

FEDERAL HOME LOAN BANK SEATTLE

Assessing the Adequacy of The Allowance for Loans and Lease Losses

August 17 and 19, 2010



Assessing the Adequacy of the Allowance for Loan/Lease Losses

Governing Pronouncements

- 1993 Policy Statement – Accounting for Contingencies (FASB 5) and Accounting by Creditors for Impairment of a Loan (FAS 114)
- 2001 Policy Statement on ALL Methodologies and Documentation
- 2004 Update on Accounting for Loan and Lease Losses
- 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses



Elements of 2006 Policy Statement

- Allowance based on comprehensive, consistently applied and well documented analysis
- Consider all information existing as of financial statement date
- Include industry, geographic, economic and political factors
- Established according to GAAP
- Banks should have an effective loan review and loan grading system



Elements of 2006 Policy Statement cont.

- Validate ALLL methodology by review of process by party independent of credit process
- The Board should provide oversight to the process and approve assessment of ALLL quarterly
- Adequate data systems to document status of ALLL



Key Concepts

- Expected vs. Unexpected Losses
- Probability of Default vs. Loss Given Default
- Prospective vs. Retrospective
- ALLL process involves a high degree of management judgment
- Inevitably imprecise
- Results in range of estimated values
- Various factors affect the collectability of loans
- Prudent, conservative, but not an excessive ALLL is appropriate



Management is Responsible For

- Maintaining effective loan review system
- Adopting and adhering to written ALLL policies
- Documenting ALLL analysis
- Maintaining the ALLL at an appropriate level
- Promptly charging off loans confirmed to be uncollectable.



Management is Responsible For cont.

- Assuring adequate data capture, reporting and reporting systems
- Periodically validating the ALLL methodology including loss estimate models



Board of Directors is Responsible For

- Overseeing management's determination of an appropriate ALLL
- Reviewing and approving written ALLL policies and procedures
- Reviewing credit process assessments prepared by loan review
- Reviewing and approving the amount estimated and reported by management for the ALLL
- Requiring management to periodically validate and review the ALLL methodology



Loan Review is Responsible For

- Assuring the Board and Executive Management
 - Policies and procedures are being complied with
 - Loan documentation is appropriate
 - Asset quality ratings are timely and accurately assigned
- Secondary responsibility for identifying potential or actual problem loans
- Independently evaluating whether the methodology used to assess the adequacy of the ALLL has been appropriately applied.



Role of Examiners

- Assess appropriateness of ALLL and supporting documentation
- Assess effectiveness of board oversight and the quality of the loan review system
- Evaluate ALLL policies, procedures and methodology
- Assess whether institution appropriately considered historical loss experience and all significant qualitative or environmental factors



Role of Examiners cont.

- Ensure that management appropriately applied FAS 114 and FAS 5
- Review any loss estimation models
- Review appropriateness and reasonableness of the overall level of the ALLL
- Review the adequacy of ALLL documentation



**How Vulnerable is Your Bank
to the
Three Deadly Sins of Portfolio
Management?**



Three Deadly Sins

- Poor Distribution of Asset Quality Ratings
- Emphasizing Higher Risk Types of Lending
- Allowing Concentrations to Build in the Portfolio
 - Borrowers
 - Geography
 - Lines of Business
 - Industry, Type of Agriculture, Property Type



Critical Factors Asset Quality Rating Framework

- Adequate granularity
- Applying AQRs to all portfolio segments
- Timely and accurate assignment of AQRs
- Monitoring Distribution of AQRs over time
- Tracking historical loss experience by AQR
- Utilizing a two factor AQR to distinguish between probability of default and loss given default.
- Concentrations in one or a few grades



Distribution of Asset Quality Ratings

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2009
1-3	68.6	66.6	66.3	63.9	68.5	68.7	65.7	63.9	62.3	60.7	54.2
4	22.2	25.2	23.8	25.7	22.9	20.9	30.1	26.0	26.3	26.5	26.9
5	5.5	4.4	5.4	4.9	4.7	4.4	4.8	5.7	6.5	6.2	9.7
6	1.8	1.7	2.1	2.1	1.8	2.0	4.7	2.4	2.4	3.6	4.1
7	1.4	1.8	2.09	2.7	1.8	1.0	1.4	1.6	1.8	2.6	4.5
8	.3	.3	.3	.3	.4	.2	.2	.2	.2	.5	.6



2004 Composite Risk Profile

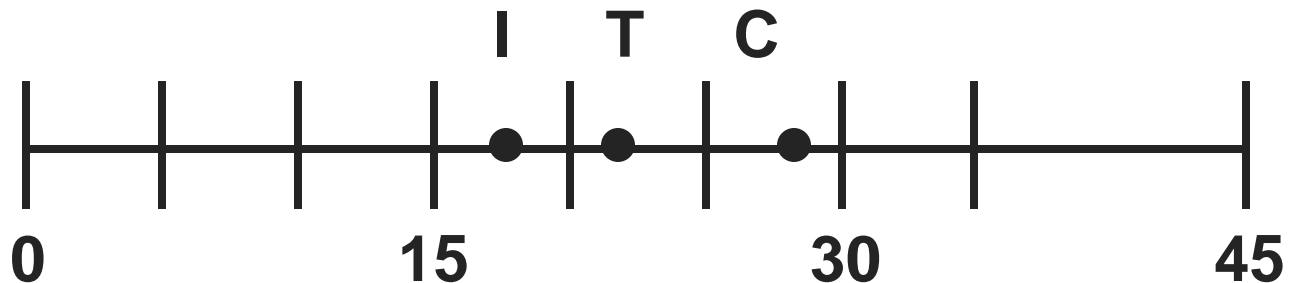
23.2 Transaction (T)

