



AICPA National Conference on Banks & Savings Institutions

ALLL Documentation

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Discussion Topics

Allowance for loan and lease losses

- ✓ **Background**
 - ✓ **Generally Accepted Accounting Principles**
 - ✓ **2006 Interagency Policy Statement (2006 IPS)**
- ✓ **Recent Developments**
 - ✓ **Current trends in credit quality**
 - ✓ **Training efforts**
 - ✓ **Enhancements to ALLL methodologies**
- ✓ **Interagency Guidance on Best Practices**





GAAP Standards

- **“Accounting for Contingencies”
(SFAS 5) (1975)**
- **“Accounting by Creditors for
Impairment of a Loan”
(SFAS 114) (1993)**





SFAS 5

- **SFAS 5 states an estimated loss from a loss contingency shall be accrued by a charge to income if BOTH of the following conditions are met:**
 - **Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements**
 - **The amount of loss can be reasonably estimated**





SFAS 5

Paragraph 22: Grouping loans of similar risk characteristics

- **“Consideration of whether an asset is impaired and the amount of loss can be reasonably estimated can be in relation to individual receivables (i.e., loans) or in relation to groups of similar types of receivables (i.e., loans). If the conditions are met, a loss accrual shall be made even though the particular receivables or loans that are uncollectible may not be identifiable.”**





SFAS 5

Paragraph 23: Loss estimates based on historical data and environmental factors

- **“The amount of loss to be provided for in the allowance will normally depend on, among other things, the experience of the enterprise, information about the ability of individual debtors to pay, and appraisal of the receivables in light of the current economic environment.”**





SFAS 114

- **Scope criteria of SFAS 114**
- **Definition of Impaired: A loan is impaired if it is probable that a creditor will not be able to collect all amounts due according to the contractual terms of the loan agreement**
 - **“All amounts due” means both contractual interest payments and contractual principal payments will be collected as scheduled in the loan agreement**





SFAS 114

- **Measure impairment based on the present value of expected future cash flows discounted at the loan's effective interest rate**
- **As a practical expedient may use**
 - **Loan's observable market price; OR**
 - **Fair value of the collateral less costs to sell if the loan is collateral dependent. (MUST use this method for regulatory reporting purposes if the loan is collateral dependent)**
 - **A loan is collateral dependent if the repayment of the loan is expected to be provided solely by the underlying collateral**





Recent Regulatory History

- **11/98 - 7/99: Joint Statements with four banking agencies and SEC**
- **7/99: GLBA – requires SEC to consult with regulators on ALLL issues**
- **7/01: 2001 Interagency Policy Statement (OCC Bulletin 2001-37) & SEC SAB 102 on ALLL documentation**
- **12/06: Interagency Policy Statement on ALLL revising 1993 Interagency Policy Statement (OCC Bulletin 2006-47) (2006 IPS)**





Current Supervisory Guidance 2006 Interagency Policy Statement

- Nature and purpose of the ALLL
- Responsibilities of the Board of Directors and Management
- Appropriate ALLL level
- Factors to Consider in Estimation of Credit Losses
- Measurement of Estimated Credit Losses (New)
- Estimated Losses in Credit Related Accounts
- Responsibilities of Examiners
- Attachment 1: Loan Review Systems
- Attachment 2: International Transfer Risk Considerations





2006 Interagency Policy Statement

- **Reiterates key concepts of GAAP and supervisory guidance**
- **Areas of revision or update**
 - **Incorporates language specific to the application of SFAS 114**
 - **Reinforces that the ALLL is an institution-specific amount**
 - **Deletes standard percentages for the ALLL and updates analytics (“benchmarks”)**
 - **Distinguishes between roles of board of directors and management**





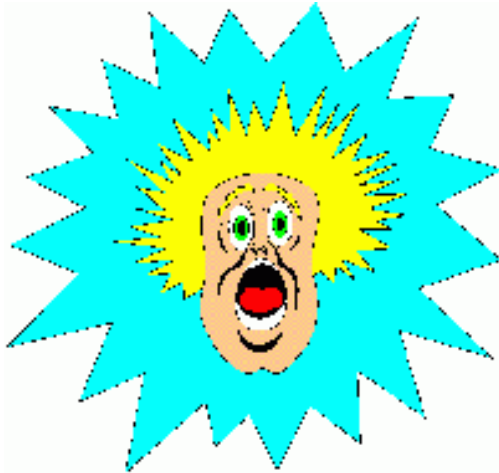
2006 Interagency Policy Statement

- **Areas of revision or update (cont.)**
 - **Clarifies appropriate treatment for off-balance sheet exposures**
 - **Emphasizes support and documentation of the ALLL (supplements, does not replace 2001 guidance)**
 - **Supplemented with 16 frequently asked questions (FAQs)**





“You mean I *really* can’t use benchmarks anymore?”





