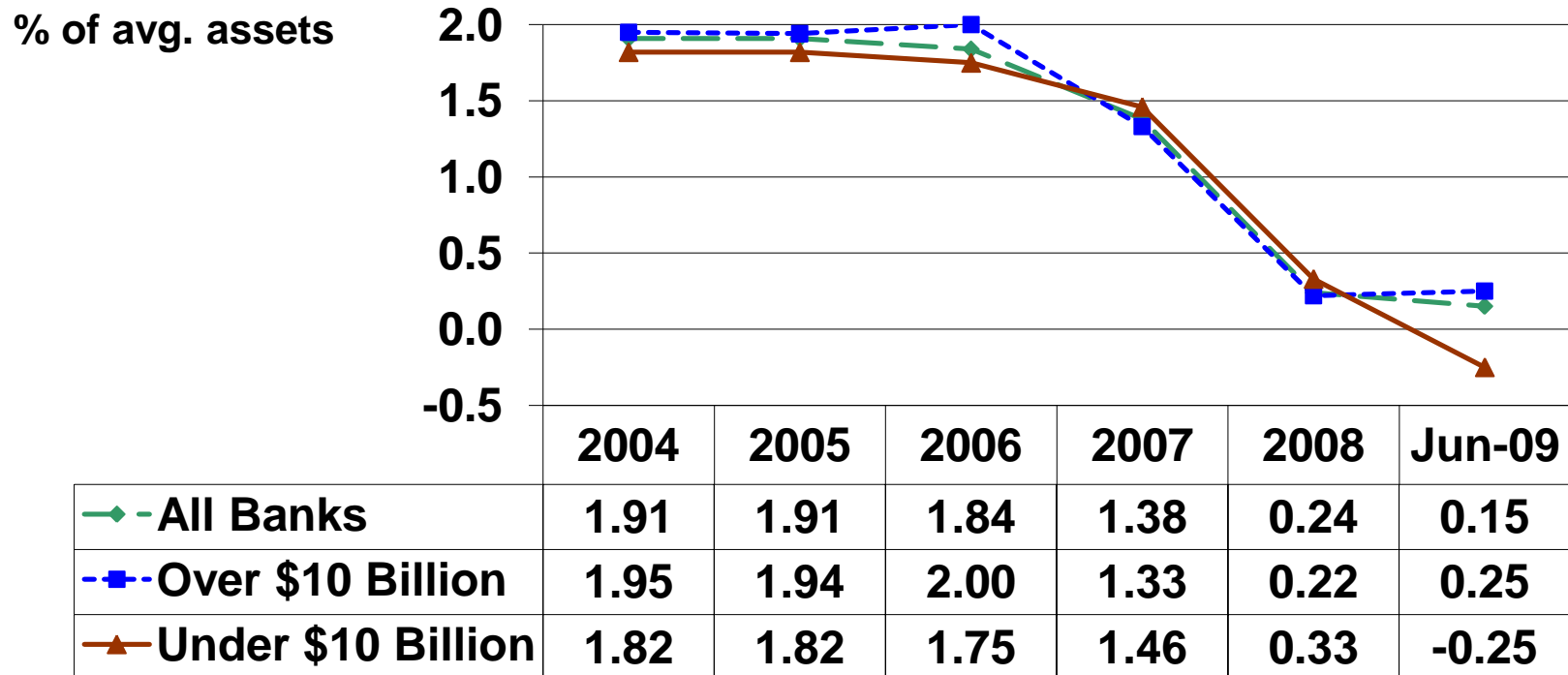


Banking Conditions

As of June 30, 2009

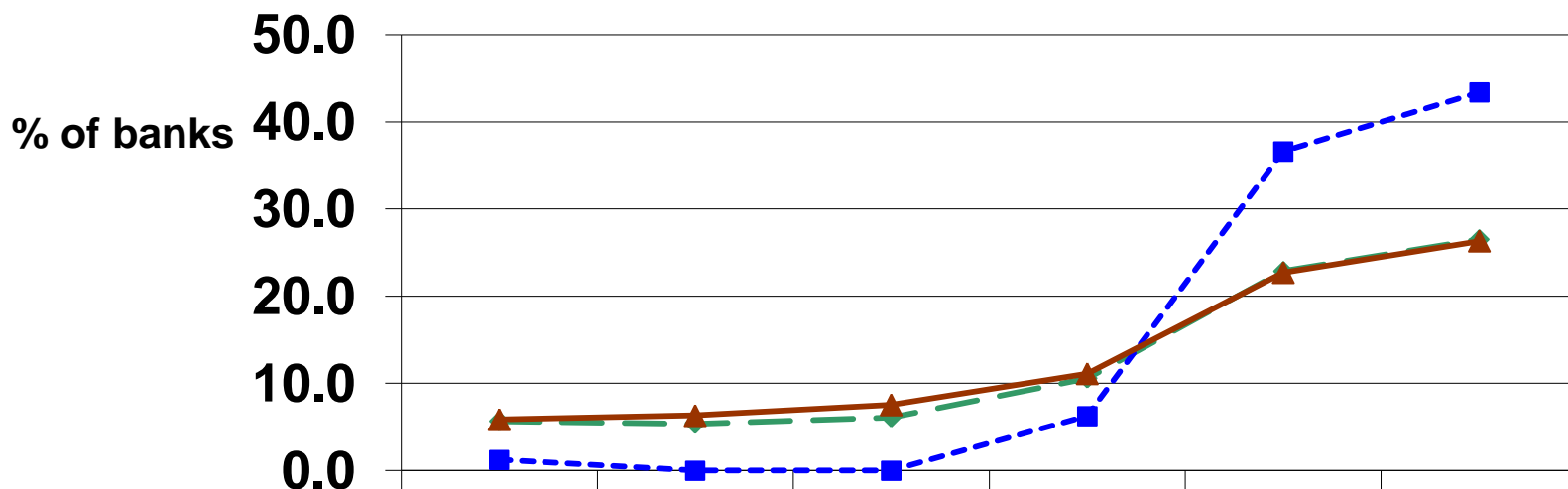
Nationwide, Earnings' Weakness Continued Through the First Half of 2009



All US Commercial Banks - Net Operating Income Before Taxes, as a percentage of average assets.

