TOPIC 4: ALLOWANCE FOR LOAN AND LEASE LOSSES

4A. ALLOWANCE FOR LOAN AND LEASE LOSSES

Question 1: (September 2001)

Regulatory guidance included in the *Comptroller's Handbook* booklet "Allowances for Loan and Lease Losses" discusses the concept of "inherent loss." What is "inherent loss," and how does it differ from "future loss?"

Staff Response:

In defining "inherent loss," the handbook does not introduce a new concept to estimate the ALLL. Rather, it describes the use of concepts developed in Statement of Financial Accounting Standards No. 5 (SFAS 5), a process that bankers, accountants, and examiners have performed for years.

"Inherent losses" are losses that meet the criteria in SFAS 5 for recognition of a charge to income. This requires a conclusion that an asset has probably been impaired. Proper accounting recognition of a loan impairment requires that a provision be made to the ALLL in the period when the loss event probably occurred, and the loss amount can be estimated. Earnings would be charged at that time. It is inappropriate to wait to charge earnings until the loss is confirmed or realized (i.e., the asset is charged off).

A "loss event" is an event that probably has occurred that impairs the value of a loan. If such a loss event occurred, even though it cannot be identified specifically, a charge is made to earnings and a provision to the ALLL. The occurrence of a "confirming event" results in the asset being classified loss and charged off against the ALLL.

A provision to the ALLL ensures that impairments or loss events that have occurred, but have not yet been identified specifically, are provided for in the period in which they occurred. Thus, the ALLL is an estimate.

Question 2: (December 2008)

What are "estimated credit losses?"

Staff Response:

The Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) (2006 Policy Statement), included in OCC Bulletin 2006-47, defines "estimated credit losses" as an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances as of the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., through a provision to the ALLL) set forth in GAAP. When available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL.

SFAS 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 loss can be reasonably estimated. These conditions may be considered in relation to individual loans or groups of similar types of loans. If the conditions are met, accrual should be made even though the particular loans that are uncollectible may not be identifiable.

Under SFAS 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. It is implicit in these conditions that it must be probable that one or more future events ("confirming event") will occur confirming the fact of the loss.

Question 3: (December 2008)

How should a bank identify loans to be individually evaluated for impairment under SFAS 114?

Staff Response:

Determining loan impairment is a multi step process. First, the bank must set the criteria for determining loans to be reviewed for impairment under SFAS 114. Second, based on those criteria, the bank would identify the loans to be individually evaluated for impairment. Finally, the selected loans are reviewed for impairment.

Footnote 1 of SFAS 114 identifies the following sources of information that is useful in identifying loans for individual evaluation for impairment:

- A specific materiality criterion.
- Regulatory reports of examination.
- Internally generated listings such as "watch lists," past due reports, overdraft listings, and listings of loans to insiders.
- Management reports of total loan amounts by borrower; historical loss experience by type of loan.
- Loan files lacking current financial data related to borrowers and guarantors.

- Borrowers experiencing problems such as operating losses, marginal working capital, inadequate cash flow, or business interruptions.

- Loans secured by collateral that is not readily marketable or that is susceptible to deterioration in realizable value.

- Loans to borrowers in industries or countries experiencing economic instability.

- Loan documentation and compliance exception reports.

Question 4: (December 2008)

What documentation should a bank maintain to support its measurement of impairment on an individually impaired loan under SFAS 114?

Staff Response:

In general, the bank should document the analysis that resulted in the impairment decision for each loan and the determination of the impairment measurement method used. Additional documentation would depend on which of the three impairment measurement methods is used.

For example, for collateral-dependent loans for which a bank must use the fair value of collateral method, the institution should document: how fair value was determined including the use of appraisals, valuation assumptions, and calculations; the supporting rationale for adjustments to appraised values, if any; the determination of costs to sell, if applicable; and quality, expertise, and independence of the appraisal. This is consistent with the 2001 Policy Statement, which discusses the supporting documentation needed.

Question 5: (December 2008)

Are large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment within the scope of SFAS 114?

Staff Response:

Generally, no. Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of SFAS 114. Such groups of loans may include, but are not limited to, “smaller” commercial loans, credit card loans, residential mortgages, and consumer installment loans. SFAS 114 would apply, however, if the terms of any of these loans are modified in a troubled debt restructuring as defined by SFAS 15. Otherwise, the relevant accounting guidance for these groups of smaller-balance homogeneous loans is contained in SFAS 5.

Question 6: (December 2008)

Can “larger” versus smaller” balance loans be quantified to identify loans that should be evaluated for impairment under SFAS 114?

Staff Response:

A single-size test for all loans is impractical because a loan that may be relatively large for one bank may be relatively small for another. Deciding whether to individually evaluate a loan is subjective and requires a bank to consider the individual facts and circumstances, along with its normal review procedures in making that judgment. In addition, the bank should appropriately document the method and process for identifying loans to be evaluated under SFAS 114.

Question 7: (December 2008)

When should a bank remove a loan from a pool and specifically allocate an amount for that loan?

Staff Response:

There are valid reasons to review a loan individually rather than in a pool of loans. Loans should be evaluated separately when sufficient information exists to make a reasonable estimate of the inherent loss. Individual loan review is generally applicable for large or otherwise significant (i.e., classified doubtful) credits, loans to companies in a deteriorating industry, or a combination of the above. In such situations, substantial information on the credit should be available, and a separate review is appropriate. If an individually analyzed loan is determined to be impaired, it should be specifically allocated for in accordance with SFAS 114, and not as part of the pool.

Pool evaluation is appropriate when information is insufficient to make such an estimate for an individual loan.

Question 8: (September 2001)

Does criticism of a loan indicate an inherent loss?

Staff Response:

Criticism of a loan, an important signal, does not always indicate existence of an inherent loss in the credit. The degree of criticism is important. For example, all loans classified doubtful have, by definition, inherent loss. The risk of loss on the loan is probable, even though the timing and exact amount has not been determined.

