

During periods of unstable financial conditions, meeting the supervisory expectations for maintaining an appropriate methodology and level for the allowance for loan and lease losses (ALLL) can be a challenge for many community banks. An appropriate ALLL methodology and level are important to ensure that the bank's financial position is accurately presented. Arriving at an appropriate ALLL involves a high degree of judgment, and while inevitably imprecise, the process should result in a reasonable estimate of incurred losses consistent with a bank's unique credit risk profile.

The purpose of this document is to describe the process used by Federal Reserve examiners to evaluate community banks' ALLL methodologies.

Expectations for Banks

Community banks are expected to implement an ALLL methodology that is consistent with generally accepted accounting principles (GAAP) and interagency supervisory guidance. In order to achieve that, a bank should have a well-defined methodology that enables bank management, the board of directors, and examiners to understand the rationale supporting the level of the ALLL. An effective process will result in an ALLL that is appropriate given credit conditions in a bank's portfolios. The board of directors is responsible for overseeing management's significant judgments and estimates pertaining to the determination of an appropriate ALLL and, at least quarterly, should review management's assessment and justification for the amounts established.

In order to demonstrate an appropriate ALLL methodology, a bank should have in place effective credit risk identification and accounting practices, as well as other credit risk management controls to ensure that the approved method-

ology is effectively implemented and consistently applied. Weaknesses in loan classification and credit grading can result in an inadequate ALLL level.

An ALLL methodology consists of two major components. Attachment A, which is intended for illustration purposes only, includes a flowchart that shows how these two components work together, as well as separate flowcharts for each component. The first component is an estimation of losses associated with individually identified impaired loans. An impaired loan is defined as a loan where it is probable the creditor will be unable to collect all amounts due according to the original contractual terms. This component must follow guidance described in Accounting Standards Codification (ASC) Topic 310 (formerly referred to as SFAS 114). Nonaccrual loans not collectively evaluated for impairment under ASC 450 pools are generally considered impaired and should be evaluated for impairment under ASC 310. Loans that meet the criteria for troubled debt restructures are considered impaired loans and should be measured for impairment under this guidance as well. ASC Topic 310 includes three possible approaches for measuring impairment (described in Attachment A).

The second major component estimates losses under ASC Topic 450 (formerly referred to as SFAS 5), which provides guidance for estimating losses on groups of loans with similar risk characteristics and includes any individual loans reviewed under ASC Topic 310 and determined not to be impaired.

How Examiners Assess the ALLL

During each examination or as part of ongoing monitoring, examiners will evaluate whether a bank's ALLL methodology, supporting loan review systems, and other controls are effective in determining and maintaining an appropriate ALLL. Examiners will accept estimates of credit losses when management has: a) reliable loan review systems and other controls providing effective credit risk identification, b) an acceptable methodology

FedLinks is intended to highlight the purpose of supervisory policy and guidance for community banking organizations. FedLinks does not replace, modify, or establish new supervisory policy or guidance.

and process that meet interagency supervisory guidance (which is consistent with GAAP), and c) documentation that demonstrates reasonable and properly supported assumptions including adjustments to historical loss rates for the effect of environmental factors.

Examiners will generally determine that a reliable process for risk identification exists when there are no material differences between examiner and bank loan classifications and no significant weaknesses exist in the bank's processes for credit risk identification. Examiners will also assess the appropriateness of the bank's adjustments to historical loss rates for the effect of environmental factors. For example, examiners will evaluate adjustments to historical loss rates considering trends, local and national economic conditions, and other relevant factors such as loan growth and delinquencies.

In situations where the bank's assumptions do not appear reasonable, or the methodology is not consistent with GAAP and supervisory guidance, examiners will require correction of specific methodology deficiencies. Examiners will work with bank management to adjust the bank's methodology during the course of the examination so that the adjusted results can be used for the evaluation of ALLL adequacy.

In the rare event that the methodology deficiencies are not correctable during the course of the examination, the examiners will develop an estimate for the ALLL and will require the ALLL to be adjusted to that level. Examiners will draw from the examination loan review findings, publicly available data on real estate or other collateral values in the lending area, and information from bank management. Financial ratios, peer group statistics, and industry and/or bank specific historical loss data may be used to support the examiner's estimate of credit losses. Subsequent to the examination, bank management will be required to correct the bank's methodology promptly so that an acceptable ALLL methodology will be implemented on an ongoing basis. Examiners will review the revised methodology to determine its appropriateness and will provide feedback to the bank.