Source: Reports of Condition and Income

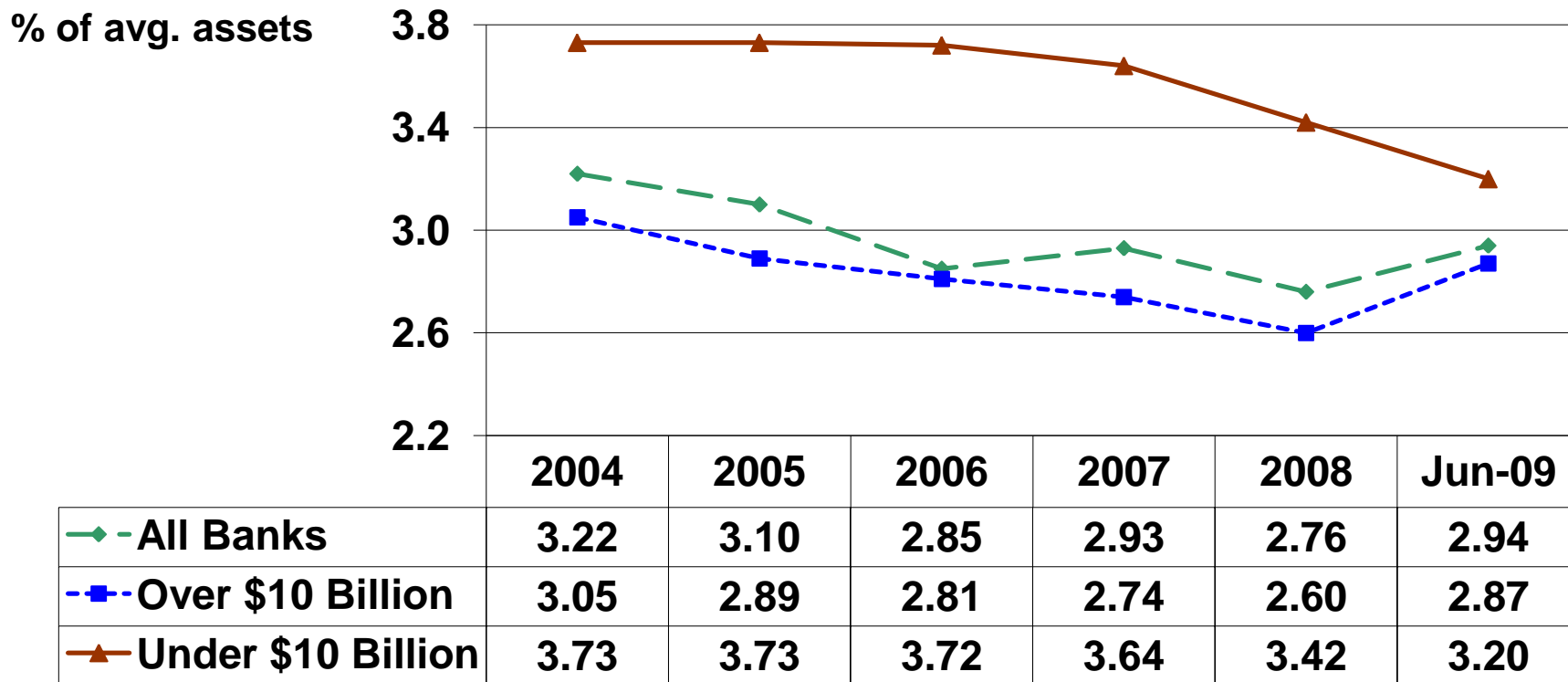
Percent of Banks with Losses Continues to Increase



	2004	2005	2006	2007	2008	Jun-09
—◆— All Banks	5.66	5.36	6.09	10.58	22.86	26.51
-■- Over \$10 Billion	1.22	0.00	0.00	6.25	36.59	43.37
—▲— Under \$10 Billion	5.86	6.32	7.55	11.12	22.7	26.31

All US Commercial Banks - Percentage of banks with negative net income.
Source: Reports of Condition and Income

Small Banks' Net Interest Margins Still Shrinking

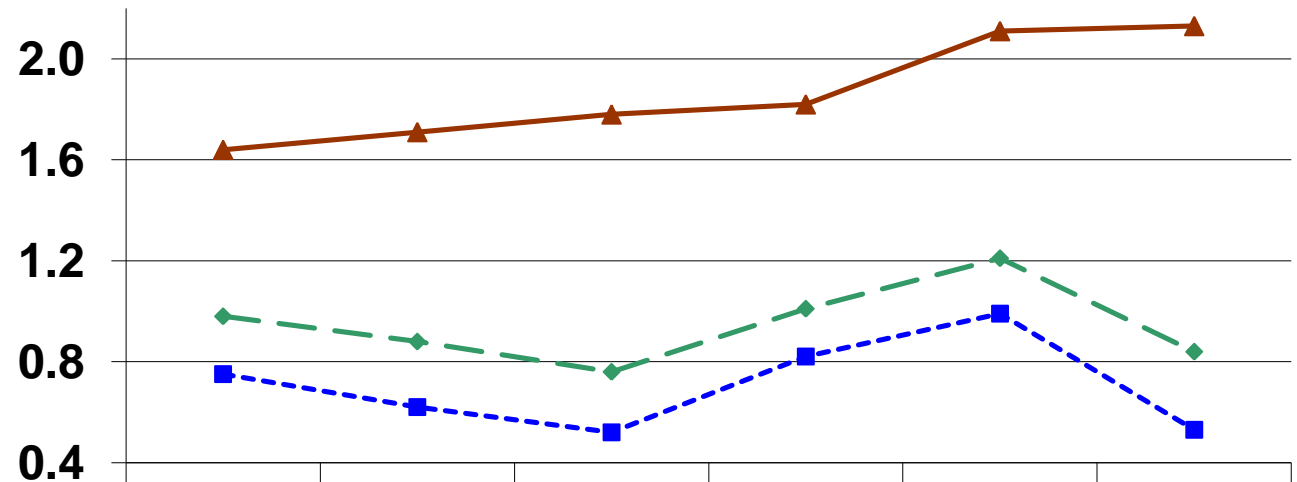


All US Commercial Banks - Interest Income Net of Interest Expense, as a percentage of average assets.