Current Supervisory Guidance 2006 FAQs

<u>Section of the 2006 Policy Statement</u>	<u>Questions</u>	<u>Page Numbers</u>
Nature and Purpose of the Allowance	1	2
Responsibilities of the Board of Directors and Management:		
Appropriate ALLL Level	2-8	2-6
Factors to Consider in the Estimation of Credit Losses	9-10	7-8
Measurement of Estimated Credit Losses	11-16	8-12





My 5 Favorite Questions from the Interagency FAQs

1. **Question #2: How do I identify loans under SFAS 114?**
2. **Question #11: Are all substandard loans individually impaired loans that should be evaluated under SFAS 114?**
3. **Question #14: Is there one correct “look back period” for calculating annualized historical net charge off rates?**
4. **Question #15: How do I calculate the ALLL with zero or little recent historical charge-offs?**
5. **Question #16: How do you document and support qualitative or environmental factors?**





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- ✓ Current trends in credit quality
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Credit Trends

- **Changes in the level of the ALLL should be directionally consistent with changes in credit risk**
 - A sound ALLL is built on solid credit risk management
 - ALLL level as a percentage of the portfolio should generally increase if credit quality trends in the institution's portfolio are declining
 - Given recent performance data it is our expectations that ALLL levels will generally increase
 - ALLL balance & methodology should be appropriate and in accordance with 2006 IPS/GAAP





Credit Trends

- **Slowing economy could keep lid on bank revenue growth and broaden credit quality issues**
 - Chances of a recession have increased and consumer confidence has deteriorated
 - Energy prices continue to rise while job growth has decelerated
 - Housing market decline has been sharper and faster than expected
 - Manufacturing continues to struggle, especially autos
 - Problems in subprime have led to a contraction of credit, even beyond subprime
 - Credit spreads have increased





Credit Trends

- **Recent turmoil in the credit markets, CRE concentrations and lax underwriting pose a risk to banks**
 - **Sharper contraction in investors' appetite for credit risk assets**
 - **Borrowers dependent on refinancing may have problems accessing funds**
 - **CRE concentrations are high with community and midsize banks**
 - **Aggressive banks, especially in prior home-price appreciation states and the Midwest, likely to be stressed**

