

# Allowance for Loan and Lease Losses: Trends, Challenges and the Future

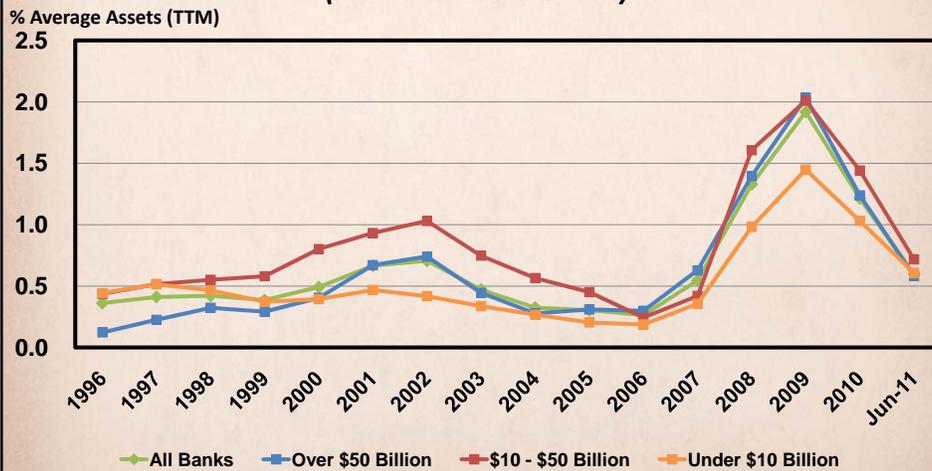


**Carol Gross**  
**Senior Examiner**  
**Federal Reserve Bank of Kansas City**  
**Supervision and Risk Management Division**

*Any comments or statements in this presentation represent the views of the authors only and not necessarily those of the Federal Reserve Bank of Kansas City or the Federal Reserve System.*

Accounting & Auditing Roundtable 2011

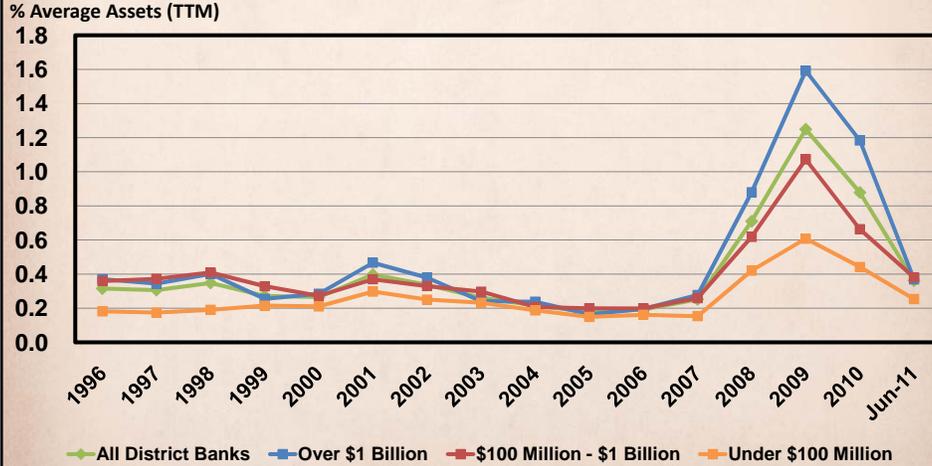
## Provisions Have Declined (All Commercial Banks)



Provisions for loan loss as a percentage of average assets (TTM) – Annualized  
 Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

