the rest of the loan portfolio and are included in the FAS 5 calculation.	This situation leads to layering because the institution is double counting the estimated incurred losses for impaired loans by including them in both the FAS 114 and FAS 5 calculations.
Certain loans identified for individual review under FAS 114 are deemed not impaired because it is probable that the institution will be able to collect all principal and interest payments according to contractual terms. The institution concludes that no allowance is necessary for the loans in question.	This situation may distort the ALLL. If the loans in question are determined not to be impaired under FAS 114, generally those loans should be grouped with other loans that share similar risk characteristics and evaluated for impairment under FAS 5.
The ALLL is materially less than or materially exceeds the amount supported by the ALLL methodology and related documentation.	Unsupported or undocumented adjustments may have been made to the ALLL subsequent to the ALLL estimation process. The amount supported by the ALLL methodology and related documentation should equal the amount recorded in the financial statements.

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