In a substandard credit, the loan is inadequately protected by the current sound worth and paying capacity of the borrower or the collateral. Although a distinct possibility exists that the bank may sustain a loss if weaknesses in the loan are not corrected, this is only a potential loss. Further, in substandard loans, inherent loss generally cannot be identified on a loan-by-loan basis.

Nevertheless, inherent losses do exist in the aggregate for substandard (and to a lesser extent, special mention and pass) loans. This inherent, but unidentified, loss on such loans should be provided for in the ALLL. This provision usually is based on the historical loss experience, adjusted for current conditions, for similar pools of loans.

Question 9: (September 2001)

What are some examples of loss events and confirming events affecting pools of loans?

Staff Response:

Loss events for loans in pools are the same as those for individual loans. Commercials loans could suffer from a decline in the economy or in profits, or an event that affects their future prospects. Consumer loans might be affected by the loss of a job or personal bankruptcy. Delinquency statistics are the most common indicators of the level of inherent losses in pools. However, external events, such as changes in the local or national economy, can also signal problems for a pool of loans before one can see change in delinquency rates.

Confirming events for pools of loans will differ between consumer and commercial credits. Again, the confirming event occurs when information reveals that the loan is no longer bankable and should be charged off. In consumer pools, charge offs are typically taken based on established thresholds (i.e., a specific number of days past due) rather than on specific adverse information about a borrower. A charge-off should be taken if adverse information about a specific borrower is received before the threshold date. Specific adverse information about borrowers usually causes the decision to charge off commercial loans analyzed in pools.

Question 10: (December 2008)

May banks project or forecast changes in facts and circumstances that arise after the balance sheet date when estimating the amount of loss under SFAS 5 in a group of loans with similar risk characteristics at the balance sheet date?

Staff Response:

No. SFAS 5 only allows the recognition of estimated losses at the measurement date based on the facts and circumstances present at the date. In developing loss measurements for groups of loans with similar risk characteristics, a bank should consider the impact of current qualitative or environmental factors that exist as of the balance sheet date. It should also document how those factors were used in the analysis and how they affect the loss measurements. For any adjustments to the historical loss rate reflecting current environmental factors, a bank should support and reasonably document the amount of its adjustments and how the adjustments reflect current information, events, circumstances, and conditions. Questions 11 through 16 illustrate this concept.

Facts:

A bank evaluates a real estate loan for estimated credit loss. The loan was made during a recent boom period for the real estate industry. However, both the general real estate market and the loan currently are troubled. Loan repayment will come primarily from the operation and eventual sale or refinancing of the collateral. Further, the value of the underlying collateral is declining. A properly performed appraisal indicates that the value of the property is 95% of the outstanding loan balance.

Historically, three real estate cycles have occurred in the last 25 years. In each cycle, real estate values fluctuated significantly. However, it is not possible at this time to determine whether local real estate properties will experience additional declines in value.

Question 11: (December 2008)

How should the bank determine the estimated credit loss on the loan?

Staff Response:

The bank should determine the amount of the credit loss for this loan based on the information in the current collateral appraisal, because it is the best estimate of current value and impairment. This current appraisal, which reflects the facts and conditions that presently exist, measures the loss that has probably occurred as opposed to future loss. Future impairments will be recognized in the periods in which the evidence indicates they probably occurred. Current recognition of those potential declines would amount to recognition of future losses rather than inherent ones. See Question 29 for further discussion.

Facts:

A local military base, which employs a significant percentage of the local civilian work force, may close. Goods and services supplied to the base by local businesses contribute greatly to their economy.

Question 12: (September 2001)

How should the local bank, in analyzing the adequacy of its ALLL, respond to rumors that the military base may appear on the list of possible closures?

Staff Response:

On a continuous basis, the bank should review the concentrations of credit risk arising from its loans to businesses and individuals associated with or dependent upon the base. The bank's assessment of the effect of the closing on the local economy and its borrowers should be regularly updated. But an unsubstantiated rumor is not an event that would require increased provisions to the ALLL. However, a concentration of credit centered on the military base is relevant to the assessment of the bank's capital adequacy.

Question 13: (December 2008)

Suppose that the rumors of the local base as a closure candidate are confirmed, and the decision is expected in six months. How would that affect the analysis?

Staff Response:

The consideration of the possible base closure does not, by itself, trigger a need for provisions to the ALLL on any individual credit. Further, in considering possible subjective adjustments to the historical loss rates on pools of loans, it is also premature to increase the loss factor. This conclusion results from the absence of a firm decision and adequate information.

Question 14: (December 2008)

How would an announcement of base closure over an 18-month period, beginning in six months, affect the evaluation of the ALLL adequacy?

Staff Response:

A loss event has now occurred that probably will result in the bank subsequently charging off loans to a number of its borrowers. The bank's loan review system should identify those significant, individual borrowers that should be evaluated for impairment under SFAS 114. This standard requires that loan impairment be measured based on the present value of the expected future cash flows discounted at the loan's effective interest rate.

However, as a practical expedient, SFAS 114 allows the use of the loan's observable market price, or the fair value of the collateral if the loan is collateral dependent. In reviewing the loan portfolio, the bank should address issues, such as the effect of the closing on:

- Borrowers with investments in the local real estate and housing rental markets.

- Borrowers operating businesses dependent on the base or its employees, and general retail trade.

For loans previously identified as impaired, an increased provision to the ALLL may be warranted, depending on whether the base closing affects the bank's estimate of the probable loss on these credits. For loans reviewed under SFAS 5, the bank should begin to adjust the historical loss rates as its estimates of probable loss increase for smaller criticized loans in a pool of similar loans, especially those credits that are currently performing and not criticized, but that are likely to be affected adversely by the base closing. The bank should review and monitor such credits. Although the amount of probable loss on those individual credits cannot be estimated yet, it can be measured for pools of similar loans. Those pools should encompass all loans not identified as individually impaired expected to be affected by the base closing, including loans in the commercial, real estate, and consumer portfolios. The more homogeneous are the pools, the easier it will be to analyze and adjust the historical loss rates. The ALLL should reflect the probable increased exposure to loss arising from loans to this group of borrowers.