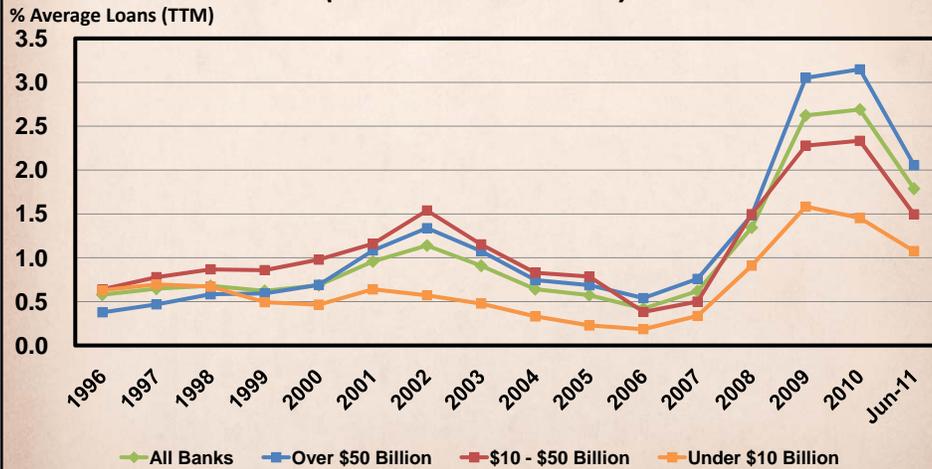
## Provisions Have Declined (Tenth District Banks)



Provisions for loan loss as a percentage of average assets (TTM) – Annualized  
Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

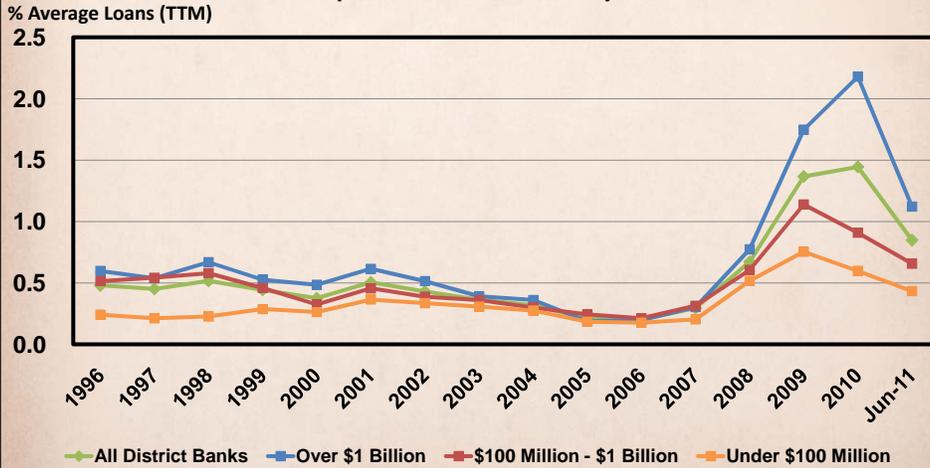
## Loan Losses Have Decreased (All Commercial Banks)



Net loan loss as a percentage of average loans (TTM) – Annualized  
Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

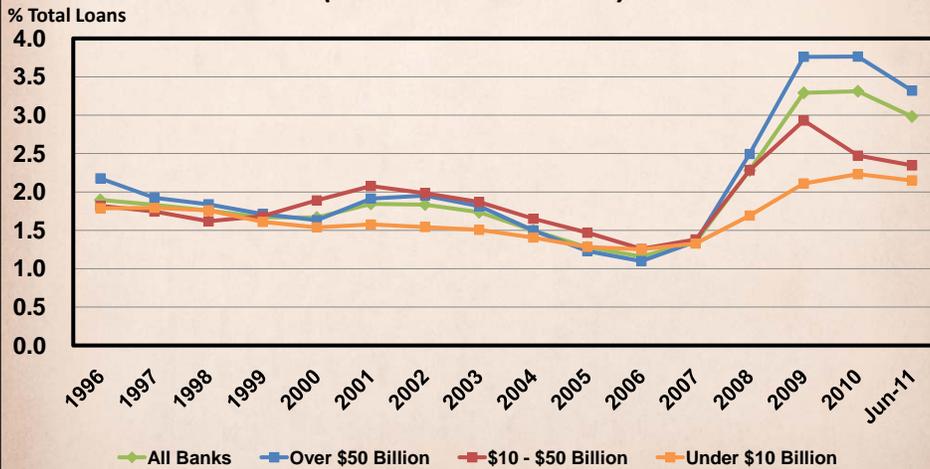
## Loan Losses Have Decreased (Tenth District Banks)



