

Examination Guidance for Evaluation of the Allowance for Loan and Lease Losses

In the current credit environment, the examination process for determining the adequacy of the Allowance for Loan and Lease Losses (ALLL) is key to determining the accuracy of financial statements and the overall condition of a financial institution being examined. While there are a number of sources of supervisory accounting guidance in these areas, the purpose of this memo is to provide a summary of the process that Department examiners should use in evaluation of the ALLL, a discussion of some of the typical issues and concerns that examiners may encounter in the evaluation process and indication of what our expectations are of bank management and the board of directors in the maintenance of a sound and adequate ALLL.

The Purpose of the ALLL

The ALLL should be reflective of management's assessment, on at least a quarterly basis, of the collectability of all loans held for investment to determine that the level of the Allowance is appropriate and in compliance with GAAP.

GAAP for the ALLL consists primarily of two sources of accounting guidance:

FAS 114 used for loans that are individually evaluated and determined to be impaired.

FAS 5 used for estimating credit losses on a group of loans with similar risk characteristics and loans individually evaluated under FAS 114 and not determined to be impaired.

Each of these components are discussed in greater detail below.

The ALLL model discussed below does not apply to loans held at fair value or loans held for sale.

The Basic Exam Process for the ALLL

The following steps should be completed in the examination process for the ALLL:

Step 1 - Policy, Methodology and Controls assessment

1. Confirm that the Board of Directors has approved the policy and methodology established by management (in consultation with their CPA's) at least annually and when material changes are made.
2. Review the Policy and the Methodology for adequacy based on the risk profile, concentration risk and portfolio composition of the institution.
3. Determine that the ALLL Policy and the Methodology established meet the standards established in Supervisory Guidance. (See listing at the end of this memorandum.)

4. Determine that the ALLL Methodology is consistent with GAAP.
5. Confirm that the Management has written documentation that supports its ALLL Methodology, including a summary document that supports the balance of the ALLL as well as any subsequent adjustments to the ALLL or the methodology.

Step 2 - Assessment of the appropriateness of the level of the allowance account and the process used to calculate the ALLL estimate used in the institution's regulatory reports.

Review the FAS 114 and FAS 5 procedures used by the bank to make sure that these capture the impairment in the loan portfolio and that the aggregate analysis accurately establishes an appropriate balance in the account.

FAS 114 Evaluation Process:

FAS 114 involves a process of individually evaluating selected credits for collectibility. A loan is impaired under FAS 114 when based on current circumstances; it is probable that a financial institution will be unable to collect all amounts due, in accordance with the loan agreement. The process includes the following:

1. Identifying loans to be evaluated for impairment-

FAS 114 does not establish specific criteria about which loans should be subject to individual review; certainly the decision of which loans should be subject to individual impairment assessment could significantly impact the assessment of the allowance account. Loans that represent significant concentrations of credit, material non-performing loans, insider loans and other material credit exposures should be subject to impairment analysis.

2. Is the loan being evaluated impaired?

If yes based on the above definition, measure the impairment amount in accordance with FAS 114. The estimated impairment should reflect consideration of one of the three standards of measurement (discussed below). If no, loans should be grouped with others loans with common characteristics and subject to evaluation under FAS 5.

3. Measure Impairment Amount

Based on one of three methods:

- a. Present Value of the expected future cash flows, discounted at the loan's effective interest rate.¹
 - b. Fair Value of the Collateral, less costs to sell (Required as soon as the credit becomes Collateral Dependent.)
 - c. Observable Market Price (not customarily available for loans).
4. Is there an impairment amount between the recorded investment² of the loan and the value based on the above criteria?

If yes, any portion of the recorded investment in the impaired loan in excess of amount calculated using one of the three measurement methods is the specific allocation to the ALLL. If no, no allocation is required (a zero allocation on an impaired loan should be rare). However, examples may include when an institution has an abundance of collateral (in the case of a collateral dependent loan), or when an impaired loan may have been charged-off to a level no allowance is required.

FAS 5 Evaluation Process:

FAS 5 requires the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is probable that an asset has been impaired at the date of the financial statements and the amount of the loss can be reasonably estimated. Consequently FAS 5 is the primary accounting guidance in estimating credit losses on groups of loans with similar risk characteristics. These conditions may be considered for the following:

1. Individual loans evaluated under FAS 114 and not determined to be impaired, and groups of similar homogenous loans with similar risk characteristics.

When measuring estimated credit losses on groups of loans with similar risk characteristics in accordance with FAS 5, a widely used method is based on each group's historical net charge-off rate³ adjusted for environmental or qualitative factors. Historical methodologies can be based on a simple average or range or may incorporate more complex techniques such as modeling or migration analysis. Loss history should be long enough to capture meaningful loss data. If no loss history, due to denovo status or new product category, estimates may be based on industry averages, until a performance history is established.

