



ACUIA 23rd Annual Conference

Allowance for Loan and Lease Losses (ALLL) Best Practices

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PRESENTATION OVERVIEW

- What is the ALLL?
- Basic auditing and review of the ALLL calculation
- Reporting considerations – internal and external
- Example ALLL methodologies/calculations
- Common Pitfalls

ALLL – WHAT IS IT?

- Nature and Purpose of the ALLL –
 - Typically, the most significant estimate in an institution's financial statements and regulatory reports
 - Because of the significance, each institution has a responsibility for:
 - Developing,
 - Maintaining, and
 - Documenting a comprehensive, systematic and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL).

ALLL – WHAT IS IT? (CONT.)

Interagency Policy Statement on the Allowance for Loan and Lease Losses, originally issued in 1999, with subsequent updates, gives us a road map for what the ALLL is, what components should be included or considered in the ALLL methodology, and board and management responsibility over the ALLL.

ALLL – INTERAGENCY POLICY

- Important aspects of loan loss allowance practices are as follows:
 - Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses;
 - Prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management's best estimate is at the high end of the range;

ALL – INTERAGENCY POLICY (CONT.)

- Determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses;
- An “unallocated” loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported;
- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio; and
- The loan loss allowance should take into consideration all available information existing as of the financial statement date, including environment factors such as industry, geographical, economic, and political factors.

ALLL – WHAT IS IT?

- Each institution's responsibility includes ensuring controls are in place to consistently determine the ALLL in accordance with:
 - Generally Accepted Accounting Principles (GAAP),
 - The institution's stated policies and procedures,
 - Management's best judgment, and
 - Relevant supervisory guidance.

ALLL – WHAT IS IT? (CONT.)

- How is all this accomplished?
 - At least quarterly, the Credit Union must:
 - Analyze the collectibility of its loans and leases (loans) held for investment; and
 - Maintain an ALLL at a level that is appropriate and determined in accordance with GAAP.

ALLL – WHAT IS IT? (CONT.)

- Every credit union has a different methodology, but all methodologies should have similarities that comply with GAAP and Interagency Guidance. Including:
 - Allowance for loans collectively evaluated for impairment (ASC 450, aka FAS 5 or general reserve),
 - Qualitative factors, and
 - Allowance for loans individually evaluated for impairment (ASC 310, aka FAS 114 or general reserve).

ALLL – WHAT IS IT? (CONT.)

- For loans that are collectively evaluated for impairment, the credit union must estimate the inherent loss embedded within those loans at the reporting period. That is determined by, but not limited to the following:
 - Based on loss history of the institution or using peer data, and
 - Adjusted for changes in trends, conditions, and other relevant factors, known as qualitative factors (there are nine that are required to be addressed, more on this).

ALLL – WHAT IS IT? (CONT.)

- There should be some level of disaggregation in the analysis, most typical is by loan categories based on similar loan terms and risks.
- As a loan's risk rating increases, the corresponding amount of ALLL associated should also increase.

- **The loss history and qualitative factors should be directionally consistent individually, as well as a whole.**

ALLL – WHAT IS IT? (CONT.)

- Qualitative factors required to be considered included, but are not limited, to the following:
 - Changes in lending policies and procedures, including changes in underwriting standards and collections, charge-off, and recovery practices not considered elsewhere in estimating credit losses;
 - Changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments;

ALLL – WHAT IS IT? (CONT.)

- Changes in the nature and volume of the portfolio and in the terms of loans;
- Changes in the experience, ability, and depth of lending management and other relevant staff;
- Changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans;
- Changes in the quality of the institution's loan review system;

ALLL – WHAT IS IT? (CONT.)

- Changes in the value of underlying collateral for collateral-dependent loans;
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations; and
- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio.

ALLL – WHAT IS IT? (CONT.)

- For all loans individually evaluated for impairment, a separate impairment analysis for each loan is required.

The ALLL is simply the total of allowance provided from the analysis of loans collectively evaluated for impairment, including the qualitative factors and those individually impaired. (Total of the FAS 5 reserve and total FAS 114 reserve.)