The staff recognizes that the estimates of the adjustments are subjective. Accordingly, they must be reviewed and refined as it becomes easier to measure the effects of the base closing.

Question 15: (December 2008)

How is the bank's analysis of the ALLL affected in the 12- to 18-month period following the announcement by the base closing?

Staff Response:

The bank should continue to focus on identifying, monitoring, and measuring the effect of the base closing on its borrowers, and on adjusting the ALLL to cover its best estimate of the inherent loss in its portfolio. Estimates of the probable loss should be refined as additional information becomes available. The risk ratings of these loans should also be appropriately adjusted. Additional provisions should be made to the ALLL, when necessary, and loans charged off when they are no longer bankable assets. As the actual effect of the base closing becomes easier to measure, the bank should continue to adjust the loss rates it applies to its loan pools. In time, the bank can identify most of the borrowers affected and have risk rated and provided appropriately for their loans.

Estimates of probable losses on both individual loans and pools of loans should continue to be refined, and appropriate adjustments made to historical loss factors and the balance of the ALLL. This is an ongoing process, and should not be calendar driven.

Facts:

State government officials announce their decision six months after the base closing to open a new minimum security prison facility on the former base site. Conversion of the site will begin in three months, and the prison will open in 12 months.

Question 16:

How will this announcement affect the analysis of the adequacy of the ALLL?

Staff Response:

The bank should begin to consider the possible effects of this “good” news on the local economy and its borrowers. The following questions should be raised:

- Will the business opportunities provided by the new facility improve repayment prospects?
- What will be the effect of the new facility on local employment?
- What will be its effect on the demand for residential and commercial real estate?

Over the next 12 months these questions will become easier to answer. As the local economy and the condition of the credits improve, the bank may be able to revise downward its estimates of probable losses and an adequate level for the ALLL.

Question 17: (September 2001)

Can a bank individually review substandard loans that are not impaired, if such analysis results in a lower estimate of inherent loss?

Staff Response:

Pool analysis is used because there is generally insufficient information to reach loan-by-loan conclusions about the exposure to loss on substandard loans. Accordingly, adequate measurement of the inherent loss may require a pool analysis. As noted in Question 2, inherent losses do exist in the aggregate for substandard loans and an estimate of the inherent loss in a pool of loans generally can be made. The estimate is based on the bank’s historical loss experience, adjusted for current conditions, on similar pools of loans.

To estimate the level of ALLL required for all substandard loans, some banks differentiate between levels of exposure to loss on significant, individual credits in the substandard category. However, the assertion that individually analyzed substandard loans require a level of allowances that is significantly below the historical loss rate for pools of similar loans must be supported clearly by the nature of the collateral or other circumstances that distinguish the loan from similarly classified credits.

Further, removal of loans with less exposure to loss changes the pool's characteristics. No two loans are alike, and the substandard classification is applied to loans with varying degrees of risk. If the lower risk loans are removed from the pool and analyzed individually, the remaining pool will consist of loans with a higher degree of exposure to loss. In providing for the inherent loss in this pool, consideration must be given to the current characteristics of the pool. This generally will lead to increased provisions to the ALLL for this pool.

Facts:

Under the banking agencies' regulatory classification guidelines, "Substandard" assets are defined as assets that are inadequately protected by the current sound worth and paying capacity of the obligor or of the collateral pledged, if any. Assets so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. They are characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.

Question 18: (December 2008)

How should an allowance be established for a commercial loan adversely classified as "Substandard" based on this regulatory classification framework?

Staff Response:

Given the definition, a "Substandard" loan that is individually evaluated for impairment under SFAS 114 (and that is not the remaining recorded investment in a loan that has been partially charged off) would not automatically meet the definition of impaired. However, if a "Substandard" loan is significantly past due or is in nonaccrual status, the borrower's performance and condition provide evidence that the loan is impaired, i.e., that it is probable that the bank will be unable to collect all amounts due according to the contractual terms of the loan agreement. An individually evaluated "Substandard" loan that is determined to be impaired must have its allowance measured in accordance with SFAS 114.

For “Substandard” loans that are not determined to be impaired in accordance with SFAS 114, experience has shown that there are probable incurred losses associated with a group of “Substandard” loans that must be provided for in the ALLL under SFAS 5. Many banks maintain records of their historical loss experience for loans that fall into the regulatory “Substandard” category. A group analysis based on historical experience, adjusted for qualitative or environmental factors, is useful for such loans.

For groups of loans with similar risk characteristics that include both loans classified “Substandard” (and not determined to be impaired) and loans that are not adversely classified, the bank should separately track and analyze the “Substandard” loans in the group. This analysis will aid in determining whether the volume and severity of these adversely classified loans differs from such loans during the period over which the bank’s historical loss experience was developed. This will aid in determining the qualitative adjustment necessary for the group of loans under SFAS 5.

Question 19: (December 2008)

Assume a substandard credit has its ALLL allocation measured in accordance with SFAS 114. Does a percentage relationship between the allocation amount and loan balance suggest the assignment of nonaccrual status and/or doubtful classification?

Staff Response:

There is no allocation percentage that would automatically require a doubtful classification and/or nonaccrual status for a substandard loan. However, specific allocations for individual substandard loans measured in accordance with SFAS 114 raise some difficult questions. First, doesn’t a bank’s estimate of the amount of allowance necessary for the loan present prima facie evidence that there is doubt about its collectibility? Further, if there is doubt about its collectibility, shouldn’t the loan be classified doubtful and put on nonaccrual? While the response to the nonaccrual issue is straight forward, the classification issue is more difficult. With respect to the nonaccrual issue, the call report instructions require that a bank not accrue interest on any loan for which payment in full of principal or interest is not expected. If a loan has been determined to be impaired, doubt of collectibility in accordance with its contractual terms therefore exists. This requires the loan to be placed on nonaccrual in accordance with the call report instructions.