Source: Reports of Condition and Income

Net Overhead Expense Is High and Increasing at Small Banks

% of avg. assets

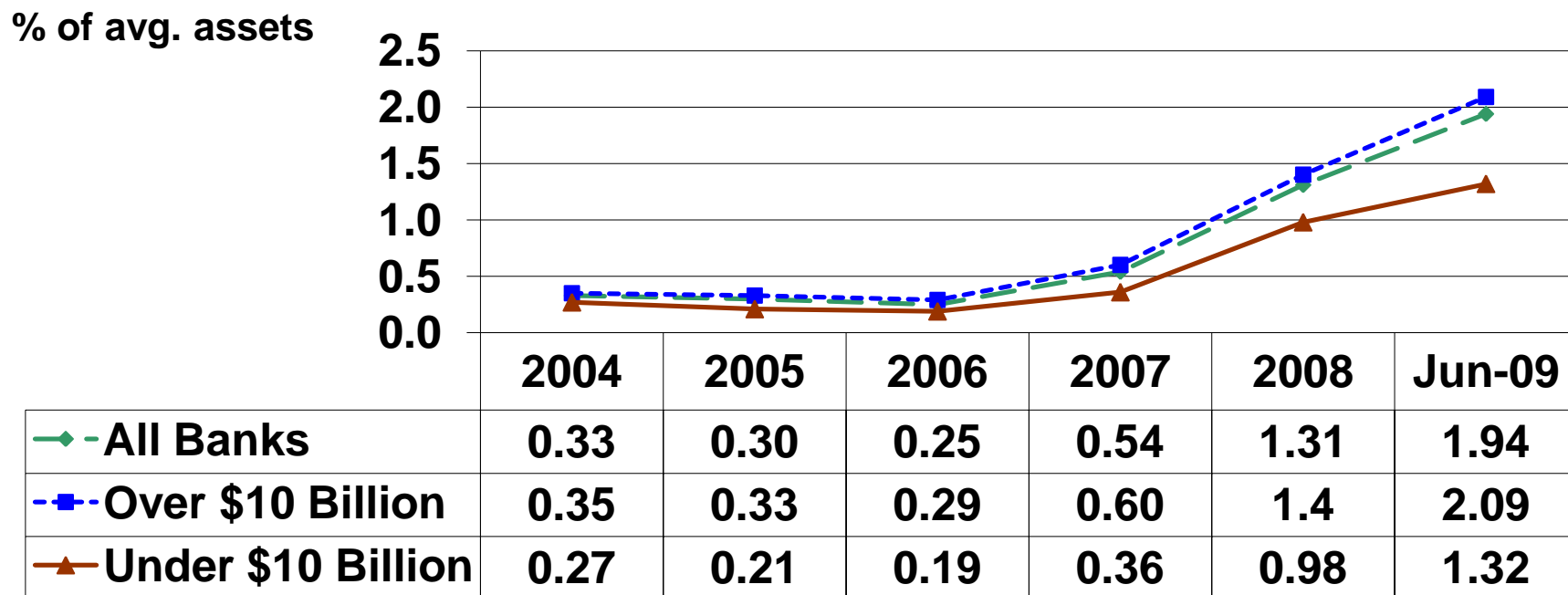


	2004	2005	2006	2007	2008	Jun-09
◆ - All Banks	0.98	0.88	0.76	1.01	1.21	0.84
■ - Over \$10 Billion	0.75	0.62	0.52	0.82	0.99	0.53
▲ - Under \$10 Billion	1.64	1.71	1.78	1.82	2.11	2.13

All US Commercial Banks - Noninterest Expense Net of Noninterest Income, as a percentage of average assets.

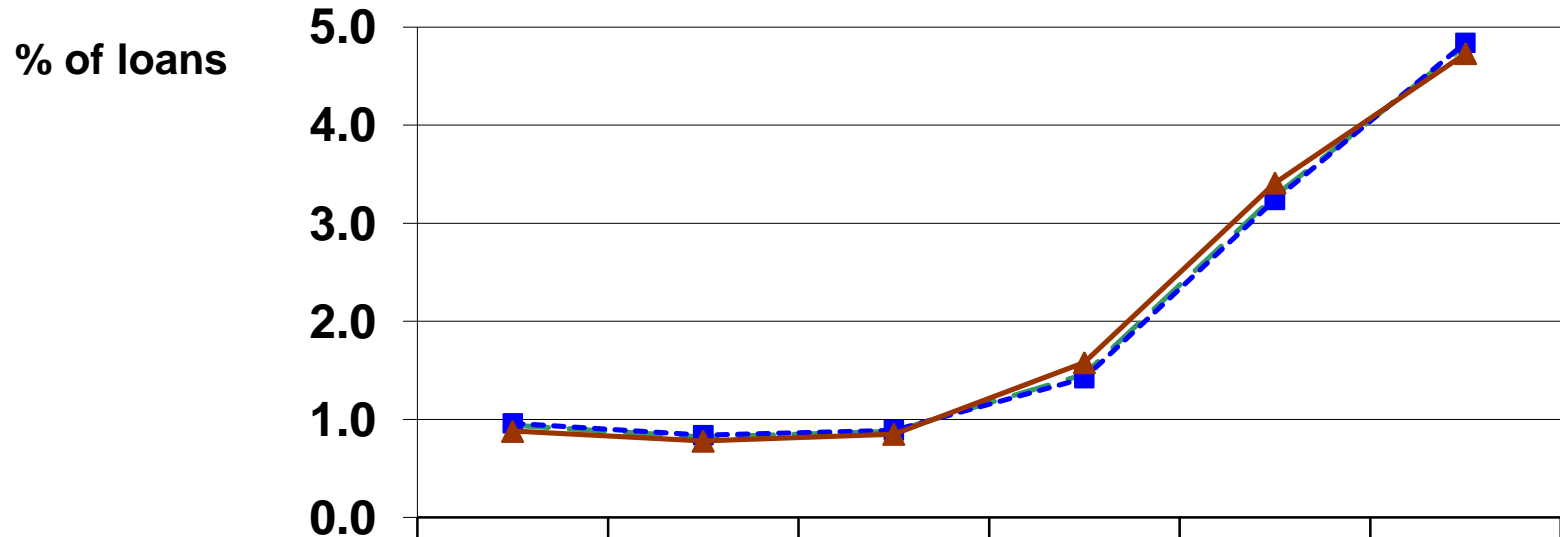
Source: Reports of Condition and Income

Loan Loss Provisions Are Accelerating At All Banks



All US Commercial Banks – Loan Loss Provision Expense, as a percentage of average assets.
Source: Reports of Condition and Income