IMPAIRED LOANS

DEFINITION OF AN IMPAIRED LOAN (RECOGNITION CRITERIA)

- A 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
- Definition – key words
 - Probable creditor will be unable to collect (could be subjective)
 - All amounts due according to original contractual terms (i.e. contractual P&I payments)
- Authoritative guidance is ASC 310-10 (formerly SFAS No. 114)

DEFINITION OF AN IMPAIRED LOAN (RECOGNITION CRITERIA) (CONT.)

- Impairment indicators
 - Past due status (e.g. over 90 days)
 - Lower graded loans (e.g. substandard or doubtful)
 - Listed on credit watch list
 - Restructured loans
 - Loans not in compliance with covenants
 - Non-accrual loans
 - Uncooperative borrower
 - Borrower in financial distress (economic, industry, individual)

MEASURING LOAN IMPAIRMENT

- Once a loan is identified as being impaired, the amount of impairment must be measured
 - Three methods to measure impairment
 - Present value of expected future cash flows discounted at the loans effective interest rate
 - Loans observable market price
 - Net realizable value of the collateral if the loan is collateral dependent (i.e. collateral is the sole source of repayment)
- The correct method to use depends on how the credit will be repaid

MEASURING LOAN IMPAIRMENT (CONT.)

- Measuring Impairment –
 - Is the loan Collateral Dependent?
 - Yes, if repayment is from –
 - The sale of the collateral **or**
 - Solely from cash flow generated by collateral's operation – income producing property (this may be a shift in our thinking)

MEASURING LOAN IMPAIRMENT (CONT.)

- Method #1 – PV of expected future cash flows
 - Use when source of repayment is borrower cash flows
 - Use for any loans meeting the definition of a Troubled Debt restructure
 - Discount rate
 - Use original note rate
 - Management assumptions need to be supported
 - Timing of cash flows
 - Ability to repay the credit
 - I.E. if an impaired loan is restructured to renew a year later, does the borrower have the ability to perform at the new maturity date? If no, PV analysis may not be appropriate and perhaps the credit is collateral dependent.

MEASURING LOAN IMPAIRMENT (CONT.)

- Method #2 – Loan’s observable market price
 - Use when source of repayment is the sale of the loan
 - Typically not used as there is not an active secondary market for the loans originated by our credit union clients
 - Could use for SBA and USDA loans

MEASURING LOAN IMPAIRMENT (CONT.)

- Method #3 – Net realizable value (NRV) of the collateral
 - Use when source of repayment is the sale of the collateral
 - This valuation method is most typical, key issues:
 - FMV of the collateral
 - Should be supported by recent appraisals or other analysis.
 - Type of appraised value should be considered relative to the condition of the collateral
 - If collateral is to be sold in bulk, the retail sales value would be inappropriate to use

MEASURING LOAN IMPAIRMENT (CONT.)

- Method #3 – NRV of the collateral (continued)
 - This valuation method is most typical, key issues:
 - Liens or other encumbrances including costs to complete
 - If paid by the credit union, these costs should be deducted from the appraised value
 - Any liens or costs to complete a project should be verified
 - Selling cost assumptions
 - Selling costs should be deducted to arrive at NRV
 - Evaluate selling cost assumptions relative to market costs, the target market, and the credit union's disposition plans
 - Selling cost assumptions should be consistent with existing impaired loan measurements
 - Selling costs do not necessarily have to be charged-off, but they must be reserved for

OTHER ISSUES ASSOCIATED WITH IMPAIRED LOANS

- Impaired loan vs. Impairment amount
 - A loan can be “impaired” and have no reserve or impairment amount under ASC 310-10 (formerly FAS 114)
 - Loans which are impaired but require no reserve under ASC 310-10 (formerly FAS 114) should continue to be excluded from the general reserve
 - If the loan is collateral dependent and the ASC 310-10 (formerly FAS 114) analysis identifies an impairment amount, it should be charged-off (not reserved for)



TROUBLED DEBT RESTRUCTURES (TDR'S)

TROUBLED DEBT RESTRUCTURING

- What is a Troubled Debt Restructure (TDR)?
- Two questions:
 - For economic or legal reasons is the debtor experiencing **financial difficulties**? And
 - has the creditor granted a **concession** to the debtor that it would not otherwise consider?
- If the answer to both questions is yes, it's likely a troubled debt restructuring.

TROUBLED DEBT RESTRUCTURING (CONT.)

