Allowance for Loan and Lease Losses: Current Issues

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Allowance for Loan and Lease Losses: Current Issues

- Concern Over the Pace and Magnitude of Allowance for Loan and Lease Losses (ALLL) Releases
- Appropriate look-back period for calculating loss rates
- Qualitative factors
- Calculating the ALLL on junior lien portfolios
- Definition of a collateral dependent loan
- Calculating the present value of cash flows
- Concern over the pace and magnitude of ALLL releases

Percentage of Allowance for Loan and Lease Losses Release to Earnings

*Provision release represents excess of net charge-off over provision

Source: Derived from Q2 Earnings Releases
Credit Quality

System charge-off rates improved across all loan types, but most still above long-term averages

Credit Quality Indicators Improving but Elevated
• Yield and earnings pressure
  – Increasing competition for limited “good” loans results in loosening underwriting
• Commercial real estate risk remains elevated
  – Difficult workouts
  – Modifications, interest-only structures
  – Risk rating accuracy
• New/Less familiar products
  – Oil and gas, asset-based lending, leverage loans, commercial and industrial
• Home equity payment shock on the horizon

Credit & Market Risk
Accounting & Auditing Roundtable 2012
Examiner Focus

- Examiners will Require that the ALLL be Established in Accordance with Supervisory Guidance
- Examiners will approach significant decreases in the allowance with caution
- Examiners will look for evidence of solid trends
- Examiners will review documentation and support
  - Are the qualitative adjustments sufficient?

Securities Exchange Commission, Public Company Accounting Oversight Board, Audit Firms

- Securities and Exchange Commission and Public Company Accounting Oversight Board have commented on documentation of qualitative and environmental factors
  - Comments are specifically about documentation and **not** about levels of the ALLL
- Meetings with auditors
Other Current Issues: Loss History

Loss Histories

- What is the appropriate time horizon for calculating historical loss rates?
  - There is no fixed period of time that banks should use to determine the historical loss experience

Loss Histories

- A bank’s supporting documentation should include an analysis of how the current conditions compare with those conditions during the period used in the historical loss rates for each group of loans assessed under Accounting Standards Codification (ASC) 450-20
Other Current Issues: Loss History

Loss Histories

- A bank should review the range of historical losses over the 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.

Other Current Issues: Qualitative Factors

Qualitative Factors/Qualitative Allowance

- These factors require judgments that cannot be subjected to an exact mathematical calculation.
- 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.
Other Current Issues: Qualitative Factors

Qualitative Factors/Qualitative Allowance

- Management should document carefully the qualitative factors considered and the conclusions reached.

Qualitative Factors/Qualitative Allowance

- Support and documentation include the following:
  - 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
Examples of underlying supporting evidence could include:
- Relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area
- Economic reports and data
- Notes from discussions with borrowers

Examiners will focus on:
- Whether documentation exists and is reasonable
- Whether management adequately identifies the qualitative factors that are determined to cause losses to differ from historical
- Whether the impact of the adjustment is directionally consistent with changes in the factors underlying the adjustment
This guidance is intended to remind institutions of existing generally accepted accounting principles (GAAP) and regulatory guidance related to estimating the allowance for junior lien loans and home equity lines of credit.


Other Current Issues: Junior Liens

- Institutions should ensure that sufficient information is gathered to adequately assess the probable loss incurred within junior lien portfolios.
- The guidance is directed toward institutions with significant portfolios and this will be the examiner’s focus as well.
Other Current Issues: Junior Liens

Junior Lien Guidance

- The guidance reminds institutions to:
  - Gather and 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

Other Current Issues: Junior Liens

- Definition is provided under GAAP
- Includes income-producing property where repayment of the loan will come solely from the collateral
- The Report of Condition and Income (Call Report) requires that the measure for loss be based upon the fair value of the collateral

Other Current Issues: Definition of Collateral Dependent

Collateral-Dependent Loans

- Definition is provided under GAAP
- Includes income-producing property where repayment of the loan will come solely from the collateral
- The Report of Condition and Income (Call Report) requires that the measure for loss be based upon the fair value of the collateral
Other Current Issues: Calculating the Present Value of Cash Flows

Calculating Present Value (PV) of Expected Cash Flows
• Requires an estimate of expected cash flows
• An estimate of expected cash flows (CFs) will consider expected defaults and prepayments
• The discount rate is the loan’s original effective interest rate

Allowance for Loan Losses

• Current U.S. GAAP
  – Incurred credit loss model
  – A loan is impaired when it is probable that a loss has been incurred based on events and conditions existing at the balance sheet date
    ➢ This does not consider possible or expected future trends that may lead to additional losses
Impairment Measurement

ASC 310-10-35-20 through 32
For impaired loans, which includes Troubled Debt Restructurings (TDRs)

Option 1
- PV of expected future CFs discounted at the loan’s effective interest rate

Option 2
- Loan’s observable market price

Option 3
- Fair value (FV) of the collateral (less cost to sell)
  - If it is a collateral dependent loan

*Options 2 and 3 are used as practical expedients to Option 1, ASC 310-10-35-22

Impairment Measurement

ASC 310-10-35-20 through 32
For impaired loans, which includes TDRs

Option 1
- PV of expected future CFs discounted at the loan’s effective interest rate
  - Must consider defaults and prepayments

Option 2
- Loan’s observable market price
  - Method not considered available because no market for impaired loans

Option 3
- FV of the collateral (less cost to sell)
  - If it is a collateral dependent loan
  - Judgment required in determining what is collateral dependent
Purchased Credit Impaired Loans

Purchased impaired loan is initially recorded at FV with no ALLL recorded at acquisition

Post acquisition, purchaser must regularly estimate CF expected to be collected to assess for impairment

Probable decrease in expected CF should be recognized as impairment through the ALLL

Loan Impairment Resources

Evaluate for Impairment
- ASC 310-10-35-16 through 17

Measure Impairment
- ASC 310-10-35-20-32

Account for Impairment
- Record ALLL
- Call Report instructions glossary entry
Questions?