“ALLL Regulatory Impact for Community Banks”

Risk Management Association
2010 Risk Management Conference
October 18, 2010

Joseph W. Rebl CPA and Dave Keim CCO, FNCB
Ardmore Banking Advisors, Inc.

- Providing consulting and outsourced services to financial institutions since 1991
- Comprised of former bankers including board chairmen, presidents, CEOs, bank chief credit policy officers, examiners-in-charge at the OCC
- Ardmore has a unique understanding of the banking industry and banking credit. Our unique blend of deep credit industry expertise and knowledge of credit data management best practices allow us to create useful practical solutions for credit data related challenges
- Clients range from community banks to the largest of multi-national banks
- Ardmore’s credit technology solutions have been featured at RMA, BAI and American Bankers Association conferences
The Allowance for Loan and Lease Losses (the “ALLL”) Agenda

- Subjective Nature of the ALLL
- FASB Guidelines (FAS No. 114 and FAS No. 5)
- Justification and Supporting Resources
- Overview of Management’s Responsibility
- Going Forward / Other Topics for Discussion

Additional Information

- Overview of a Board of Directors’ Responsibility
- Review the “Don’ts” (Red Flags to Examiners)
- Review the “Dos” (Best Practices)
Subjective Nature of the ALLL

- One of the most subjective balance sheet accounts
- Regulatory concerns regarding “managing earnings”
- Goal of Regulators and Independent Accountants – A need to support a subjective analysis with as much objectivity as possible
- Note – The as stated purpose of the ALLL calculation is to determine the inherent losses in the existing portfolio (even if not yet identified) not future losses. (Or maybe not?)
Why is the ALLL Important from a Lender’s Point of View

- The ALLL is a reflection of the accuracy of risk identification, and inaccurate ratings by lenders will impact the ALLL, the Call Report and reflect badly on them personally.

- The health of the Bank is dependent on proper amounts and use of capital. An inaccurate ALLL could use too much capital and curtail lending activities.

- An inaccurate ALLL can cause turmoil in a Bank and with Bank regulators, which then will negatively impact the lending process.

- Bad numbers will reflect badly on the Bank in the marketplace and will enable the competition to have an edge with customers & prospects.

- Reserves on a loan impacts profitability and potentially lender compensation.
Revised Interagency Policy Statement
Issued December 2006

- Enhanced 2001 Interagency Policy Statement
- Banks responsible for:
  - Developing Policies & Procedures within regulatory requirements
  - Analyzing loan collectability
  - Calculating the ALLL within the requirements of GAAP
  - Maintaining an appropriate level of the ALLL
Interagency Policy Statement

- The ALLL does not apply to:
  - Loans carried at fair value
  - Loans held for sale
  - Off-balance sheet credit exposures
Overview of FAS No. 114 and FAS No. 5

- FAS No. 114
  - Review individual loans for potential impairment
  - Loans deemed impaired – segregated from the loan portfolio and any calculated loss is allocated on a loan by loan basis
FAS No. 114

- Impaired Loan Worksheet
- 3 Methods of Loan Valuation:
  - Present Value of Discounted Cash Flow
  - Appraised Value of Collateral, if Collateral dependant
  - Comparable Market Value
- Impaired Loans Segregated from FAS No. 5 Homogeneous Pools of Loans
FAS No. 114

- Segregation from FAS No. 5 Pools
  - Impaired with Allocated Reserve
  - Impaired with no Allocated Reserve
  - No Impairment Found
    - Add back to the Homogeneous Pool of Loans (FAS No. 5)
FAS No. 5

- Calculates inherent losses within homogeneous pools of similar loans in the portfolio (exclusive of impaired loans)
- Homogeneous pools of loans – Loans with similar characteristics
  - 1 – 4 family first mortgage loans
  - Commercial Real Estate Loans
FAS No. 5

- Basis Points are applied to Individual Pools of Loans based on:
  - Historical Charge-Offs
  And then:
  - Changes in Various Qualitative Factors
- Directional Consistency
  - Include at least Prior Quarters basis points in narrative for comparison
- No “Rounding”, Layering or Multipliers – 2x
FAS No. 5
Historical Charge-Offs

- Average Charge-Offs by Loan Segment for a period of time (2 yrs, 3 yrs, etc.)
- To reflect more recent charge-off trends, weighting may be applied to charge-off history
- If no significant charge-off history – Peer Group (UBPR) may be used.
# FAS No. 5

**Historical Charge-Offs Justification**

Bank MIS Generates 3 year Loss History Reports

- Broken Out By: Risk Grade
- Branch
- Loan Type
- “Pool”