- A Troubled Debt Restructuring may include:
 - A transfer from the borrower to the financial institution of real estate or other assets
 - A modification of the loan terms
 - A combination of the above
- Regulators are encouraging credit unions to work with borrowers to prevent foreclosure
- Accounting for a troubled debt restructure differs from a standard restructuring

TROUBLED DEBT RESTRUCTURING (CONT.)

- Primary accounting guidance
 - ASC 310-10 (formerly FAS 114) – Receivables, Subsequent Measurement
 - ASC 310-40 (formerly EITF 02-04) – TDRs by Creditors
 - ASU 2011-02 – Determining Whether a Restructuring is a TDR
- Regulatory guidance
 - http://www.ncua.gov/Resources/Documents/LCU2013-3_SupervisoryLetter.pdf
 - <http://www.occ.gov/news-issuances/bulletins/2012/bulletin-2012-10.html>
 - <http://www.occ.gov/publications/publications-by-type/other-publications-reports/BAAS.pdf>

TROUBLED DEBT RESTRUCTURING (CONT.)

- Is the debtor for economic or legal reason experiencing financial difficulty?
 - Debtor is in default of one or more debts
 - Debtor is in (or in the process of filing) bankruptcy
 - Debtors securities have been delisted
 - Going concern issues
 - Projected cash flows are insufficient to service debt according to the terms of the debt service agreement
 - Debtor is unable to borrow funds at market interest rates from other creditors

TROUBLED DEBT RESTRUCTURING (CONT.)

- Has the creditor granted a concession it would not otherwise consider?
 - Types of modifications of loan terms
 - Reduced interest rates (or not at market rate)
 - Extend maturity date
 - Provide terms not offered for new debt of similar risk
 - Reduce or forgive principal, accrued interest or fees
 - Added collateral or guarantees inadequately compensate
 - Amortizing to non-amortizing (moving to interest only)
 - A/B note structure
 - Substitution of borrower and/or guarantor
 - Certain Substandard loan renewals



TROUBLED DEBT RESTRUCTURING (CONT.)

Said another way, the modification is a TDR if the borrower cannot go to another lender and qualify for and obtain a loan with similar modified terms.

TROUBLED DEBT RESTRUCTURING (CONT.)

Once a TDR, Always a TDR?

YES

But reporting is a different story.....

- Market rate at the time of restructure **and**
- Compliant with modified terms

Then it no longer needs to be reported as a TDR...but it will still follow ASC 310-10 (FAS 114) accounting treatment.



BASIC AUDITING AND REVIEW

ALLL – AUDITING

The next few slides gives you an idea what steps your financial statement auditor performs. We will direct you on steps that make sense for you to incorporate into your quarterly review.

ALLL – AUDITING (CONT.)

- To audit the ALLL consider performing the following procedures:
 - Reconcile loans in the ALLL model to total loans, to ensure the completeness. **(Included in quarterly certification?)**
 - Recalculate or trace the calculation of the total ALLL to verify accuracy and completeness of the calculation. **(Included in quarterly certification?)**
 - Ensure all impaired loans are excluded from the general reserve calculation and are supported by impairment analyses. **(Included in quarterly certification?)**
 - Ensure the factors used in the general reserve are directionally consistent.
 - Perform an analysis to determine if the total ALLL appears reasonable.
 - Review and verify the support provided by management as to the appropriateness of the qualitative factors and overall ALLL.

HOW TO VERIFY ALL IMPAIRED LOANS ARE IDENTIFIED?

- The loan department will assert which loans are impaired
 - Our job is to verify the list is complete
- At balance sheet date
 - Inquire regarding the extent of Troubled Debt Restructures
 - Compare impaired loan listing to non-accrual loan list
 - Compare impaired loan listing to past due loan list
 - Verify loans past due > 90 days are on non-accrual and considered impaired
 - Compare classified assets to the prior year and evaluate the nature and reasonableness of risk rating upgrades
 - Could indicate a potential Trouble Debt Restructure

HOW TO VERIFY ALL IMPAIRED LOANS ARE IDENTIFIED? (CONT.)