¹ The effective interest rate on a loan is the rate implicit in the loan (e.g., the contractual interest rate adjusted for any net deferred loan fees and cost, and any premium or discount existing at the origination or acquisition of the loan.

² The recorded investment includes any capitalized interest, net deferred fees or cost, unamortized premium or discount, less any charged-off amount.

³ Historical net-charge off rates are calculated over a specific period of time (e.g., three or five years) which can vary based on a number of factors including relevance of past period's experience to the current period or point in the credit cycle.

Also note that in a time of rapid market deterioration, as is currently being experienced in many areas, a shorter-term historical perspective of three to six months might be more appropriate than a longer term measurement.

After considering historical loss rates, qualitative or environmental factors should be considered. Typically this would be performed by adjusting the historical loss rate to a loan group based on management assessment of these factors. These factors may also be reflected through separate stand-alone adjustments within the FAS 5 component of the ALLL. These factors can include changes in lending policies and procedures; changes in economic and business conditions; changes in volume and severity of past due and adversely classified loans, and in nonaccrual volume; changes in nature, volume, and term of loans; changes in lending management and quality of loan review; changes in underlying collateral values; effects of concentrations; and the effect of other external factors.

In any event, the historical loss rates and any qualitative or environment adjustments should be reasonable and adequately documented.

2. Based on the above, determine the amount or appropriate point within a range of loss for each segment being evaluated which should include an estimate of loss for qualitative or environmental factors.
3. Aggregate each of these FAS 5 estimates of loss for each segment and include in the total ALLL level.

Determination of Inadequate Methodologies used in the analysis of the ALLL

It has been determined in a number of cases during the examination process that the methodologies for the FAS 114 and/or FAS 5 analyses were not reasonable based on the condition of the bank, were not adequately documented or were not in compliance with GAAP. Under these circumstances, examiners should attempt to identify this early in the examination process, and they should contact senior management and indicate that the methodology appears inadequate, the reason for this determination and that management needs to seek input from their CPA to establish a methodology that is appropriate, well documented and GAAP compliant. A short but reasonable period (ex. 30 days) should be provided to resubmit the ALLL methodology to the regulatory authorities. If a bank fails to meet this submission criteria, then the Allowance account will be evaluated based on examination classifications, risk weighted as determined to be appropriate by the EIC, *therefore bank management would be well served by meeting these time frames, in order to have greater input into this assessment process.*

General allocations to the ALLL - Should the loan or any portion thereof be charged off?

The topic of a specific allocation to the ALLL and the amount of charge off has been of particular interest to bank management in their discussions with federal and state regulators. As reflected above, when loans are subject to an individual impairment analysis under FAS 114, a loan must be measured using one of the three measurement methods in FAS 114. A loan is impaired if the PV of the expected cash flows, the FV of the collateral, or the FV of the loan is less than the bank's recorded investment in the loan. Therefore, when discussing if any portion

of a loan should be charged-off, it would be primarily dependent on if the loan would be considered collateral dependent. As defined by FAS 114, a loan is collateral dependent if repayment of the loan is expected solely based on the value of underlying collateral. Therefore, if there are other risk mitigants, such as the availability of other sources of payments or cash flow, guarantors that add value or other credit risk mitigants, it would not normally be a collateral dependant loan. However, a debtor's financial condition can deteriorated to a point that only the collateral remains, in effect, the loan becomes the functional equivalent of a nonrecourse loan. As such, if an impaired loan were deemed to be collateral dependent and required to measure impairment using the FV of the collateral, the amount of the recorded investment in the impaired loan in excess of the fair value of the collateral that can be identified as uncollectible should be considered a confirmed loss and should be promptly charged off against the ALLL.

For example, consider the following scenario:

A bank has determined that it is probable that they will be unable to collect the interest and principal on a commercial real estate loan according to the loans contractual terms (it meets the impairment definition under FAS 114) and it has been determined that the loan is collateral dependent. The loan has a recorded investment value on the books for \$1,500,000 and the appraisal in the file which appears adequate, reasonably timely and independent, reflects an appraisal or fair value of \$1,450,000. Furthermore, it has been determined based on average historical disposition that in the case of commercial real estate the bank normally only receives 86% of AV on the disposition of Commercial Real Estate.

A. What is the amount of total impairment under FAS 114 and the amount that should be allocated to the general allowance?

B. What is the amount of the confirmed loss that should be charged off immediately by the bank?

C. How would the credit be evaluated differently if it were determined to NOT be collateral dependent under FAS 114 (assuming no observable market price)?

A. \$1,500,000 recorded investment - \$1,450,000(.86) FV of the collateral less estimated cost to sell = \$253,000 total impairment to be allocated to the general allowance.