What factors might cause an examiner to consider the methodology deficient? A deficient methodology contains significant flaws—usually structural flaws—that render it unreliable for calculating a reasonable estimate of losses inherent in the loan portfolio. For example, the methodology might not accurately include impaired loans or might not include reasonable loss histories for portfolio segments.

More often, a methodology is rendered deficient due to inadequate credit risk management practices. Management might have inaccurate risk identification of problem credits or inadequate appraisal/collateral evaluation processes. Liberal underwriting practices or extension, renewals, or interest capitalization might delay the timely recognition of past-due or nonaccrual credits. In addition, a methodology might be considered deficient if actual losses regularly exceed management's estimates either for pooled or individually evaluated loans.

Credit administration factors that render a methodology deficient include:

- *Inaccurate loan grading system*
 - Material grading differences between internal ratings and external loan review or examination ratings.
 - Weak or absent independent loan review.
 - Insufficient staffing for problem loan identification and monitoring.
 - Failure to recognize downgrades or losses in a timely fashion.
- *Weaknesses in underwriting practices, including renewals, and credit analysis*
 - Improper loan structure for the loan type.
 - Frequent extensions or renewals without principal reduction.
 - Inappropriate use of interest reserves.
 - Frequent capitalization of accrued interest.
 - Insufficient analysis of secondary sources of repayment (guarantor financial capacity and willingness).

- ***Inadequate portfolio monitoring or oversight***
 - High volume of loan policy exceptions and/or credit administration deficiencies, particularly the absence of current and reliable financial statements or tax returns.
 - Inadequate risk limits or monitoring of existing or emerging concentrations.
 - Poor or non-existent identification of impaired loans and lack of associated impairment analysis.
 - Inadequate collateral valuation procedures, including real estate evaluations or appraisals.
 - a. Reliance on stale values, which do not reflect changes in the market or collateral condition existing at the reporting period.
 - b. Flawed valuations (e.g., inappropriate or outdated sales comparisons, unrealistic vacancy and expense assumptions, and unsupported absorption assumptions).
 - c. Inadequate collateral valuation review practices.

Common Pitfalls

In order to reduce the potential for a deficient methodology, the following common pitfalls should be avoided.