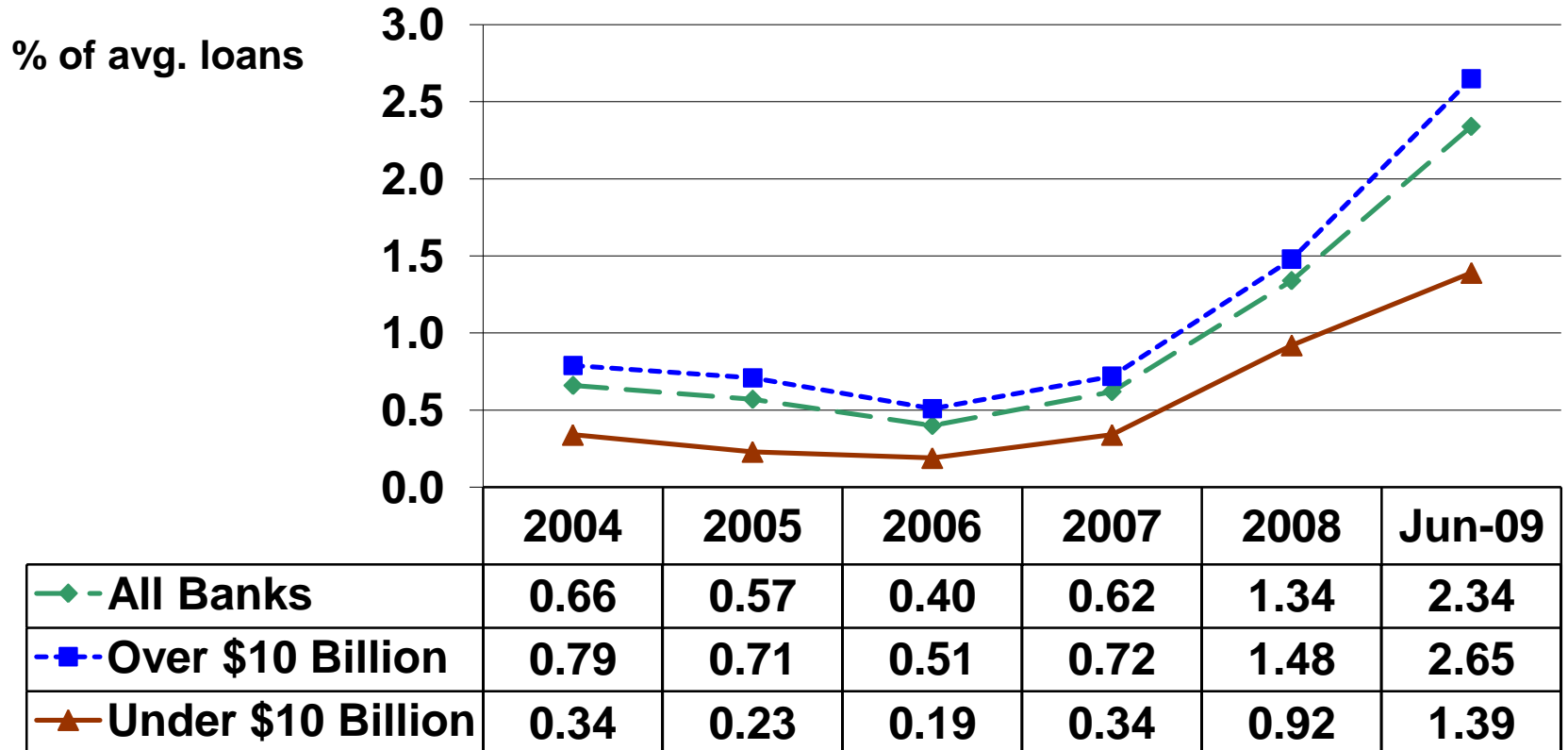
Nonperforming Assets Are At Very High Levels



	2004	2005	2006	2007	2008	Jun-09
—◆— All Banks	0.94	0.82	0.88	1.46	3.28	4.81
-■- Over \$10 Billion	0.96	0.84	0.89	1.42	3.24	4.84
—▲— Under \$10 Billion	0.88	0.78	0.85	1.58	3.41	4.73