17.2 Intrinsic (I)

28.3 Concentration (C)

68.7 Total

Risk Profile



2009 Composite Risk Profile

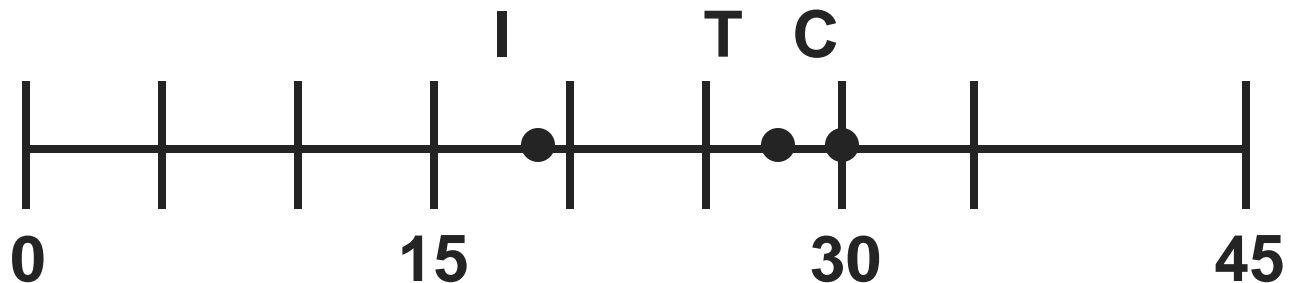
29.1 Transaction (T)

19.4 Intrinsic (I)

29.7 Concentration (C)

78.2 Total

Risk Profile



Evaluating the Adequacy of the ALLL Methodology FAS 5

- **Segmenting the Portfolio**
 - Asset Quality Rating
 - Lines of Business
- **Historical Experience by Line of Business**
 - Migration/Vintage Analysis
 - Probability of Default
 - Loss Given Default



Evaluating the Adequacy of the ALLL Methodology FAS 5 cont.

- Data Requirements
 - Discrete points in time
 - Individual asset quality ratings for each loan
 - Date of change in asset quality rating
 - Balance outstanding at multiple point in time
 - Repayments
 - Charge offs



Improving the FAS 5 Process

- Segment the portfolio based on the bank's portfolio composition
- Utilize ranges of historical losses not just the average
- Effectively use the environmental/qualitative factors to adjust historical loss experience to reflect the current credit environment for each portfolio segment.



Issues FAS 5

- Look Back Period
- Weights
- Time Horizon
- Range of Losses/Standard Deviation
- Off Balance Sheet Exposures
- Standard Percentages
- Unallocated Reserves
- Directionally Consistent
- Contra-cyclical
- Stress Testing



IMPAIRMENT

A loan is impaired when , based on current information and events, it is probable that the bank will be unable to collect all amounts due (principal and interest) according to the loan's contractual terms



Evaluating the Adequacy of the ALLL Methodology FAS 114

- **Measuring Impairment**
 - Present Value of Future Cash Flows
 - Fair Value of Collateral
 - Observable Market Price of Loan
- **Criteria**
 - Classified
 - Collateral Dependent
 - Troubled Debt Restructure



Improving the FAS 114 Process

- Establish a threshold for FAS 114 assessment
- Develop a comprehensive worksheet to be used for each loan
- Be realistic about collateral values, cost to hold/sell and probability of loss
- Be realistic about time to hold/sell and apply an appropriate present value
- Insist on fair value appraisals



FAS 114

Issues

- Collateral Dependent
- Layering
- No Impairment
- Current Appraisal
- Troubled Debt Restructures



Evaluating the Adequacy of the ALLL Qualitative “Q” or Environmental Factors

- Levels and Trends in Delinquencies and Impaired Loans
- Levels and Trends in Charge-offs and Recoveries
- Trends in Nature, Volume and Terms of Loans
- Effects of Changes in Risk Selection, Lending Policies and Underwriting Standards



Evaluating the Adequacy of the ALLL Qualitative “Q” or Environmental Factors

- Experience, Ability and Depth of Management and Staff
- International, National, Regional and Local Economic Trends and Conditions
- Effect of Other External Factors e.g. Competition, Legal and Regulatory Requirements



Evaluating the Adequacy of the ALLL Qualitative “Q” or Environmental Factors

- Changes in Lending Policies/Procedures
- Existence and Effect of Credit Concentrations
- Changes in Mix and Volume of Loans
- Changes in Underlying Value of Collateral on Collateral Dependent Loans
- Changes in Industry Conditions Especially in Industries Representing a Portfolio Concentration
- Changes in Quality of Loan Review



Independent Assessment

- Independent Validation
- Directionally Consistent
- Peer Comparisons



Documentation

- Methodology
- Basis for Historical Experience FAS 5
- Basis for Test for Impairment FAS 114
- Support for Environmental Factors
- Board Approval



Documentating Basis for Test for Impairment FAS 114

- **Present Value of Future Cash Flows Method**
 - Amount and Timing of Cash Flows
 - Effective Interest Rate Used to Discount the Cash Flows
 - Basis for Determination of the Cash Flows
- **Fair Value of Collateral Method**
 - How Fair Value was Determined Including Use of Appraisals, Valuation Assumptions, Calculations
 - Supporting Rationale for Adjustments to Appraised Values
 - Determination of Cost to Sell
 - Appraisal Quality and Expertise/Independence of Appraiser
- **Observable Market Price of a Loan Method**
 - Amount, Source and Date of Observable Market Price



Challenges

- Historical Experience
- Adequate vs. Appropriate
- Limitations on the Portion of the Reserve that Can be Included in Tier 2 Capital
- Competing Agendas
 - Board
 - Executive Management
 - Credit Administration
 - Regulators
 - SEC
 - FASB/PCAOB



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Questions?