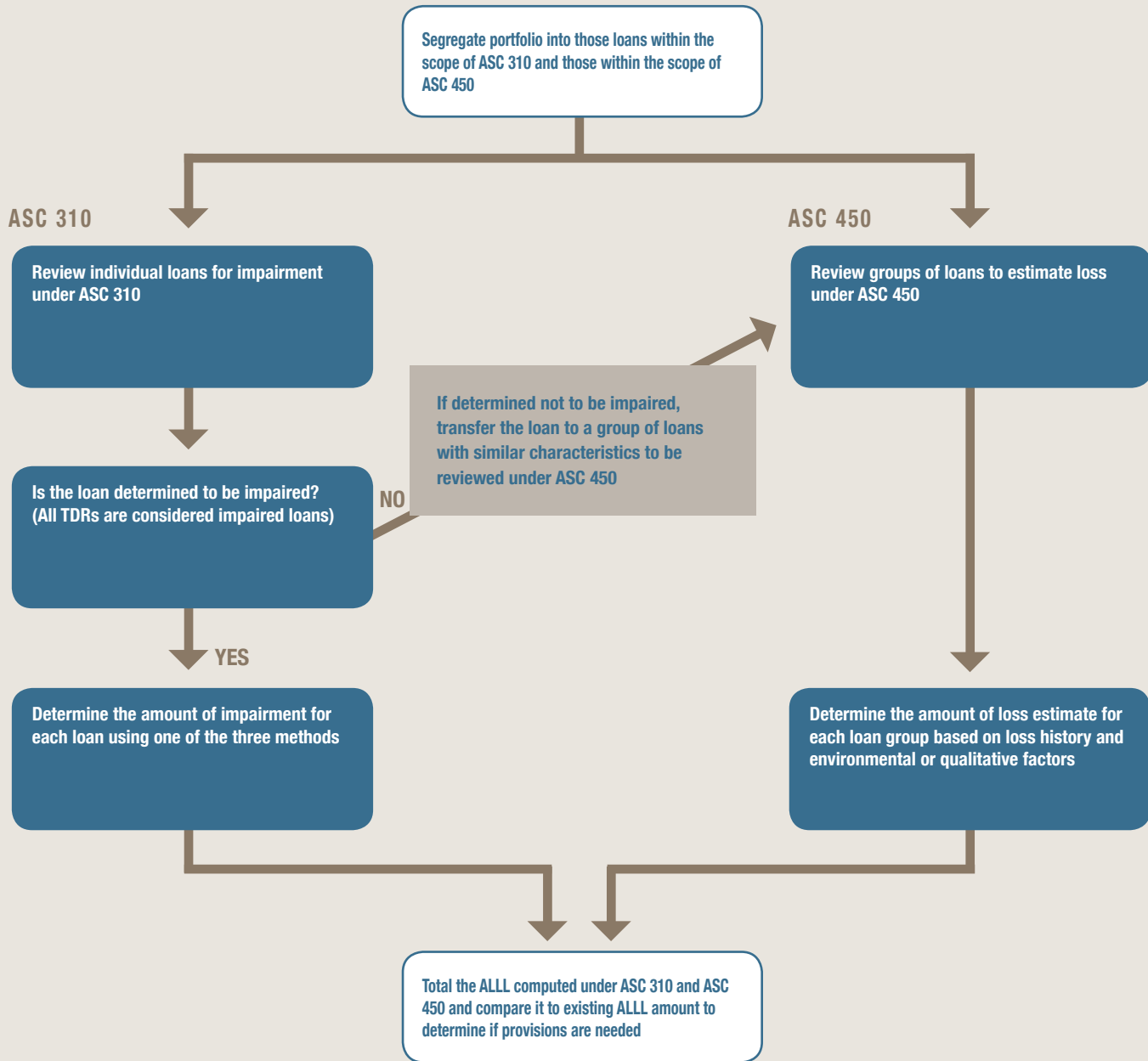
- ***Managing to a predetermined level or percentage.*** Provisions should be adjusted based on current conditions and analysis, not solely based on predetermined budgeted amounts.
- ***Relying on loss histories skewed by recent loan growth.*** Growth in loan volume may reduce historical loss rates on a percentage basis given the lag between loan origination and losses. In addition, rapid loan growth can be an indicator of higher potential future losses. Therefore, at a minimum, ASC 450 factors should provide directional consistency based on loan growth, delinquencies, and loss trends to capture losses that have likely been incurred but have not yet surfaced.

- ***Including ASC 450 environmental factor adjustments without consideration of overall reasonableness.*** Banks are not required to operate within benchmarks or reasonable checks. However, after environmental factor adjustments have been made, the overall ALLL level should be evaluated for reasonableness.
- ***Relying on outdated collateral values for ASC 310 analysis.*** Adjustments should be made quarterly to reflect current market conditions in accordance with accounting and regulatory guidance.
- ***Determining substandard accruing loans are not impaired, and not including these loans in an ASC 450 analysis. Loans that are not impaired should be included in the bank's ASC 450 analysis.***
- ***Layering ALLL allocations under both ASC 310 and ASC 450.*** For loans designated impaired, such as restructured trouble debt, the allowance should be based on the ASC 310 impairment analysis. No additional allowance is allowed under ASC 450 even if the measurement of impairment under ASC 310 is zero.

