“ALLL Methodology and Best Practices”

New Jersey Bankers Association
Internal Audit Committee Meeting
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Ardmore Banking Advisors, Inc.
Independence, Integrity, Experience and Quality

- Providing professional and independent risk management services to financial institutions for over 20 years.
- The Ardmore team includes staff with extensive bank and/or regulatory experience, derived from holding senior-level positions in the banking industry including former CEO's, Credit Policy Officers, Senior Credit Officers, and/or Examiners-in-charge for the OCC.
- From outsourced loan review to our cutting-edge credit informatics solutions, the Ardmore team follows a holistic approach to create a value-added solution tailor-made for our clients.
- Clients range from community banks to the largest of multinational banks
- Ardmore’s credit technology solutions have been featured at RMA, BAI and American Bankers Association conferences
- Best Practices in identifying, quantifying, monitoring and controlling credit-related Risk
Ardmore Banking Advisors, Inc.
Agenda

- Regulatory Radar
- Subjective Nature of the ALLL
- Regulatory Directives & Guidelines
- The ALLL Methodology
- Overview of the Board’s Responsibility
- What’s Ahead for ALLL?
- Do’s (“Best Practices”) & Don'ts (“Red Flags”)

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What’s Hot on the Regulators’ Radar

- ALLL
- 3 P’s
- Concentrations
- Special Assets
- Capital
- Risk Appetite
- Documentation
- Leading Indicators
- MIS Architecture
- Interest Rate Risk
- Stress Testing
- Concentrations

Solutions Built by Bankers for Bankers
Holistic & Integrated Risk Management

Credit

Lending

Audit & Compliance

Finance

MIS/IT

Operations
Do you have your finger on the pulse of your loans?

Or are you managing by delinquency?
Troubled Loan Purgatory
Overview of Causes and Effects

- “Spike” or “Bulge” in Pass Watch, Special Mention, Sub-Standard
- “Extending and Pretending” or “Staying and Praying”
- Statistically Significant Number of Loans Demonstrating Insufficient DSC
- Are Loans Receiving the Special Attention the Ratings require?
- Timeliness of Rating from Recognition to Re-evaluation
- Best vs. Worst Case Scenarios
- Historical Reduction in Reserves
- Sales vs. Credit Culture, Compensation Structure, Regulatory Directives
- Impact on Reserves and in-turn Capital, Balance Sheet, Lending, Profitability and Return on Equity

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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?)
FASB

Original Pronouncements-
- SFAS No. 5 – Accounting for Contingencies (March 1975)
- SFAS No. 114 – Accounting by Creditors for Impairment of a Loan (May 1993)

FASB prepared the Accounting Series Codification (ASC) to supersede the original pronouncements:
- ASC 310.10 – supersedes SFAS No. 114 – procedure for identifying impaired loans
- ASC 450.20 – supersedes SFAS No. 5 – procedure for determining the necessary ALLL on homogeneous pools of loans not included in the impairment calculation (ASC 310.10)
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
- Veracity of documentation, analysis and supporting materials
- Timely and current review and information
Interagency Policy Statement

The ALLL does not apply to:

- Loans carried at fair value
- Loans held for sale
- Off-balance sheet credit exposures
Impaired Loans (ASC 310.10)

Segregation from homogeneous loan pools

- Impaired with allocated reserve
- Impaired with no allocated reserve
- No impairment found
  - Add back to the homogeneous pool of loans (ASC 450.20)
Impaired Loans

- Impaired Loan Worksheet (Updated Action Plan)
- 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 ASC 450.20 Homogeneous Pools of Loans
- Summary Schedule of Impaired Loans and Allocated ALLL
ASC 450.20

- Calculates inherent losses within homogeneous pools of similar loans in the portfolio (exclusive of impaired loans)

- Homogeneous pools of loans – Loans with similar characteristics (e.g.):
  - 1 – 4 family first mortgage loans
  - Commercial Real Estate Loans
  - C & I Loans

- Integrate with Risk Appetite Scenario and concentration policy
Homogeneous Loan Pools

- Basis Points are applied to individual pools of loans based on:
  - Historical charge-offs
- Then - adjusted to reflect changes in current conditions:
  - Considering Eight Qualitative Factors
- Directional Consistency
  - Include at least prior quarters basis points in narrative for comparison
- No “Rounding”, Layering or Multipliers – 2x
Average Historical Net Charge-Offs

- Average net charge-offs by loan segment for a specific period of time (three years, five years, etc.)
- To reflect the effect of current economic conditions – weight the more recent periods heavier than earlier periods
- No relevant charge-off history – Peer Group Data (UBPR)
- Survey other banks with similar loan portfolios
- Customize/tailor for specific bank experience and nuances
- Address performance through recent deep recession/financial crisis: distinctions
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
Supporting Narratives

- Supporting narratives should be prepared for each Qualitative Factor – for each loan segment.
- Where applicable – Supporting data should be included – Fed Beige Book, local and regional unemployment data, etc.
- In some cases an argument may be made for preparing a narrative for a specific Qualitative Factor on a bank-wide basis.
  - i.e. if Board oversight is the same for the entire portfolio, a single narrative could be prepared and the resulting basis point allocation could be applied to each loan segment.
  - Specific failures and successes.
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: Integrate basis points with factual narrative.