The classification issue requires careful judgment. No two loans are alike. Each classification definition must be applied to loans that possess varying degrees of risk. In most portfolios, a few substandard loans will fall on the line between special mention and substandard, and a few others will be almost doubtful. Although some loans classified as substandard are weaker than others, it may be appropriate to determine that those weaknesses are not so severe as to warrant a doubtful classification. One must keep in mind when deciding whether to make individual allocations for substandard loans that two elements of risk are reflected in our classification system. The risk that the loan will not perform as agreed (the risk of default), and the risk that it will not be repaid in full (the risk of loss).

Loans are classified as substandard because their weaknesses do not reflect the risk of default that warrants a doubtful classification. Nevertheless, in the event of default, varying degrees of exposure to loss will occur within the substandard category. Consideration of collateral, guarantees, etc., is necessary. Exposure to loss on a large, unsecured substandard loan may be substantially greater than on a similarly sized substandard loan that is secured by real estate.

Question 20: (September 2001)

What is a migration analysis and when is it used?

Staff Response:

Migration analysis is a methodology for determining, through the bank's experience over a historical analysis period, the rate of loss incurred on pools of similar loans. Migration analysis may take many forms, ranging from a simple average of the bank's historical loss experience over time to a sophisticated analysis that also weighs differences in underwriting standards, geographic locations, seasoning of loans, etc. The staff has not identified any particular form of migration analysis as being the best, or most appropriate, for all banks.

Question 21: (December 2008)

If a bank concludes that an individual loan specifically identified for evaluation is *not* impaired under SFAS 114, should that loan be included in the assessment of the ALLL under SFAS 5?

Staff Response:

Yes, that loan should be evaluated under SFAS 5. If the specific characteristics of the individually evaluated loan that is not impaired indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics, the loan should be included in the assessment of the ALLL for that group of loans under SFAS 5. Banks should measure estimated credit losses under SFAS 114 only for loans individually evaluated and determined to be impaired.

Under SFAS 5, a loss is recognized if characteristics of a loan indicate that it is probable that a group of similar loans includes some estimated credit losses even though the loss cannot be identified to a specific loan. Such a loss would be recognized if it is probable that the loss has been incurred at the date of the financial statements and the amount of loss can be reasonably estimated. This response is consistent with EITF D-80, Question 10.

Question 22: (December 2008)

If a bank assesses an individual loan under SFAS 114 and determines that it is impaired, but it measures the amount of impairment as zero, should that loan be included in the assessment of the ALLL under SFAS 5?

Staff Response:

No. For an impaired loan, no additional loss recognition is appropriate under SFAS 5 even if the measurement of impairment under SFAS 114 results in no allowance. An example would be when the recorded investment in the impaired loan has been written down to a level where no allowance is required. This response is consistent with EITF D-80, Question 12.

However, before concluding that an impaired SFAS 114 loan needs no associated loss allowance, the bank should determine and document that its measurement process is appropriate and that it considered all available and relevant information. For example, for a collateral-dependent loan, the following factors should be considered in the measurement of impairment under the fair value of collateral method: volatility of the fair value of the collateral, timing and reliability of the appraisal or other valuation, timing of the bank's or third party's inspection of the collateral, confidence in the bank's lien on the collateral, historical losses on similar loans, and other factors as appropriate for the loan type.

This response is consistent with the *Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* (2001 Policy Statement), Question 3, and the Securities and Exchange Commission's Staff Accounting Bulletin No. 102, Question 7.

Question 23: (December 2008)

Is the practice of "layering" the ALLL appropriate?

Staff Response:

No. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same estimated credit loss. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. One example of inappropriate layering occurs when a bank includes a loan in one loan category, determines its best estimate of loss for that loan category, and then includes the loan in another loan category, which receives an additional ALLL amount.

Another example of inappropriate layering occurs when an allowance has been measured for a loan under SFAS 114, but the loan is then included in a group of loans with similar risk characteristics for which an ALLL is estimated under SFAS 5. The allowance provided for an individually impaired loan under SFAS 114 can not be supplemented by an additional allowance under SFAS 5. Inappropriate layering occurs when a bank includes a loan in two different SFAS 5 pools of loans for purposes of providing an allowance. When measuring and documenting estimated credit losses, banks should take steps to prevent the layering of loan loss allowances. This is consistent with the 2001 Policy Statement, Appendix B.

Question 24: (September 2001)

Assume the loan review and allocation process operates satisfactorily, and losses are recognized promptly. Is it acceptable for there to be no provision to the ALLL for a pool of uncriticized loans?

Staff Response:

By definition, uncriticized loans do not have inherent loss individually. However, experience indicates that some loss could occur even when loan review systems provide timely problem loan identification. A lack of information or misjudgment could result in failure to recognize that an uncriticized credit has become impaired.

Accordingly, banks must include a provision in the ALLL for those existing, but unidentified, losses in pools of uncriticized loans. The loss factor for pools of pass loans in banks possessing a reliable loan review system should be much smaller than it is in banks lacking adequate loan review systems.

Migration analysis is often applied to pools of past due and/or classified loans, because their classification reflects the fact that a loss event has probably already occurred.

Question 25: (December 2008)

Is it appropriate to estimate an allowance for “pass” loans?

Staff Response:

Yes. In determining an appropriate level for the ALLL, a bank must analyze the entire loan and lease portfolio for probable losses that have been incurred that can be reasonably estimated. A loan designated “pass” generally would not be impaired if individually evaluated. However, if the specific characteristics of such a loan indicate that it is probable that there would be an estimated credit loss in a group of loans with similar characteristics, then the loan should be included in the assessment of the ALLL for that group of loans under SFAS 5.