Resources and Guidance

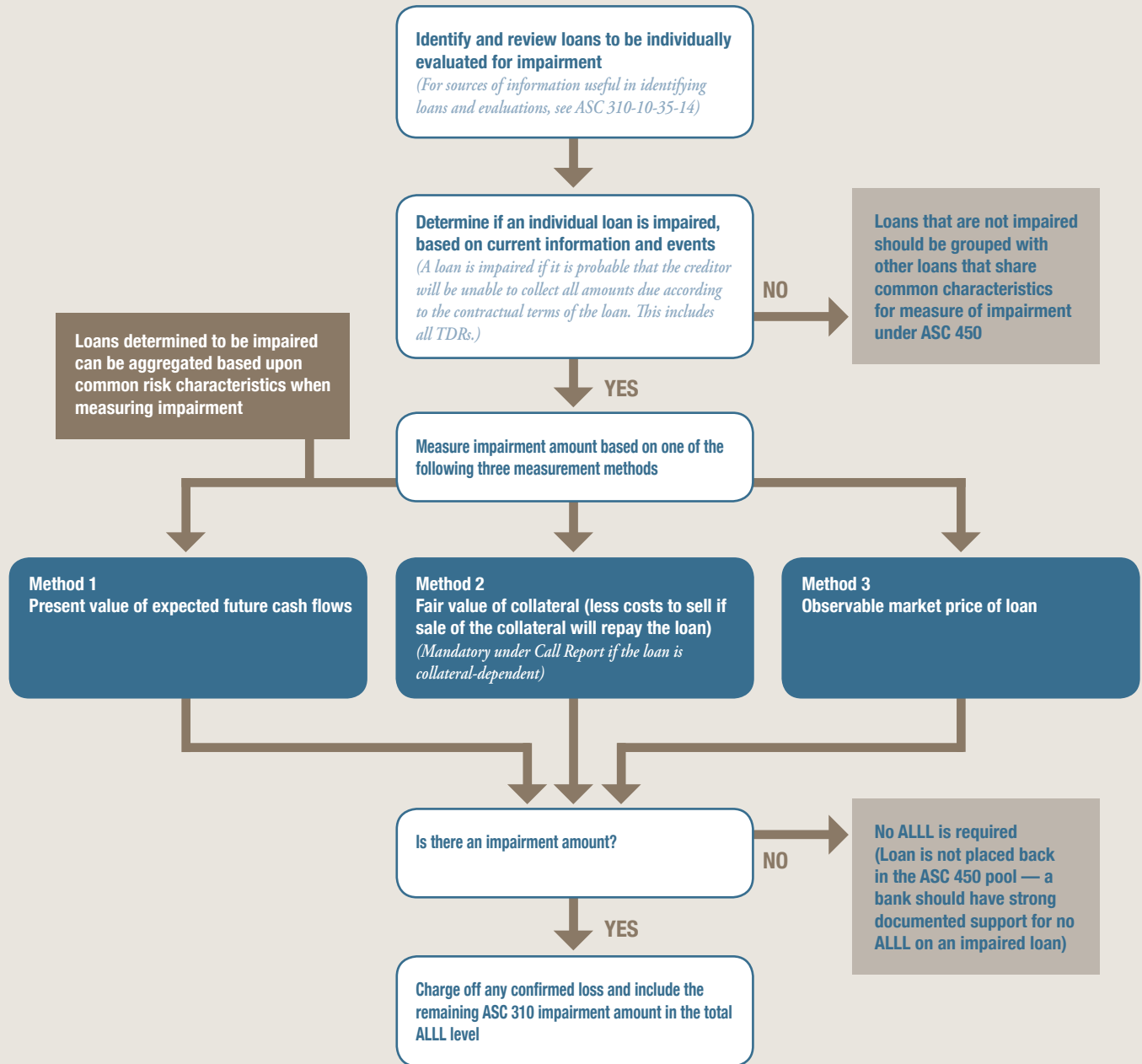
The Federal Reserve and other federal banking regulators have issued a number of policy statements related to the ALLL over the years. Highlights from each of these policy statements are included in Attachment B. Community banks are encouraged to utilize the links to these policy statements to further develop their understanding of supervisory expectations.