- Demonstrate the veracity of analysis supporting numbers

- 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
Identifying Additional Risk

- Should consider heavier weighting for loan pools risk rated special mention and below.
- Should be able to support the adjustment factors being applied to the original basis point allocations.
Summary Schedule

- Adequacy calculation should have a summary schedule that includes
- ASC 301.10 reserve for impaired loans
- ASC 450.20 reserve for the homogeneous loan pools
  - 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

Unfunded loan commitments and unfunded letters of credit require an individual calculation to determine the amount of inherent losses within the unfunded commitments:

- An individual liability should be established on the balance sheet
- Separate from the ALLL
Overview of Board of Directors’ Responsibility

- At least annually, review and reapprove the ALLL policy.
  - (Helpful Hint – Record the date of the most recent Board approval at the end of the Policy)

- At least quarterly, review the documents supporting the ALLL calculation

- Validation – Annual “Validation” that the ALLL process is working as designed

- Ask Questions – Understand what is being done and why: document the process so a third party can understand it
Overview of Board of Directors’ Responsibility (Continued)

At a minimum the review should include:

- Review of each impaired loan, including how the underlying value of the loan was determined, any allocated reserve and any action plan to limit future losses
- Overview of the ASC 420.50 calculation
- Approve the level of the ALLL and any provisions or reductions necessary to the Provision
What’s Ahead for ALLL

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
Why Prudent Reserving Resonates with Bankers

- Comments by Eugene L. Ludwig, Comptroller of the Currency under Bill Clinton.
- Banker – Credit a little too soft, pricing and terms too loose – liked to “bump” his ALLL.
- Previously troubled credits improving and the softness isn’t “identifiable” in an accounting sense. Therefore-
- Accounting rules actually require him to reduce his ALLL.
- Fallback – Capital. (Capital drawdown – sign of weakness.)
- Accounting rules – losses either “known” or “unknown”.
  - ALLL – absorbs the “known” losses.
  - Capital – absorbs the “unexpected” losses.
Prudent Reserving (Continued)

- Can’t afford accounting rules that effectively chide bankers for having a sense of caution.

- No change – in a real economic speed bump, those capital reserves will be drawn down in dramatic fashion (serious regulatory and market consequences).

- Bankers should be free to set whatever ALLL they want, as long as it’s well-reasoned, consistent with regulatory requirements and transparent to the public.

- Prudential supervisors, not accountants, should be in charge of this issue.

- Source: American Banker, October 4, 2012
The Don’t & Do’s
The “Don'ts” – Red Flags to Examiners

- **Don’t** – Use a flat percentage of outstanding loans to determine the amount of the ALLL (the “Old Days”)

- **Don’t** – Review a “brief summary” schedule of impaired loans. The Board should be apprised of the status of each loan and the action plan to limit losses

- **Don’t** – Apply “flat percentages” to loan segments, based on the risk ratings of the loans (i.e. special mention = 10%, substandard = 20%, doubtful = 50%) One of the biggest “Red Flags”

- **Don’t** – Adjust ALLL balance to reflect peer data, budget, etc.
The “Dos” – Best Practices

Do - Have an approved ALLL policy that addresses:

- Roles and Responsibilities
- The Bank’s Accounting Policies, as they relate to the ALLL
- Description of the Methodology
- Maintain specific and current documentary support for the qualitative factors and basis points: show the math
- Outline of Internal Controls in Place
The “Dos” – Best Practices

- **Do** - Have supporting schedules for both the ASC 310.10 and ASC 450.20 portions of the calculation

- **Do** - Include a Summary Schedule, totaling the amount of allocated reserve under both ASCs and showing the amount of unallocated reserve, if any

- **Do** - Establish an individual liability (separate from the ALLL) for inherent losses in the balances of unfunded loan commitments and lines of credit

- **Do** - Validation- At least annually the ALLL process should be validated by a party independent of the calculation
Have Questions About Asset Quality? Ardmore Helps You Find the Answers

- Outsourced/ Co-Sourced Loan Review
- Advanced Credit Information Solutions
- Stress Testing & Migration
- Due Diligence/M&A
- Credit Policy Enhancement
- Residential Mortgage & Consumer Services
- Credit Risk Management Consulting

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