<table>
<thead>
<tr>
<th>Charge Off Amount for total of 17 Industry selections, total of 10 Product selections, total of 24 Officer selections, total of 8 Delinquency selections (Risk Rating)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Charge Off Amount</strong></td>
</tr>
<tr>
<td>1: Minimal Risk</td>
</tr>
<tr>
<td>2: Moderate Risk</td>
</tr>
<tr>
<td>3: Average Risk</td>
</tr>
<tr>
<td>4: Acceptable Risk</td>
</tr>
<tr>
<td>5: Questionable Quality</td>
</tr>
<tr>
<td>6: Special Mention</td>
</tr>
<tr>
<td>7: Substandard</td>
</tr>
<tr>
<td>8: Doubtful</td>
</tr>
<tr>
<td>Grand Total</td>
</tr>
</tbody>
</table>

<table>
<thead>
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<th>Charge Off Amount for total of 17 Industry selections, total of 10 Product selections, total of 24 Officer selections, total of 8 Delinquency selections (Product Group)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Charge Off Amount</strong></td>
</tr>
<tr>
<td><strong>Commercial Construction</strong></td>
</tr>
<tr>
<td><strong>Commercial Real Estate</strong></td>
</tr>
<tr>
<td><strong>Commercial Lending</strong></td>
</tr>
<tr>
<td><strong>1-4 FAMILY MORTGAGE</strong></td>
</tr>
<tr>
<td><strong>Residential Construction</strong></td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
</tr>
</tbody>
</table>

Ardmore Banking Advisors
# FAS No. 5
## Historical Charge-Offs Justification

- **Risk Migration Reports**
- **Migration Broken Out By:**
  - Classified to Loss Pools and Vintage (Origination Date)

### Bank Balance for Sep 2008 (Leaf Descendants)

<table>
<thead>
<tr>
<th>Vintage</th>
<th>all</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td></td>
</tr>
<tr>
<td>0: No Risk Rating</td>
<td>1: Minimal</td>
</tr>
<tr>
<td>Classified</td>
<td>$33,102,798.12</td>
</tr>
<tr>
<td>6: Special Mention</td>
<td>$15,200,409.00</td>
</tr>
<tr>
<td>7: Substandard</td>
<td>$16,928,007.61</td>
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</table>

### Bank Balance for Sep 2008 (Leaf Descendants)

<table>
<thead>
<tr>
<th>Vintage</th>
<th>1+ - 2 Years Ago</th>
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<tbody>
<tr>
<td></td>
<td></td>
</tr>
<tr>
<td>Subtotal</td>
<td></td>
</tr>
<tr>
<td>0: No Risk Rating</td>
<td>1: Minimal</td>
</tr>
<tr>
<td>Classified</td>
<td>$6,732,646.68</td>
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<tr>
<td>6: Special Mention</td>
<td>$4,488,409.00</td>
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<tr>
<td>7: Substandard</td>
<td>$7,743,806.00</td>
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<tr>
<td>8: Doubtful</td>
<td></td>
</tr>
<tr>
<td>9: Loss</td>
<td></td>
</tr>
</tbody>
</table>
FAS No. 5

Eight Qualitative Factors

1. Changes in Lending Policies and Procedures
2. Changes in Concentrations of Credit
3. Changes in the Nature & Volume of the Portfolio
4. Changes in Volume & Severity of “Problem” Loans
5. Changes in National & Local Economic conditions
6. External Factors- Competition, Legal & Regulatory Experience
7. Ability & Depth of Management
8. Change in Loan Review & Depth of Board Oversight
FAS No. 5
Range of Basis Points

- Need a range of basis points for Qualitative Factors to determine how much “risk” there is, compared to the respective narrative

- Two Tier Risk Rating
  - Low Risk Range 5 – 10 - 15 bps
  - High Risk Range 10 – 20 – 30 bps

- Basis points relate to Factors
  - Stable
  - Moderate
  - Weak
FAS No. 5
Qualitative Factor Justification

Bank MIS Generates Trend Concentration Reports

- Delinquency, Non Accrual
FAS No. 5
Qualitative Factor Justification
Bank MIS Generates Trend Concentration Reports