Under SFAS 5, the determination of estimated credit losses may be considered for individual loans or in relation to groups of loans with similar characteristics. This determination should be made on a group basis even though the loans that are uncollectible in the group may not be individually identifiable. Accordingly, the ALLL for a group of loans with similar risk characteristics, which includes loans designated as "pass," should be measured under SFAS 5.

Question 26: (September 2001)

Do specific guidelines exist for the "qualitative" or "environmental" adjustment factors?

Staff Response:

These factors require judgments that cannot be subjected to exact mathematical calculation. There are no formulas for translating them into a basis-point adjustment of the bank's historical loss rate for a pool of loans. The adjustment must reflect management's overall estimate of the extent to which current losses on a pool of loans will differ from historical loss experience. It would include management's opinion on the effects of current trends and economic conditions on a loss rate derived through historical analysis of a pool of loans.

Those adjustments are highly subjective estimates that should be reviewed at least quarterly in light of current events and conditions. Management should document carefully the qualitative factors considered and the conclusions reached.

Question 27: (December 2008)

How should a bank document and support the qualitative or environmental factors used to adjust historical loss experience to reflect current conditions as of the financial statement date?

Staff Response:

As noted in the 2006 Policy Statement, banks should support adjustments to historical loss rates and explain how the adjustments reflect current information, events, circumstances, and conditions in the loss measurements. Management should maintain reasonable documentation to support which factors affected the analysis and the impact of those factors on the loss measurement. Support and documentation includes descriptions of each factor, management's analysis of how each factor has changed over time, which loan groups' loss rates have been adjusted, the amount by which loss estimates have been adjusted for changes in conditions, an explanation of how management estimated the impact, and other available data that supports the reasonableness of the adjustments. Examples of underlying supporting evidence could include, but are not limited to, relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers.

Management must exercise significant judgment when evaluating the effect of qualitative factors on the amount of the ALLL because data may not be reasonably available or directly applicable for management to determine the precise impact of a factor on the collectibility of the institution's loan portfolio as of the evaluation date. For example, the bank may have economic data that shows commercial real estate vacancy rates have increased in a portion of its lending area. Management should determine an appropriate adjustment for the effect of that factor on its current portfolio that may differ from the adjustment made for the effect of that factor on its loan portfolio in the past. It is management's responsibility to use its judgment to determine the best estimate of the impact of that factor and document its rationale for its best estimate. This rationale should be reasonable and directionally consistent with changes that have occurred in that factor based on the underlying supporting evidence previously discussed.

Question 28: (December 2008)

If a bank measures impairment based on the present value of expected future cash flows for SFAS 114 purposes, what factors should be considered when estimating the cash flows?

Staff Response:

The bank should consider all available information reflecting past events and current conditions when developing its estimate of expected future cash flows. All available information would include a best estimate of future cash flows taking into account existing "environmental" factors (e.g., existing industry, geographical, economic, and political factors) that are relevant to the collectibility of that loan. This response is consistent with EITF D-80, Question 16.

Facts:

A bank writes down an individually impaired loan to the most recently appraised value of the collateral because that portion of the loan has been identified as uncollectible, and, therefore, is deemed to be a confirmed loss.

Question 29: (December 2008)

Should there be a loan loss allowance under SFAS 114 associated with the remaining recorded investment in the loan?

Staff Response:

Generally, yes. Typically, the most recent appraised value will differ from fair value (less costs to sell) as of the balance sheet date. For an impaired collateral-dependent loan, the bank should generally charge off any portion of the recorded investment in excess of the fair value of the collateral. Estimated costs to sell also must be considered in the measure of the ALLL under SFAS 114 if these costs are expected to reduce the cash flows available to satisfy the loan.

Although the bank should consider the appraised value of the collateral as the starting point for determining its fair value, the bank should also consider other factors and events that may affect the current fair value of the collateral since the appraisal was performed. The bank's experience with realization of the appraised values of impaired collateral-dependent loans should also be taken into account. In addition, the timing of expected cash flows from the underlying collateral could affect the fair value of the collateral if the timing differs from that contemplated in the appraisal. This may result in the appraised value of the collateral being greater than the bank's current estimate of the collateral's fair value (less costs to sell).

As a consequence, the bank's allowance for the impaired collateral-dependent loan under SFAS 114 is based on fair value (less costs to sell), but the charge-off (the confirmed "loss") is based on the higher appraised value. The remaining recorded investment in the loan after the charge-off will have a loan loss allowance for the amount by which the estimated fair value of the collateral (less costs to sell) is less than its appraised value. This is consistent with the guidance in Appendix B of the 2001 Policy Statement, which notes that the bank would classify as "Loss" the portion of the recorded investment deemed to be the confirmed loss, and classify the remaining amount as "Substandard."

Facts:

Some banks remove loans that become adversely classified from a group of "pass" loans with similar risk characteristics in order to evaluate the loans individually under SFAS 114 (if deemed impaired) or collectively in a group of adversely classified loans with similar risk characteristics under SFAS 5.

Question 30: (September 2001)

How does this removal of loans from the pool affect the calculation of the historical loan rates?

Staff Response:

Loans that have been analyzed individually and provided for in the ALLL should be included in their respective pools of similar loans to determine the bank's historical loss experience. This will provide a more meaningful analysis of loss ratios or percentages on loans with similar characteristics. *However, to avoid double accounting of inherent loss, any loan that has been provided for should be excluded from the current pool of loans when applying the historical loss factor to estimate the losses in the remaining pool.*

Question 31: (December 2008)

May a bank include amounts designated as "unallocated" in its ALLL?