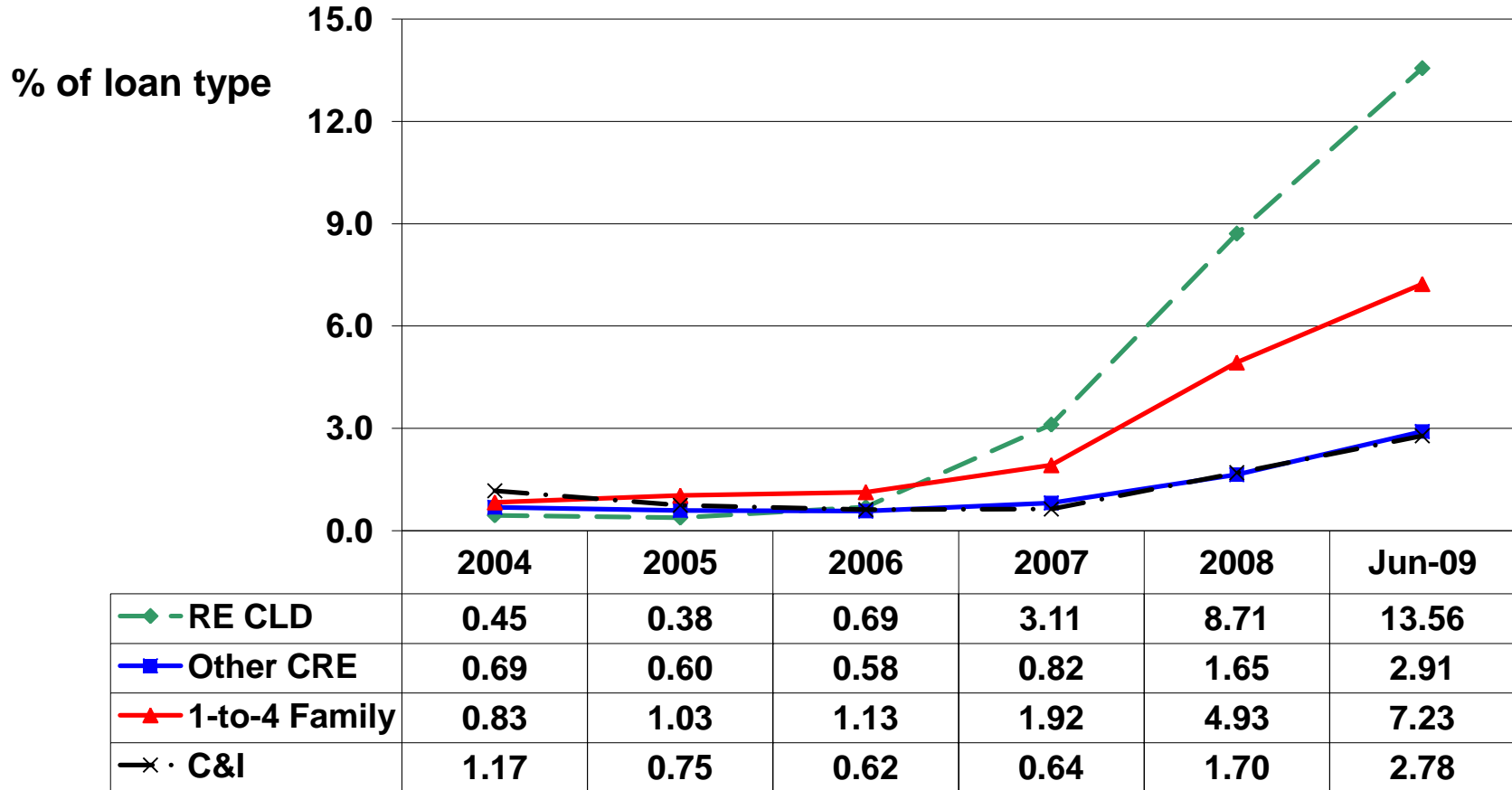
All US Commercial Banks - Noncurrent Assets-to-Total Loans.
Source: Reports of Condition and Income

Net Loan Losses Are Rising Rapidly



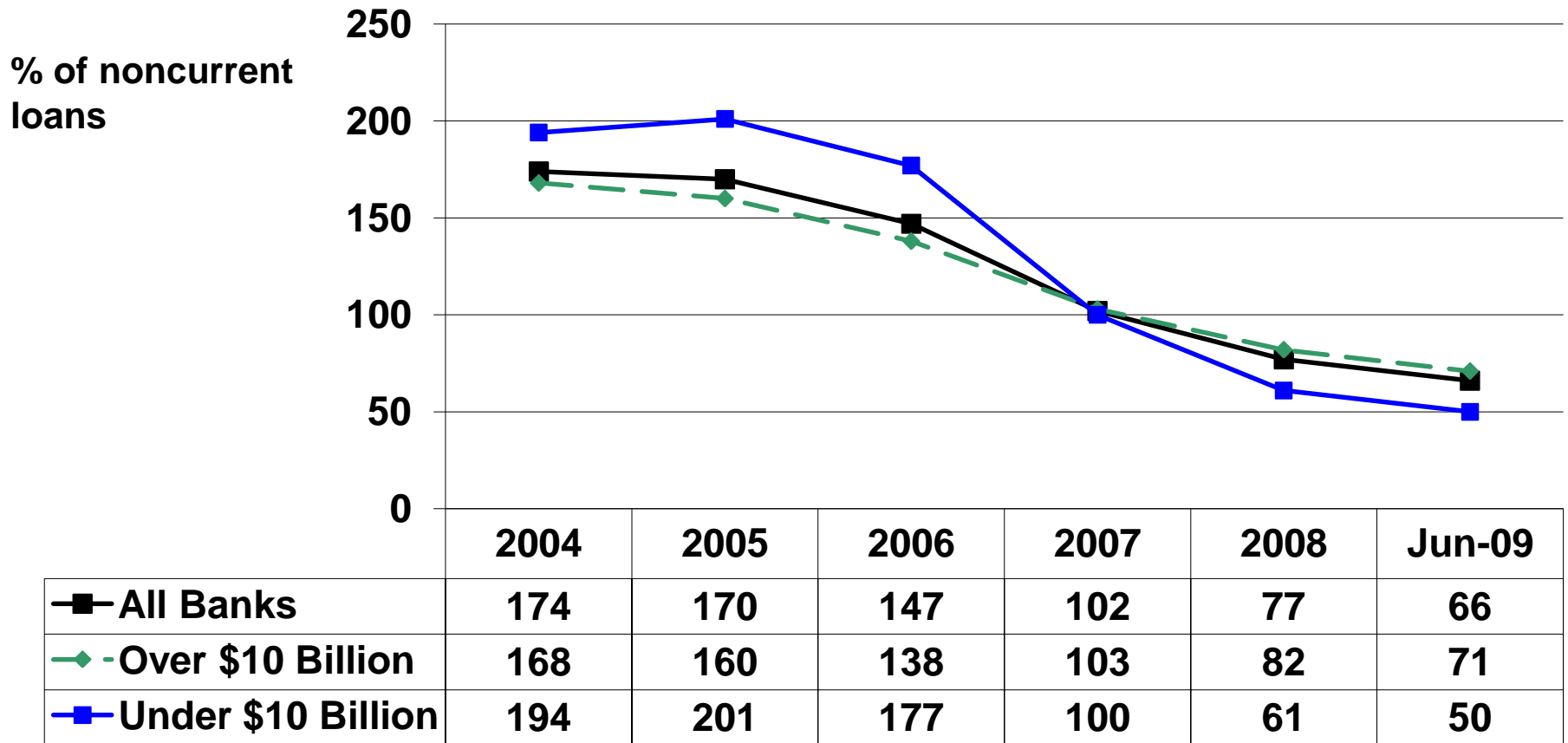
All US Commercial Banks – Net Loan Losses-to-Average Total Loans.
 Source: Reports of Condition and Income