INTERACTION OF ASC 310 AND ASC 450



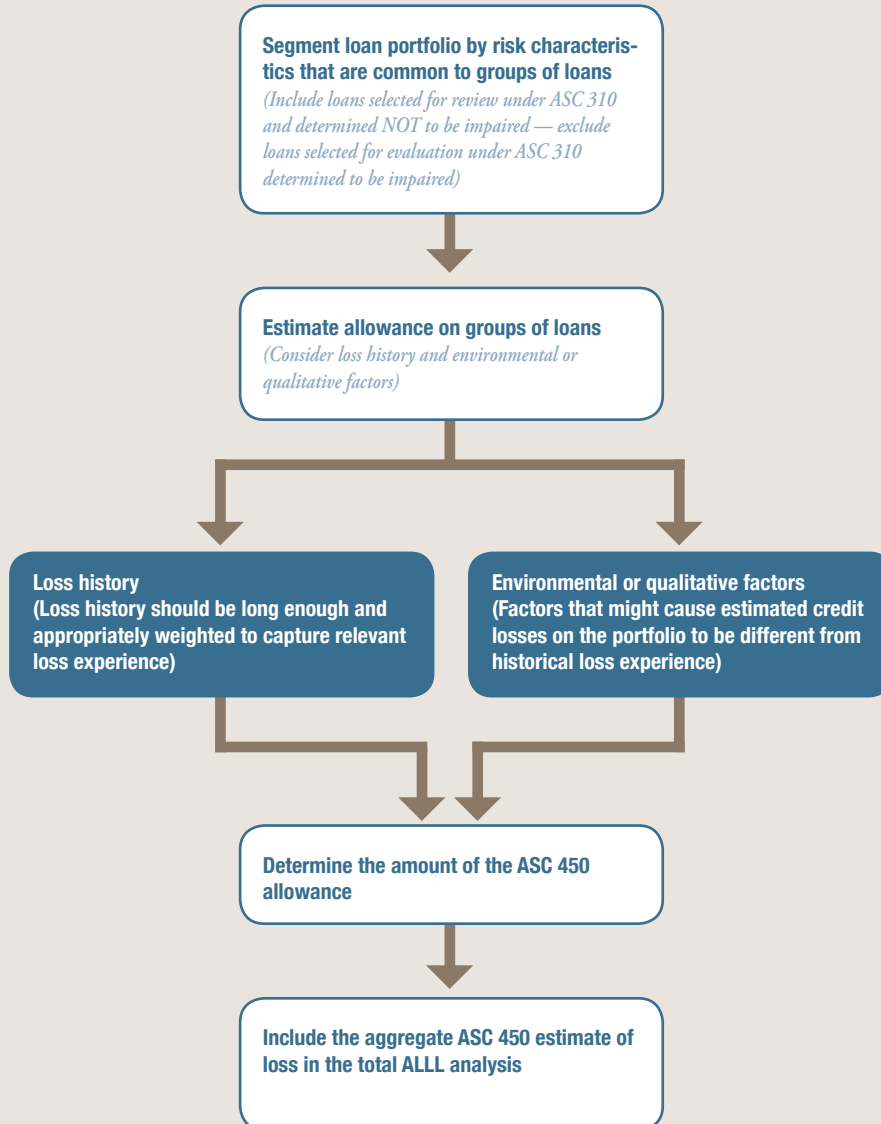
ASC 310

ASC 310 provides guidance on loss estimation for loans that are identified for individual evaluation



ASC 450 – CONTINGENCIES

ASC 450 provides guidance on loss estimation for groups of smaller or homogenous loans



SIGNIFICANT ALLL GUIDANCE FOR COMMUNITY BANKS

HIGHLIGHTS OF SUPERVISORY GUIDANCE

Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1-4 Family Residential Properties, January 31, 2012 (SR Letter 12-3)

- Reminds institutions of existing GAAP and regulatory guidance related to estimating the allowance for junior lien loans and home equity lines of credit. Directed toward institutions with significant portfolios and reminds institutions to:
 - Gather sufficient information to adequately assess probable loss
 - Analyze data on the associated senior lien loans.
 - Periodically refresh relevant credit quality indicators.
 - Incorporate credit quality data into the allowance estimation process by segmenting the portfolio or establishing a qualitative allowance.
 - Ensure income recognition practices are appropriate.

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

- Discusses the nature and purpose of the ALLL
- An appropriate ALLL covers estimated credits losses on:
 - Individually evaluated impaired loans
 - Loans evaluated within groups with 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 of ALLL
 - Evaluate reasonableness

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

- Guidance discusses:
 - Policies and procedures
 - Methodology
 - ALLL requirements under SFAS 114 (now ASC 310)
 - ALLL requirements under SFAS 5 (now ASC 450)
 - ALLL balance in total
 - Validation of the methodology
- Technical Q&As:
 - Measuring and supporting SFAS 114 (now ASC 310) 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 SFAS 5 (now ASC 450) for loans initially reviewed individually and determined not to be impaired
- Documenting the reported ALLL
- Description of applicable GAAP
- Interaction of SFAS 114 (now ASC 310) and loans with a split classification
- Inappropriate layering of losses
- ALLL level must conform to GAAP
- Similar Securities and Exchange Commission (SEC) guidance in Staff Accounting Bulletin 102

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

- Statement by the federal banking agencies and the SEC on 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.