Staff Response:

Yes, the ALLL may include an amount labeled as "unallocated" as long as it reflects estimated loan losses determined in accordance with GAAP and is properly supported. The term "unallocated" is not defined in GAAP, but has various meanings in practice. For example, some banks refer to the portion of the ALLL based on qualitative or environmental factors as "unallocated," while others consider those adjustments to be an element of the "allocated" ALLL under SFAS 5. Still others believe "unallocated" refers to any ALLL amounts that are not attributable to or were not measured on any particular groups of loans.

Economic developments that surface between the time management estimates credit losses and the date of the financial statements, as well as certain other factors such as natural disasters that occur before the date of the financial statements, are examples of environmental factors that may cause losses that apply to the portfolio as a whole and are difficult to attribute to individual impaired loans or to specific groups of loans and, as a consequence, result in an "unallocated" amount.

An "unallocated" portion of the ALLL may or may not be consistent with GAAP. If a bank includes an amount labeled "unallocated" within its ALLL that reflects an amount of estimated credit losses that is appropriately supported and documented, that amount would be acceptable as part of management's best estimate of credit losses. The label "unallocated," by itself, does not indicate whether an amount so labeled is acceptable or unacceptable within management's estimate of credit losses. Rather, it is management's objective evidence, analysis, and documentation that determine whether an "unallocated" amount is an acceptable part of the ALLL under GAAP.

Appropriate support for any amount labeled "unallocated" within the ALLL should include an explanation for each component of the "unallocated" amount, including how the component has changed over time based upon changes in the environmental factor that gave rise to the component. In general, each component of any "unallocated" portion of the ALLL should fluctuate from period to period in a manner consistent with the factors giving rise to that component (i.e., directional consistency).

Question 32: (December 2008)

Is there a specific period of time that should be used when developing historical experience for groups of loans to estimate the SFAS 5 portions of the ALLL?

Staff Response:

There is no fixed period of time that banks should use to determine historical loss experience. During periods of economic stability, a relatively long period of time may be appropriate. However, during periods of significant economic expansion or contraction, the relevance of data that are several years old may be limited. Accordingly, the period used to develop a historic loss rate should be long enough to capture sufficient loss data. At some banks, the length of time used varies by product; high-volume consumer loan products generally use a shorter time period than more specialized commercial loan products.

A bank should maintain supporting documentation for the techniques used to develop its loss rates. Such documentation includes evidence of the average and range of historical loss rates (including gross charge-offs and recoveries) by common risk characteristics (e.g., type of loan, loan grade, and past due status) over the historical period of time used. At larger banks, this information is often further segmented by originating branch office or geographic area. A bank's supporting documentation should include an analysis of how the current conditions compare to conditions during the time period used in the historical loss rates for each group of loans assessed under SFAS 5. A bank should review the range of historical losses over the time period used, rather than relying solely on the average historical loss rate, and should identify the appropriate historical loss rate from within that range to use in estimating credit losses for the groups of loans. This ensures that the appropriate historical experience is captured and is relevant to the bank's current portfolio.

Question 33: (December 2008)

How should a bank that has had a very low or zero historical loss rate over the past several years use this historical loss experience in calculating estimated credit losses for loans that are not determined to be impaired?

Staff Response:

As noted in the 2006 Policy Statement, historical loss experience provides a reasonable starting point for the bank's analysis. However, historical losses, or even recent trends in losses, are not by themselves a sufficient basis to determine the appropriate level for the ALLL. Because the bank's historical loss experience is minimal, any SFAS 5 allowances that exceed the historical loss experience should be based on qualitative or environmental factors. Management should consider such factors as changes in lending policies, changes in the trend and volume of past due and adversely classified loans, changes in local and national economic conditions, and effects of changes in loan concentrations. This will ensure that the ALLL reflects estimated credit losses in the current portfolio.

Question 34: (December 2008)

How should guarantor payments and proceeds anticipated from conversion of collateral be handled when measuring impairment under SFAS 114 using the present value of expected cash flows method?

Staff Response:

All expected cash flows should be included when measuring the amount of impairment for an individually evaluated credit. Per SFAS 114, estimated cash flows should be based on reasonable and supportable assumptions and projections considering all available evidence. Anticipated payments directly from the borrower serve as the primary component in the discounted cash flow model. In addition, any anticipated repayment from a guarantor or through collateral conversion (reduced by estimated selling costs) should be captured in the expected cash flow analysis.

Question 35: (September 2001)

Do “trends” in describing the qualitative factors imply recognition of future losses?

Staff Response:

The word “trends” refers to the effect of current trends on the historical rate of loss. It refers only to effects through the evaluation date and does not imply that the bank should try to capture the effects of possible future events in its adjustment for historical loss factors. Qualitative adjustments to historical loss experience are important in estimating the level of loss inherent in the current loan portfolio. As an example, a recent adverse trend in delinquencies and nonaccruals reflects loss events that have already occurred. The resulting increase in charge-offs may not yet be reflected fully in the historical loss experience. However, this trend must be considered when determining the adequacy of the ALLL.

Similarly, a recent deteriorating trend in the local economy is, in itself, an event that has adversely affected the bank’s borrowers and will probably result in its charging off loans at a greater rate than its historical loss experience indicates. The bank’s historical loss factor should, therefore, be adjusted to provide for an increased level of charge-offs.

Finally, a recent change in the volume and terms of loans being originated may affect (either positively or negatively) charge-offs. If, for example, the bank tightened its approval standards for new credit card borrowers, or increased the level of holdback on discounted paper, it could reasonably expect lower levels of loss on those pools of loans in the future.

Question 36:

In the "Interagency Policy Statement on the Review and Classification of Commercial Real Estate Loans," the discussion of the ALLL urges consideration of ". . . reasonably foreseeable events that are likely to affect the collectibility of the loan portfolio." Does this statement conflict with the guidance given in the previous responses?