B. \$1, 500,000 recorded investment - \$1,450,000 FV or AV = \$ 50,000 (confirmed loss).

Since the impaired loan is collateral dependent, the maximum the bank is expected to collect is the FV/AV of the collateral or \$1,450,000, the amount of the excess of the recorded investment in the loan over the FV/AV of the collateral, or \$50,000 is a confirmed loss, that should be immediately charged off, per supervisory guidance. Therefore, \$253,000 is the amount that should be allocated to the general allowance, with \$50,000 of that amount charged off. The \$203,000 that remains in the ALLL is the estimated cost to sell and is considered an unconfirmed loss.

- C. If the loan had not been considered collateral dependent, then the impairment should have been based on the expected net present value of the estimate future cash flows based on the loan's discounted effective rate. If the recorded investment value exceeded the discounted present value of the estimated cash flows, the amount of this impairment would be the specific allocation to the ALLL as a part of the FAS 114 component.

If a loan is determined to be impaired under FAS 114 and is a collateral dependent loan, then what should the examiner recommend to bank management regarding disposition of the loan?

I know that this has been discussed with examiners previously, but I wanted to reiterate that strategies regarding whether to pursue particular collection strategies, foreclose on real estate or take property into Other Real Estate are management decisions for operating management and the Board of Directors, even on properties that are determined to be impaired under FAS 114 and collateral dependent. Examiners should confirm that the impairment analysis is properly reflected in the ALLL and that charge offs to the allowance are made if required, as discussed above. Regulatory focus should be on fair and accurate financial statement presentation of the condition of the bank.

As we have discussed in a number of different banking forums, the degree of aggregate asset quality problems in a financial institution may impact the flexibility of both bank management and the regulators in being able to work with borrowers with impaired loans. Financial institutions subject to Memoranda of Understanding or Cease and Desist Orders will likely be subject to classified asset reduction schedules that may impact their ability to work with classified borrowers unless those borrowers are able to reduce their credit exposure to bank through sales, loans performance or write-downs by the bank.

Loan Documentation of Impairment under FAS 114

Loan documentation should include the impairment analysis of the individual credit reviewed, the basis for the present value assessment being calculated or in the case of a collateral dependent loan, the fair-value method used to determine collateral value, including the basis of any adjustments made to appraised values, determination of the costs of disposition and an assessment of quality, independence and timeliness of the appraisal being used.

The interest rate used to determine the net present value of loan cash flows should be the loan's effective interest rate, based on reasonably supportable assumptions and projections. What is the relationship between an examination classification of Substandard or Doubtful and the amount that must be maintained in the Allowance Account for such a credit?

In the past, examiners utilized a general rule of thumb that classified credits had to have coverage in the allowance account equal to a minimum of 15% of Substandard classifications, 50% of Doubtful Classifications and 100% of Loss classifications. This system, while less complex and easy to understand, had obvious deficiencies in that these weightings might overstate or understate actual loss risk exposure on particular classified credits. The Department no longer utilizes this method except with denovo banks with little or no historical loss history.

Under current examination procedures, for loans that are subject to specific review during the examination process, examiners will estimate the loss exposure based on their credit and collateral analysis, including their discussions with bank management of borrower performance, cash flow and other operating characteristics. For smaller credits which may be past due or in non-accrual, normally considered by the bank under the FAS 5 analysis, examiners will consider the non-performing status of the loan, collateral position (if any) and input from bank management in accessing loss exposure. The examiner would compare these aggregate assessments with management's ALLL methodology under FAS 114 and FAS 5 to determine whether the allowance account was appropriately funded and reasonably reflective of the condition of the bank.

Often, it is the extent to which the internal and external loan review process in the bank is accurately reflective of adverse classifications in the examination process that determines whether the balance in the Allowance account is deemed adequate by the Examiner-in-Charge.

Use of Standard Allowance Percentages

The Department in the past utilized certain standard loss percentages that were recommended in the allowance account, based on a percentage of the total loan portfolio. This is no longer Department practice, except in the case of denovo institutions which are expected to maintain an allowance account of at least 1% of total loans outstanding while they remain in denovo status. Even in these cases, this is a regulatory floor and it is our expectation that these institutions develop a satisfactory ALLL methodology that is GAAP compliant and appropriate for the long-term needs of the bank.

Examiners should avoid the use of standard allowance percentages as targets, although it may be appropriate to note the bank's level in comparison with its peers or to note the trend of this percentage compared to historical levels, particularly if it appears that funding is inadequate based on trends noted regarding asset quality in the bank.

The supervisory focus should be on the adequacy of the ALLL based on sound methodology under FAS 114 and FAS 5.