Net loan loss as a percentage of average loans (TTM) – Annualized  
Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

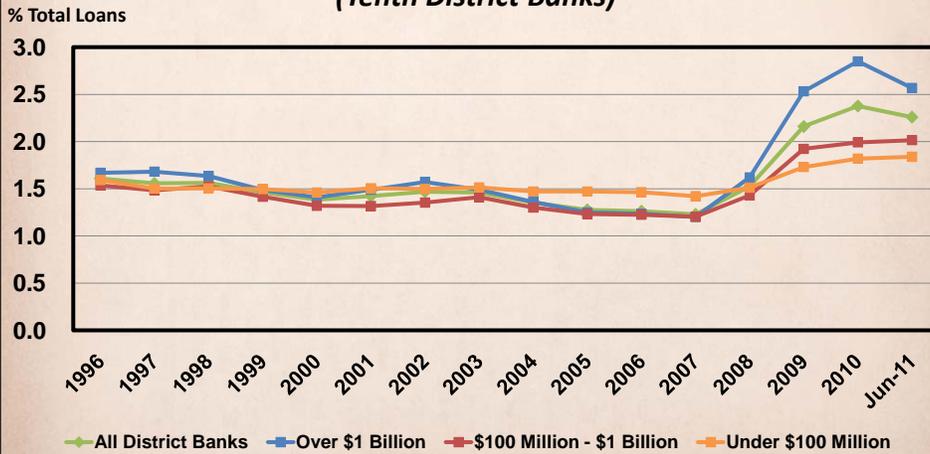
## Allowance For Loan Losses Declined (All Commercial Banks)



Allowance for loan loss as a percentage of total loans  
Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

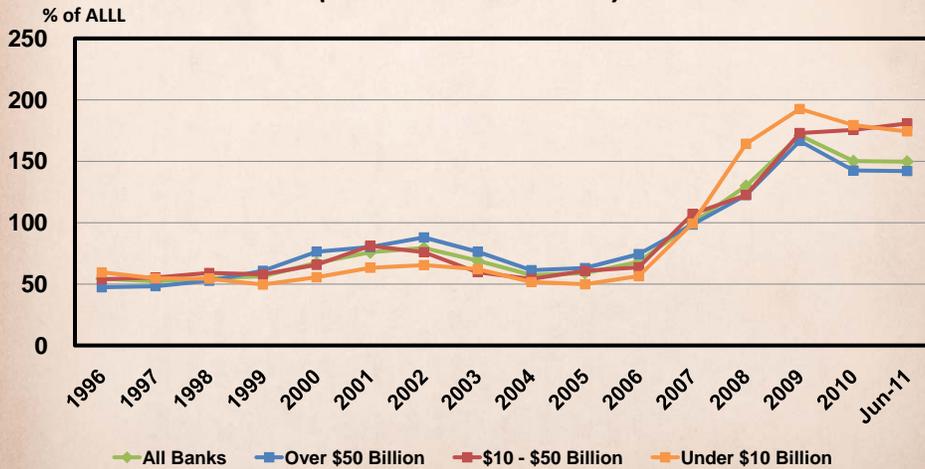
## Allowance For Loan Losses Remains Steady, But Has Declined For Larger District Banks *(Tenth District Banks)*



Allowance for loan loss as a percentage of total loans  
Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