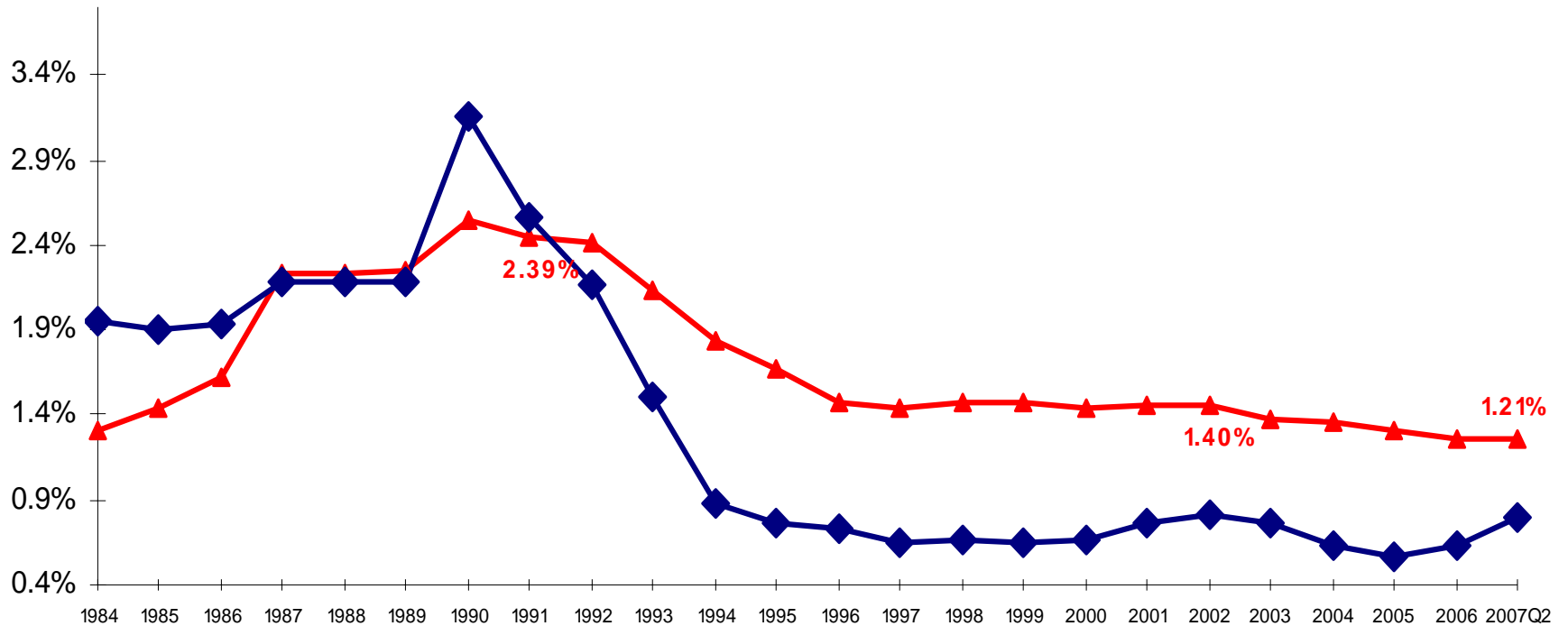




Credit Trends

Call Report View of Community Bank ALLL and Nonaccrual Trends

▲ ALLL + OBSALL ◆ Nonaccrual





Credit Trends

- **ALLL levels are at historical lows though it appears declining trends have leveled off**
- **Community banks are experiencing increasing trends in nonperforming commercial loans and leases**
- **Retail performance deteriorated over the last 18 months as delinquency trends are rising**





ALLL Examiner Training Recap

- **60 sessions held for thousands of examiners with positive feedback**
- **Sessions included:**
 - **One day instructor led case/interactive course**
 - **Modules**
 - **Section 1: Overview of ALLL**
 - **Section 2: Calculate Loss Rates**
 - **Section 3: FAS 5 Estimate of ALLL**
 - **Section 4: Segmentation**
 - **Section 5: Ranges**
 - **Section 6: Environmental Factors**
 - **Section 7: FAS 114 Impaired Loans**
 - **Section 8: Adding it up**





Environmental Factors – Example

1a. The underwriting standards for Other Consumer were liberalized at the end of 2004 in response to competition. As a result, past dues are beginning to increase. Management estimates that incurred losses have increased 25 basis points from historic levels.





Environmental Factors – Example

	C & I	Ag	C & D	Other Comm. Real Estate	Residential Mortgage	Indirect Consumer	Other Consumer
Historical Loss Rate (5 year avg)	0.64%	0.65%	0.78%	0.72%	0.21%	2.44%	1.27%
1 - Change in underwriting stds							0.25%
2 - C&D similar to 2001/02							
3 - Conditions in CRE							
4 - Rumor or company relocation							
5 - State of local economy							
6 - Personal bankruptcy rates							
7 - Turnover; lack of experience							
Adjusted Loss Rates							





ALLL Training Takeaways

- **ALLL = SFAS 114 + SFAS 5**
- **Document compliance with SFAS 114**
- **Segmentation of portfolio**
- **SFAS 5 historical loss rate for each segment adjusted for qualitative factors**
- **Directional consistency**
- **Discontinue use of benchmarks**





Top 5 Current Discussions on Bank ALLL Methodologies

- 1. How do I transition from benchmarks to my own history?**
- 2. Should my ALLL be the same level as peers?**
- 3. How do I document adjustments for qualitative or environmental factors?**
- 4. What do I need to do because of FAS 114?**
- 5. How do I make my examiner and CPA happy?**





“This really isn’t helping me at all. How do I get from Point A to Point C?”





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Interagency Best Practices

- **Project added in 2006 at request of audit firms**
- **Working group began in 2007**
- **Activities of Working Group**
 - **Review of ALL Methodologies**
 - **Discussions with Audit Firms including Consulting Arm**
 - **Creation of Outline of Series of Papers to be issued**
- **Current Status and Expected Release**





Interagency Best Practices

Current Draft Outline of topics being discussed

- **Getting Started: Purpose and Governance**
- **Analyzing the Portfolio: SFAS 5 (Segmentation) and SFAS 114 (Identifying Impaired Loans)**
- **SFAS 5: Approaches to Calculating Loss Rates & Data Integrity**
- **SFAS 5: Approaches to Adjusting Loss Rates (Qualitative or Environmental Factor Considerations)**
- **SFAS 114: Measurement of Impairment and Documentation**
- **Summary of the ALLL (linking data, internal reporting, directional consistency, validation)**





Interagency Best Practices

Series of White Papers: example format

- **Discussion of concept of topic**
- **Elements of best practices**
 - **Discussion of size and complexity considerations**
 - **Examples/illustrations**
- **Benefits**
- **Considerations**
- **References**





Interagency Best Practices

Common Themes of Best Practices

- **Establish governance policies (roadmap of ALLL responsibilities & policies)**
- **Data integrity**
- **Importance of segmentation**
- **Establishing ranges in the “Q” factors policy**
- **Incorporating “Q” factors at segmented level**
- **SFAS 114 “scope” policies**
- **Summary ALLL Review Procedures**





Top 5 All-Time ALLL Questions

- 1. Do I really have to use my own loss experience?**
- 2. How much enhancement to my ALLL process do you expect?**
- 3. Are you telling me it is OK for the ALLL to go both up and down at different times?**
- 4. So, it is OK to have a significant amount of the ALLL come from qualitative factors?**
- 5. Are the bank regulators and auditors honestly on the same page?**





Questions