Use of Unallocated amounts in the ALLL

Supervisory guidance has indicated that it is permissible to utilize amounts that are labeled as "unallocated" in the allowance account provided that these amounts are adequately supported and documented. For instance, economic deterioration that occurs between the estimate of credit losses and the date of the financial statements is an example of additional exposure that may be difficult to apply to individual credits but which may be reflected in the allowance account as an unallocated adjustment amount. GAAP requires such amounts to be appropriately supported and documented to be an acceptable component of the Allowance account.

Unallocated amounts will be subject to greater scrutiny than allocated provisions, and in many cases such qualitative and environmental factors can be included as an adjustment of the historical loss rates used under FAS 5, rather than being presented as an unallocated amount.

What are Troubled Debt Restructurings and how will impaired credits meeting this definition be properly reflected in the financial statements?

Under FAS 15, a restructuring of debt constitutes a Troubled Debt Restructuring (TDR) if a creditor for economic or legal reasons related to the debtor's financial difficulties grants a concession to the debtor it would not otherwise consider. A TDR involves a transfer from the borrower to the bank (including via foreclosure or repossession) of real estate, receivables from third parties, other assets, or an equity interest in the borrower in full or partial satisfaction of the loan; modification of the loan terms; or a combination of the two. In a TDR, a loan is considered impaired and FAS 114 must be applied, even if a loan would not otherwise fall within the scope of FAS 114 because it would otherwise be part of a large group of smaller-balance homogeneous loans that are collectively evaluated for impairment. For example, FAS 114 applies to TDRs of 1-4 family residential mortgage loans that may have been previously evaluated in a larger pool under FAS 5.

In summary, loans modified in a TDR must be evaluated for impairment under FAS 114, as part of the ALLL analysis; this applies to all TDR loans, including both commercial and retail credits. Under FAS 114, when using the present value of a cash flow method to measure impairment, the expected cash flows are discounted at the effective interest rate of the original note. For a residential mortgage loan with a "teaser" rate, the teaser rate is not the effective interest rate. As a result, one common approach is to consider the original effective interest rate to be a blend of the starter rate and the fully indexed rate at the time of modifications.

Federal and State regulators have noted inconsistencies in the reporting of TDR's in financial institution call reports. Determining if a TDR should be reported on nonaccrual status depends on several factors⁴. Once the credit is restructured, a decision must be made regarding the likelihood that all principal and interest will be collected in full under the new loan agreement.

- If the loan prior to modification was still in accrual status and the borrower has demonstrated performance under the previous terms and shows the capacity to continue to perform under the restructured terms, the loan will likely remain on accrual status.
- If the borrower was materially delinquent on payments prior to the TDR or in nonaccrual status, but shows the capacity to meet the restructured terms. The loan would likely continue to be recognized as nonaccrual until the borrower has demonstrated a reasonable period of performance, generally six months.
- If the borrower does not perform under the restructured terms, the TDR was probably not appropriately structured and it be recognized as nonaccrual.

⁴ 1-4 residential loans that may be exempt from nonaccrual reporting, however, banks should apply other alternative methods of evaluation to assure that the bank's net income is not overstated. For example, a bank may establish an "interest and fee" contra asset or a valuation allowance against the accrued interest receivable.

All TDR loans that under their modified terms are past due 30 days or more or are in nonaccrual status as of the report date must be in the appropriate loan category in Schedule RC-N. In addition, TDR's are separately disclosed in Call Report Schedule RC-C, Memorandum Item 1a or 1b or Schedule RC-N Memorandum 1a, or 1b.

These transactions should be reported as TDRs for each reporting period during the calendar year in which the restructuring occurred. Reporting is discontinued in subsequent years if the loan is in compliance with its modified terms. However, if the concession granted includes a reduction in interest rate to a "below market rate" at the time of the restructuring, the loan must be reported as a TDR as long as it remains a bankable asset.

Off-balance Sheet Credit Exposures

FAS 5 is applicable to all loss contingencies; however, the ALLL is not designed to cover off balance sheet credit exposures such as loan commitments, standby letters of credit and other off-balance sheet exposures. Any allowance for credit losses on off-balance sheet exposures should be reported on the balance sheet as an "Other Liability," not as part of the ALLL.

Accounting and Supervisory Guidance on the ALLL

Supervisory Guidance

- Federal Interagency Policy Statement on the allowance for Loan and Lease Losses
- Questions and Answers on Accounting for Loan and Lease Losses

Accounting Guidance

- Statement of Financial Accounting Standards No. 5, Accounting for Contingencies, May 1975
- Statement of Financial Accounting Standards No. 14, Accounting by Creditors for Impairment of a Loan
- EITF Abstracts, Appendix D, Topic D-80, Application of FASB Statements 5 and 114 to a Loan Portfolio, May 19-20, 1999