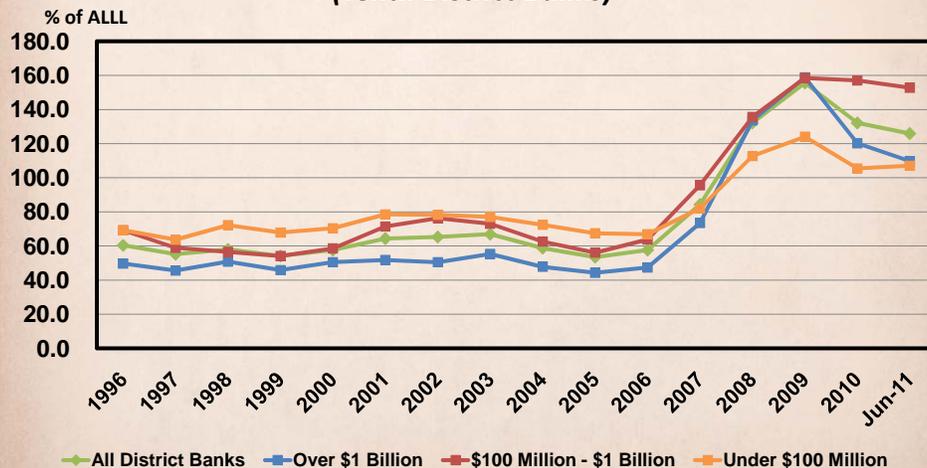
## Noncurrent Loans Still Exceed ALLL *(All Commercial Banks)*



Noncurrent loans as a percentage of the allowance for loan loss  
Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

## Noncurrent Loans Still Exceed ALLL (Tenth District Banks)



Noncurrent loans as a percentage of the allowance for loan loss  
Source: Reports of Condition and Income

Accounting & Auditing Roundtable 2011

## ALLL: Accounting Concepts (ASC 310)

- GAAP definition of impairment: *A loan is impaired when it is probable that the entity will be unable to collect all amounts due according to the contractual terms of the receivable\** (ASC 310-10-35-10)
- ALLL is an estimate of losses for loans held for investment
  - Loans outside of the scope of this ASC:
    - Groups of homogeneous loans (ASC 450-20),
    - Unfunded loan commitments (ASC 450-20),
    - Loans held for sale (Interagency Policy Statement issued March 2001),
    - Purchased impaired loans at initial recording (ASC 310-30),
    - Purchased nonimpaired loans at initial recording (ASC 805),
    - Loans measured under the Fair Value Option (ASC 825-10-15),
    - Loans reported at fair value (ASC 948),
    - Leases (ASC 840)
  - Impairment for loans within the scope of this ASC measured in one of 3 ways...

\*Need not consider an insignificant delay or insignificant shortfall in amount of payments

Accounting & Auditing Roundtable 2011

## Impairment – Accounting Guidance

ASC 310-10-35-22: Measure impairment based on:



Present value of expected future cash flows discounted at the loan's effective interest rate



Loan's observable market price



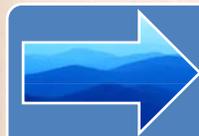
Fair value\* of the collateral, if the loan is collateral dependent\*\*

\* Per ASC Master Glossary: *The amount at which an asset (or liability) could be bought (or incurred) or sold (or settled) in a current transaction between willing parties, that is, other than in a forced or liquidation sale.*

\*\* This method is required (per Call Report instructions) if the loan is collateral dependent.

Accounting & Auditing Roundtable 2011

## Impairment – Supervisory Guidance



FFIEC Instructions for Preparation of Consolidated Reports of Condition and Income (Call Report Instructions)



*Interagency Policy Statement on the Allowance for Loan and Lease Losses (SR 06-17, OCC 2006-47, FIL 105-2006)*



*Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions (SR 01-17, OCC 2001-37, FIL 63-2001, CEO #250)*

Accounting & Auditing Roundtable 2011

## ASC 310/ALL Issues

### Impaired Loans

- Inconsistent definition of 'impaired'

### Collateral Value

- Appraisal/evaluation outdated
- Value not adjusted for costs to sell

### Other Factors

- Misunderstanding accounting and supervisory guidance within the lending function

Accounting & Auditing Roundtable 2011

## ALL: More Accounting Concepts (ASC 450)

- GAAP requires an estimated loss from a loss contingency shall be accrued by a charge to income if **both** of the following conditions are met:
  - a. Information available before the financial statements are issued indicates that it is probable that an asset had been impaired at the date of the financial statements **and**
  - b. The amount of loss can be reasonably estimated.  
(ASC 450-20-25-2)
- Probable is defined as: *the future event or events are likely to occur.*