Noncurrent CLD & Residential Loans Have Exploded Since 2006



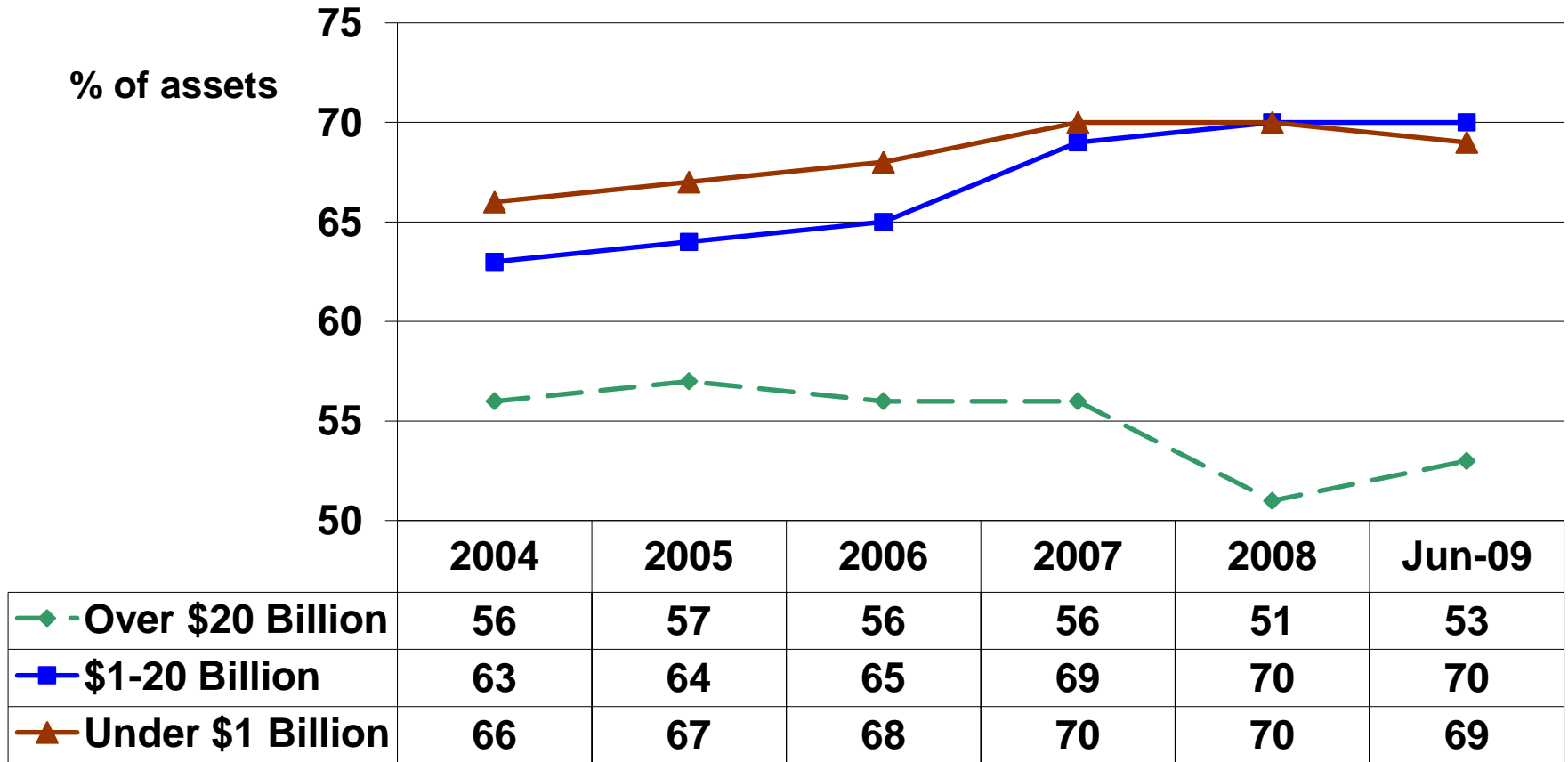
All US Banks - Noncurrent Loans to Loans - By Loan Category.
 Source: Reports of Condition and Income

Coverage Ratios Are Declining



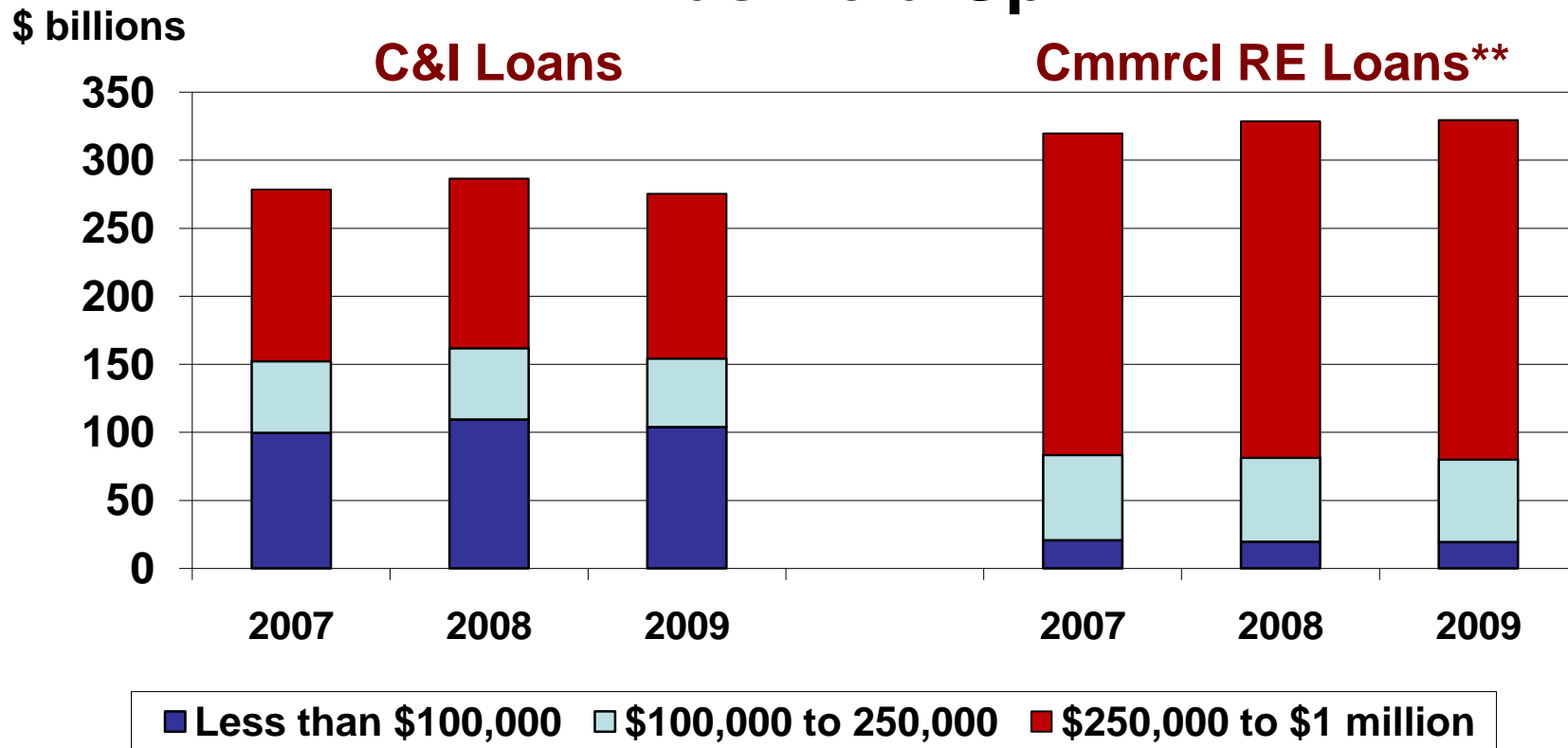
All US Banks – Loan loss reserves to noncurrent loans.
 Source: Reports of Condition and Income