Staff Response:

The staff does not believe that conflict exists. The interagency policy statement addresses troubled, collateral-dependent real estate loans. For such a loan, the value of the collateral is critical in determining the loan classification and the level of the ALLL. Expectations about the effects of reasonably foreseeable events are inherent in the valuation of real estate.

For example, a real estate loan may be secured by a property with a significantly above market (but soon to expire) lease. This lease will not be renewed at its current rate. This reasonably foreseeable event should be considered in valuing the property. Another reasonably foreseeable event would be construction of a new commuter rail station. It would almost certainly affect nearby property values in a positive manner.

The departure of the tenant and completion of construction resemble "confirming events" more than "loss events." In the first example, the value decline is inherent in the fact that an existing lease will expire and will no longer generate the current above market level of income. In the second example, property values will increase well before construction is complete.

Question 37: (December 2008)

Will a bank be subject to criticism if its methodology is inappropriate, but its ALLL balance is appropriate?

Staff Response:

Yes. The OCC places increased emphasis on an ALLL evaluation process that is sound, based on reliable information, and well documented. Even if a bank's current ALLL balance is appropriate, management does not have a sound basis for determining an appropriate level for the ALLL on an ongoing basis if its evaluation process is deficient.

Question 38: (December 2008)

Must bank management review the appropriateness of the ALLL quarterly?

Staff Response:

The appropriateness of the ALLL must be reviewed at least quarterly. Otherwise, management may not be able to determine the accuracy of the bank's call reports. However, significant loans analyzed individually should be monitored regularly, and provisions made to the ALLL as events occur. This should be a continuous, and not calendar driven, process.

The amount of time that elapses between reviews for pools of loans and other less significant, individually analyzed loans affects the strength of the loan review process. The process should also react to internal and external events that might indicate problems in a particular credit or group of credits.

Question 39: (September 2001)

Do materially excessive allowances also pose a problem?

Staff Response:

The risk of error or imprecision is inherent in the entire allocation process. Accordingly, as noted in Emerging Issues Task Force Topic D-80, most guidance has discussed the ALLL in the context of a range of reasonable estimates. A bank should recognize its best estimate within its estimated range of losses. In this process, banks should take into account all available information existing as of the measurement date, including "environmental" factors.

However, an ALLL that clearly and substantially exceeds the required level misstates both the earnings and condition of the bank and constitutes a violation of 12 USC 161. Elimination of such excess ALLL should be accounted for as a credit to (or reduction in) the provision for loan and lease losses. If an improper estimate or error is discovered after a call report is filed, the guidance in the call report instructions for accounting changes should be consulted.

Question 40: (December 2008)

What action must a bank take when its ALLL is not appropriate?

Staff Response:

The staff believes that an ALLL established in accordance with the 2006 Policy Statement and the 2001 Policy Statement falls within the range of acceptable estimates determined in accordance with GAAP. When the reported amount of a bank's ALLL is not appropriate, the bank will be required to adjust its ALLL by an amount sufficient to bring the ALLL reported on its call report to an appropriate level as of the evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate in the circumstances.

Facts:

A bank has overdraft accounts of approximately $2 million. As of the reporting period date, approximately $200,000 is deemed to be uncollectible.

Question 41: (April 2005)

How should the bank account for losses related to the overdraft accounts?

Staff Response:

Any losses related to these accounts should be charged against the ALLL. In accordance with the AICPA Audit and Accounting Guide for Depository and Lending Institutions, checking accounts that are overdrawn should be reclassified as loans and should, therefore, be evaluated for collectibility as part of the evaluation of the ALLL. Since the bank's ALLL methodology is required to consider the overdraft accounts, the subsequent charge offs of the overdraft accounts would be charged against the ALLL.

If the bank did not properly consider the overdraft accounts part of its ALLL methodology, it would not be appropriate to charge off losses to the ALLL without recording a corresponding provision for these accounts. The bank would need to reassess the provision for the outstanding overdraft accounts and make an appropriate adjustment to the ALLL, as necessary.

Facts:

A bank offers an overdraft protection program to a specific class of customers under which it may at its discretion pay overdrafts up to a specified amount. The overdraft protection essentially serves as a short-term credit facility; however, no analysis of the customer's creditworthiness is performed. The bank charges the customer a flat fee each time the service is triggered, and a daily fee for each day the account remains overdrawn. As of the reporting period date, the bank has overdraft account balances of $2 million (excluding associated fees), of which $200,000 is deemed to be uncollectible.

Question 42: (April 2005)

How should the bank account for uncollectible overdraft protection fees?

Staff Response:

The bank may provide a loss allowance for uncollectible fees or recognize in fee income only that portion of earned fees estimated to be collectible. The bank may charge off uncollected overdraft fees against the ALLL only if such fees are recorded with overdraft account balances as loans, and the estimated losses on the fees are provided for in the ALLL.

Question 43: (June 2003)

Since the call report instructions do not require consumer credit card loans to be placed on nonaccrual based on delinquency status, how should a bank determine that income is recorded accurately?

Staff Response:

Because a portion of the accrued interest and fees on credit card accounts is generally not collectible, banks must evaluate the collectibility of the accrued interest and fees. In this respect, a bank may provide a loss allowance for these uncollectible interest and fees, or place the delinquent loans and impaired receivable on nonaccrual status. This allowance may be included in the ALLL, as a contra account to the credit card receivables, or in other liabilities. However, regardless of the method employed, banks must ensure that income is measured accurately.

Question 44: (June 2003)

How should banks treat over-limit credit card accounts in their ALLL methodologies?

Staff Response:

Bank ALLL methodologies do not always recognize fully the loss inherent in over-limit credit card accounts. For example, if borrowers are required to pay over-limit and other fees, in addition to the minimum payment amount each month, roll rates and estimated losses may be higher than indicated on the overall portfolio analysis. Accordingly, banks should ensure that their ALLL methodology addresses the incremental losses that may be inherent on over-limit credit card accounts.

Question 45: (December 2008)

How should banks provide for the loss inherent in credit card workout programs?