- Industry

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>23: Construction</td>
<td>$33,984,579.66</td>
<td>7%</td>
<td>$32,684,624.97</td>
<td>7%</td>
</tr>
<tr>
<td>31-33: Manufacturing</td>
<td>$117,443,325.31</td>
<td>3%</td>
<td>$12,620,716.26</td>
<td>3%</td>
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<tr>
<td>42: Wholesale Trade</td>
<td>$1,671,045.56</td>
<td>0%</td>
<td>$1,509,124.14</td>
<td>0%</td>
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<tr>
<td>44-45: Retail Trade</td>
<td>$4,584,974.60</td>
<td>1%</td>
<td>$4,424,143.28</td>
<td>1%</td>
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<tr>
<td>48-49: Transportation and Warehousing</td>
<td>$2,682,615.63</td>
<td>1%</td>
<td>$2,773,022.64</td>
<td>1%</td>
</tr>
<tr>
<td>51: Information</td>
<td>$120,487.20</td>
<td>0%</td>
<td>$120,159.68</td>
<td>0%</td>
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<tr>
<td>52: Finance and Insurance</td>
<td>$25,334,129.62</td>
<td>5%</td>
<td>$26,426,282.79</td>
<td>6%</td>
</tr>
<tr>
<td>53: Real Estate and Rental and Leasing</td>
<td>$315,206,685.63</td>
<td>68%</td>
<td>$324,577,379.75</td>
<td>69%</td>
</tr>
<tr>
<td>54: Professional, Scientific, and Technical Services</td>
<td>$3,655,268.97</td>
<td>1%</td>
<td>$4,332,165.07</td>
<td>1%</td>
</tr>
<tr>
<td>55: Management of Companies and Enterprises</td>
<td>$2,372,705.43</td>
<td>1%</td>
<td>$2,314,331.57</td>
<td>0%</td>
</tr>
<tr>
<td>56: Administrative and Support and Waste Management</td>
<td>$2,728,678.20</td>
<td>1%</td>
<td>$2,712,144.43</td>
<td>1%</td>
</tr>
<tr>
<td>57: Educational Services</td>
<td>$1,408,469.98</td>
<td>0%</td>
<td>$1,404,647.24</td>
<td>0%</td>
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<tr>
<td>58: Health Care and Social Assistance</td>
<td>$41,358,797.74</td>
<td>6%</td>
<td>$41,777,783.18</td>
<td>6%</td>
</tr>
<tr>
<td>71: Arts, Entertainment, and Recreation</td>
<td>$3,069,344.47</td>
<td>1%</td>
<td>$3,059,127.46</td>
<td>1%</td>
</tr>
<tr>
<td>72: Accommodation and Food Services</td>
<td>$2,357,680.80</td>
<td>0%</td>
<td>$2,352,428.03</td>
<td>1%</td>
</tr>
<tr>
<td>81: Other Services (except Public Administration)</td>
<td>$9,446,550.79</td>
<td>2%</td>
<td>$9,145,156.84</td>
<td>2%</td>
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<tr>
<td>92: Public Administration</td>
<td>$260,440.12</td>
<td>0%</td>
<td>$259,584.90</td>
<td>0%</td>
</tr>
<tr>
<td><strong>Grand Total</strong></td>
<td><strong>$461,962,800.77</strong></td>
<td><strong>100%</strong></td>
<td><strong>$472,283,688.22</strong></td>
<td><strong>100%</strong></td>
</tr>
</tbody>
</table>
Diversification within the Loan Portfolio as it Relates to the ALLL Calculation

- Diversification within the loan portfolio spreads the risk among differing portfolios having different economic risks ("all the eggs in one basket")

- Individual loan segments will react differently to the 8 Qualitative Factors

- Loan Segments should be evaluated individually with each of the 8 Qualitative Factors, as well as net charge-offs for each respective loan segment
Summary Schedule

- Adequacy calculation should have a summary schedule that includes
- FAS No. 114 reserve
- FAS No. 5 reserve
  - Includes Higher Risk Rated reserve (if any)
- The sum of these (the calculated reserve)
- The actual reserve any additional provision or the excess reserve (the unallocated reserve - which should not be excessive)
Unfunded Loan Commitments and Letters of Credit

- When problem loans are identified with unfunded commitments inherent losses within the unfunded commitments should be identified
  - An individual liability should be established on the balance sheet
  - Separate from the ALLL
Going Forward…

FASB Mulls a Radical Change to Reserving Practices

- New proposed methodology – part of FASB’s “fair-value mandate” (Mark to Market for Loans).
- Expected Loss Model – Record expected loss when the loan is made, not when a subsequent event occurs that causes the reserve allocation.
- Proposal would require banks to set reserves based on long term loss expectations rather than wait for possible signs of imminent default.
- Regulatory guidance may change the reserve requirements.
- Dodd Frank era still undefined.

Source: American Banker, August 31, 2010

- “…It’s time to press the reset button…as examiners found themselves limited by existing accounting rules.”
- “…Growing agreement that the “incurred loss” model had unfortunate consequences:
  - Delayed reserve building
  - Magnified the effect of losses when then did occur
  - Undermined public confidence in the financial system”
- “…15 years of an incredibly favorable credit cycle and very benign loss history.”
- “…Our accounting doctrines did not let bankers do what many knew was instinctively right, and that was to increase their reserve builds.”
“Regulatory structure is itself about to undergo sweeping changes.”

“…calling for the restoration of strong mortgage underwriting standards putting an end to ‘no-doc’ loans, creating minimum floors for down payments, maximum loan-to-value ratios and limits on debt to income”

Concern for “…massive buildup of commercial real estate concentrations on community bank balance sheets.”

“…specific capital expectations for correlated exposures over certain limits…buffer above regulatory capital minimums that they would be expected to maintain.”