- Subsequent to the balance sheet date, compare the quarter-end impaired loan listing to:
 - Subsequent impaired loan listing
 - Subsequent non-accrual loan list
 - Subsequent past due loan list
- The goal of this review is to identify any loans that should be considered impaired at the financial reporting date that were not previously identified
- If any newly impaired loans are identified, the related impairment needs to be evaluated in the context of a subsequent event



REPORTING – INTERNAL AND EXTERNAL

ALLL – INTERNAL REPORTING

Interagency Policy states that on a quarterly basis and prior to paying dividends, the ALLL and PLLL should be presented to the board of directors for approval. The board of directors is responsible for overseeing management's significant judgments and estimates pertaining to the determination of an appropriate ALLL.

ALLL – INTERNAL REPORTING (CONT.)

- Board of director oversight should include, but is not limited to the following:
 - Reviewing and approving the institution's written ALLL policies and procedures at least annually.
 - Reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the institution.
 - Reviewing management's assessment and justifications for the amounts estimated and reported each period for the PLLL and ALLL
 - Requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

ALLL – EXTERNAL REPORTING

- Quarterly:
 - NCUA Call Report 5300
- Annually in the Audited Financial Statements:
 - As of the date of each income statement presented:
 - The balance in the ALLL at the beginning and end of each period
 - Additions charged to operations (provision expense)
 - Direct write-downs charged against the allowance (charge-offs)
 - Recoveries of amounts previously charged-off
 - The accounting policy and methodology used by the credit union to estimate its ALLL and any liability for off-balance sheet credit losses and related charges for loan losses in the notes to the financial statements.

ALLL – EXTERNAL REPORTING (CONT.)

- Annually (continued):
 - Additional disclosures include:
 - Description of credit quality indicators (pass, watch, special mention, substandard, doubtful)
 - A break down, by loan category by credit quality indicator
 - Analysis of past due loans
 - Impaired loans both with and without a related allowance
 - Loans modifications considered troubled debt restructures, and any subsequent modifications or defaults



EXAMPLE ALL METHODOLOGIES/CALCULATIONS

EXAMPLE – ECONOMIC FACTORS

Economic factors	Range
	+/- 15bp
Changes in lending department	0
Changes in economic conditions	-5
Changes in portfolio	10
Changes in experience	0
Changes in classified loans	-5
Changes in loan review	-5
Changes in collateral	0
Changes in concentrations	10
Changes in external factors	10
Overall adjustment	<hr/> 15
Total loans	\$ 400,000,000
Environmental	600,000

EXAMPLE – COLLATERAL DEPENDENT

Loan amount	1,500,000
Appraised value	1,250,000
Less:	
Age of appraisal	(62,500)
Broker costs	(75,000)
Taxes	(25,000)
Legal	<u>(1,000)</u>
Net realizable value	<u>1,086,500</u>
Impairment	(413,500)

EXAMPLE – BASIC ALL

Specifically Evaluated Impaired Loans	Net carrying balance		Reserve required
Impaired loans rated substandard	\$ 250,000		25,000
Impaired loan rated special mention	<u>\$ 1,000,000</u>		<u>60,000</u>
Total Impaired Loans	\$ 1,250,000		\$ 85,000
 General Allowance			
Total Loans	\$ 400,000,000		
Less: Impaired loans	<u>\$ 1,250,000</u>		
Remaining Loans	\$ 398,750,000		
		Historical loss factor	Economic factor
Substandard, not impaired	\$ 300,000	0.50%	10.00% \$ 31,500
Special mention, not impaired	\$ 4,400,000	0.50%	3.00% \$ 154,000
Remaining loans	<u>\$ 394,050,000</u>	0.50%	0.80% <u>\$ 5,122,650</u>
	\$ 398,750,000		Required reserve \$ 5,393,150
		Recorded Allowance	1.25% <u>\$ 5,000,000</u>
		Unallocated	<u>\$ 393,150</u>



COMMON PITFALLS

COMMON PITFALLS

- Excluding all or some of the Q-factors
- Incomplete loan population
- Subsequent risk rating changes not incorporated into the calculation
- Subsequent appraisals prior to quarter or year-end that should be included at quarter or year-end
- Improper inclusion of impaired loans in the general reserve (layering)
- Calculation errors
- Directional inconsistent
- Lack of controls

COMMON PITFALLS (CONT.)

- Unsupported loss factors, adjustments, Q-factors, and unallocated
- Lack of meaningful measurement thresholds for Q-factors
- Lack of meaningful risk rating system
- Lack of responsiveness to changes
- Lack of testing (back or stress) of methodology
- What have you seen at your institution?

QUESTIONS?