Accounting & Auditing Roundtable 2011

## ASC 450/ALLL Issues

### Historic Analysis

- Historical loss period is inappropriate
- No linkage to actual experience
- Impaired loans not segregated from rest of portfolio
- Selective exclusion of large losses

### Analysis Adjustment

- Selective use of economic and business trends
- Inadequate assessment of changes in volume/severity of past dues
- Provisions are made based on budget rather than comprehensive analysis of current portfolio condition

### Other Factors

- Changes in lending policies, procedures, staffing, loan review system, nature/volume of portfolio
- Changes in underlying collateral value
- Concentrations – volume/level/trend

Accounting & Auditing Roundtable 2011

## ASC 450/ALLL Issues

### Inconsistent Methods

- Inconsistent use of factors in analysis over time

### Insufficient Documentation

- Qualitative adjustments are not adequately supported
- Inconsistent with methodology
- No supporting documentation
- Use of quantitative measures only (ratios without analysis)

### Directional Inconsistency

- Problem loans increase and ALLL (proportionately to problems) decreases
- ALLL components increase but adjustments decrease

Accounting & Auditing Roundtable 2011

## ALLL Issues Junior Liens on 1-4 Family

### Issue

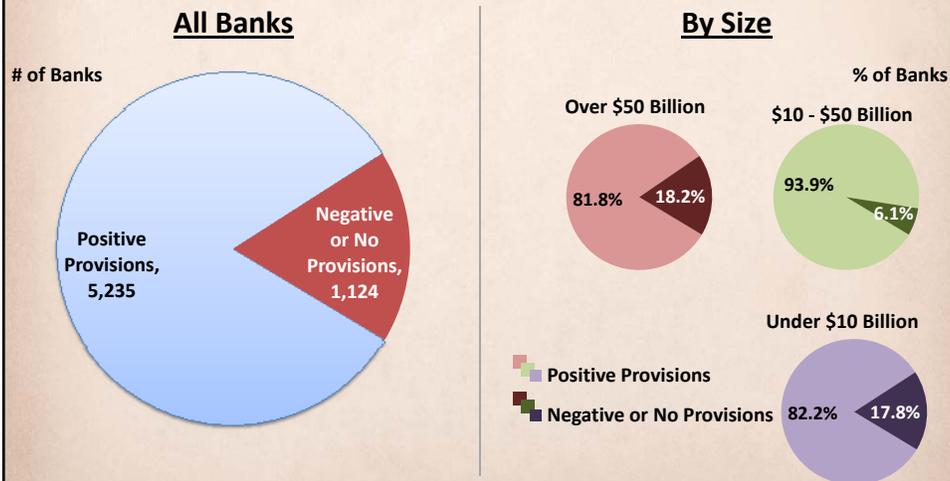
- Investor/Analyst concern over volume of troubled HELOCs in areas where there have been declines in residential values
- Regulatory ALLL guidance
- SEC disclosure expectations

### Policies/ Procedures

- Establish policy – contact , MIS reporting, bids on foreclosure sales, ALLL methodology
- Track status on first liens/collectability of 2nd liens
- Determine collateral values
- Conversion to amortizing

Accounting & Auditing Roundtable 2011

## Current Bank Provisions (All Commercial Banks)



Source: Reports of Condition and Income – June 2011

Accounting & Auditing Roundtable 2011

## ALLL Issues

### Negative Provision for Loan Loss

#### Board and Senior Management

- Refer to regulatory guidance
- Support ALLL level and conclusions
- Be cautious

#### Examiners

- Healthy skepticism when analyzing appropriateness of reserves
- Looking for strong evidence of sustainable, improving loan performance and reduced loss rates

Accounting & Auditing Roundtable 2011

## The Future of the ALLL

- FASB's Exposure Draft: *Accounting for Financial Instruments and Revisions to the Accounting for Derivative Instruments and Hedging Activities*
  - Impairment Measurement
    - Expected loss model vs. historical loss model
    - Numerous comments on Exposure Draft – good book/bad book
    - FASB issued Supplementary Document – Three-Bucket Approach
    - Redeliberations ongoing

Accounting & Auditing Roundtable 2011