Loan Levels Remain High At Smaller Banks



All US Banks – Total loans to assets.
Source: Reports of Condition and Income

Small Business Lending Has Held Up



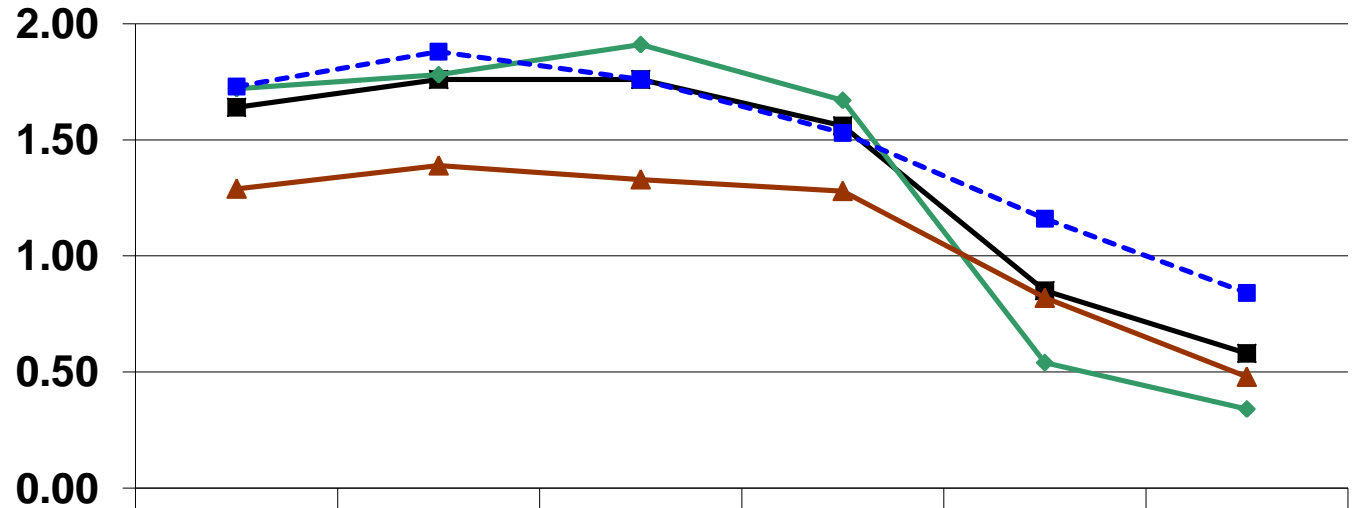
All US Banks - \$ volume of loans with original amounts less than \$1 million.

** - Only includes loans secured by existing nonresidential properties.

Source: Reports of Condition and Income – June of each year.