Staff Response:

As noted in Question 5, large groups of smaller-balance homogeneous loans, such as credit card loans, that are collectively evaluated for impairment are not included in the scope of SFAS 114, and the guidance for groups of smaller-balance homogeneous loans contained in SFAS 5 is applied. However, if the smaller-balance loan has been modified in a troubled debt restructuring as defined by SFAS 15, impairment should be assessed in accordance with SFAS 114. Banks should determine whether the credit card workout program qualifies as troubled debt restructurings.

Banks should ascertain that their ALLL provides appropriately for the estimated credit loss in credit card workout programs. Accounts in workout programs should be segregated for performance measurement, impairment analysis, and monitoring purposes. When the bank has multiple programs with different performance characteristics, each program should be reviewed separately.

An appropriate allowance should be established and maintained for each program. Generally, the ALLL allocation should equal the estimated loss in each program based on historical experience adjusted for current conditions and trends. These adjustments should take into account changes in economic conditions, volume and mix of the accounts, terms and conditions of each program, and collection history.

Question 46: (June 2003)

After a credit card loan is charged off, how should banks account for subsequent collections on the loan?

Staff Response:

Recoveries represent collections on amounts that were previously charged off against the ALLL. Accordingly, the total amount credited to the ALLL as a recovery on a credit card loan (which may include amounts representing principal, interest, and fees) is limited to the amount previously charged off against the ALLL on that loan. Any amounts collected in excess of the amount previously charged off should be recorded as income.

In certain instances the OCC has noted that the total amount credited to the ALLL on an individual loan exceeds the amount previously charged off against the ALLL for that loan. Such a practice understates a bank's net charge-off experience, which is an important indicator of the credit quality and performance of a bank's portfolio. Accordingly, such a practice is not acceptable.

Facts:

Two severe hurricanes caused severe damage to certain geographic regions late in the third quarter of 20XX.

Question 47: (May 2006)

How should banks with borrowers affected by the hurricanes determine the appropriate amount to report for their ALLL in their financial statements for the third quarter of 20XX?

Staff Response:

For banks with loans to borrowers in the affected area, it may be difficult at that date to determine the overall effect that the hurricanes will have on the collectibility of these loans. Many of these banks will need time to evaluate their individual borrowers, assess the condition of underlying collateral, and determine potential insurance proceeds and other available recovery sources.

For its financial statements, management should consider all information available about the collectibility of the bank's loan portfolio to make its best estimate of probable losses within a range of loss estimates, recognizing that there is a short time between the storms' occurrence and the required filing date for the third quarter financial statements. Consistent with GAAP, the amounts included in the ALLL in third quarter call reports for estimated credit losses incurred as a result of the hurricanes should include those amounts that represent probable losses that can be reasonably estimated. As banks are able to obtain additional information about their loans to borrowers affected by the hurricanes, the estimates of the effect of the hurricanes on loan losses could change over time and the subsequent estimates of loan losses would be reflected in the banks' subsequent financial statements.

In particular, for commercial loans whose terms have been modified in a TDR that provides for a reduction of either interest or principal (referred to as a modification of terms), banks should measure the impairment loss on the restructured loan in accordance with SFAS 114. In this regard, a credit analysis should be performed in conjunction with the restructuring to determine the loan's collectibility and estimated impairment. The amount of this impairment should be included in the ALLL. As additional information becomes available indicating a specific commercial loan, including a loan that is a TDR, will not be repaid, an appropriate charge-off should be recorded.

Facts:

Customer A, with a $100,000 line of credit, draws the line of credit down fully, then intentionally pays the loan off with a bad check drawn on another institution. The customer immediately draws down an additional $100,000 before the check clears. Customer A now owes the bank $200,000, although the amount of credit extended was only $100,000. The customer does not have the ability to repay the debt.

Question 48: (December 2008)

Is $100,000 charged against the ALLL and $100,000 classified as an operational loss?

Staff Response:

No. This entire loss should be recorded through the ALLL. While a portion of the loss includes apparently fraudulent actions on the part of Customer A, the activity occurred within the bank’s legitimate lending function. Even though the credit limit was $100,000, the bank ultimately loaned the borrower $200,000. Since the losses relate to the bank's actions for Customer A's credit, it is considered a credit loss and charged against the ALLL.

The staff considers the following definitions to distinguish fraud as operational losses charged to other noninterest expense or as credit losses charged against the ALLL:

Credit Loss

Losses that arise from a contractual relationship between a creditor and a borrower (i.e. the bank still has legal ability to collect from a borrower).

Credit losses arise from the contractual relationship between a creditor and a borrower and may result from the creditor’s own underwriting, processing, servicing or administrative activities along with the borrower’s failure to pay according to the terms of the loan agreement. While the creditor’s personnel, systems, policies or procedures may affect the timing or magnitude of a credit loss, they do not change its character from credit to operational.

The accounting guidance for credit losses provides that creditors recognize credit losses when it is probable that they will be unable to collect all amounts due according to the contractual terms of a loan agreement.

Operational Loss

Losses that arise outside of a relationship between a creditor and a borrower (i.e. the bank does not have the legal ability to collect from a borrower) are considered operational losses. If these losses are “probable” and “reasonably estimable” as defined in SFAS 5, an expense should be accrued and an other liability recorded. Once the actual losses are confirmed, they should be charged against the other liability.

Facts:

An independent third party steals the identification and credit card numbers of various individuals and then uses an illegal credit card machine to create counterfeit credit cards bearing the names and card numbers of the individuals. Subsequently, charges are made on these counterfeit cards, and losses are incurred by the bank.

Question 49: (December 2008)

Should these losses be charged against the ALLL?

Staff Response:

No. This would be considered an operational loss as the bank did not issue the credit cards and did not have a contractual relationship with a borrower. The bank could not legally collect from a borrower because it was not the borrower's charges.