Tenth District Bank Earnings Still Declining

% of avg. assets

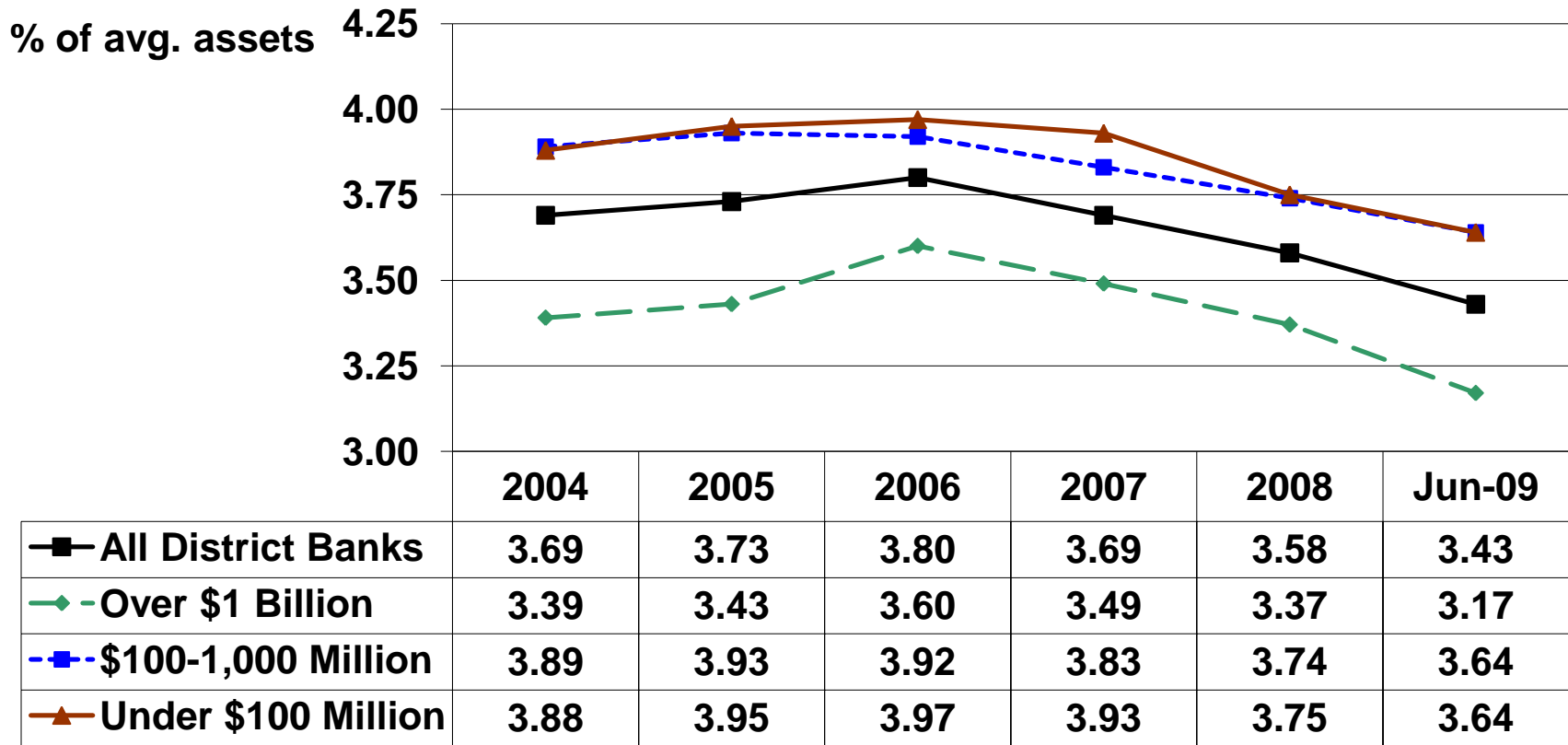


	2004	2005	2006	2007	2008	Jun-09
—■— All District Banks	1.64	1.76	1.76	1.56	0.85	0.58
—◆— Over \$1 Billion	1.72	1.78	1.91	1.67	0.54	0.34
- - ■ - - \$100-1,000 Million	1.73	1.88	1.76	1.53	1.16	0.84
—▲— Under \$100 Million	1.29	1.39	1.33	1.28	0.82	0.48

Tenth District Banks - Net Income Before Security G&L, Extraordinary Items and Taxes, as a percentage of average assets.

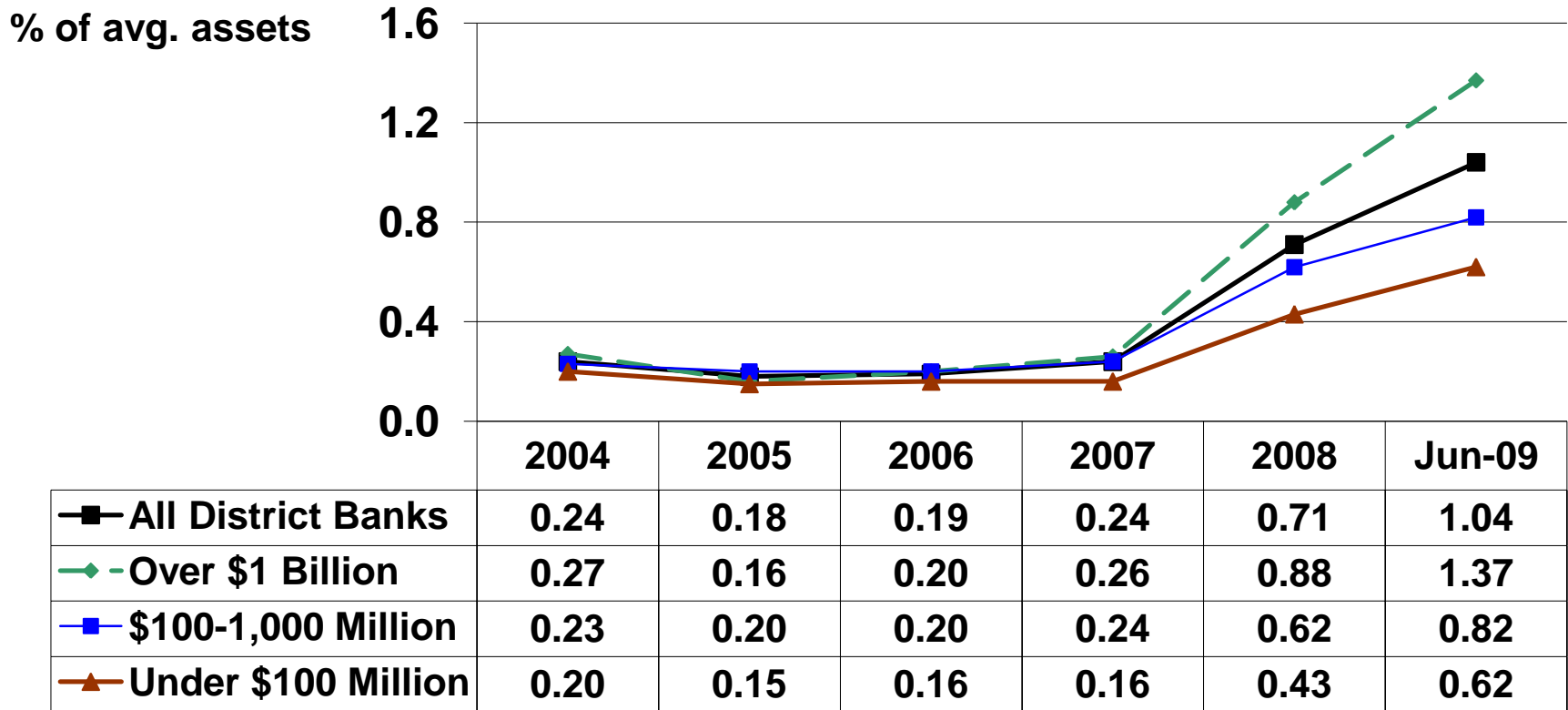
Source: Reports of Condition and Income

Interest Rate Margins Are Very Low & Falling



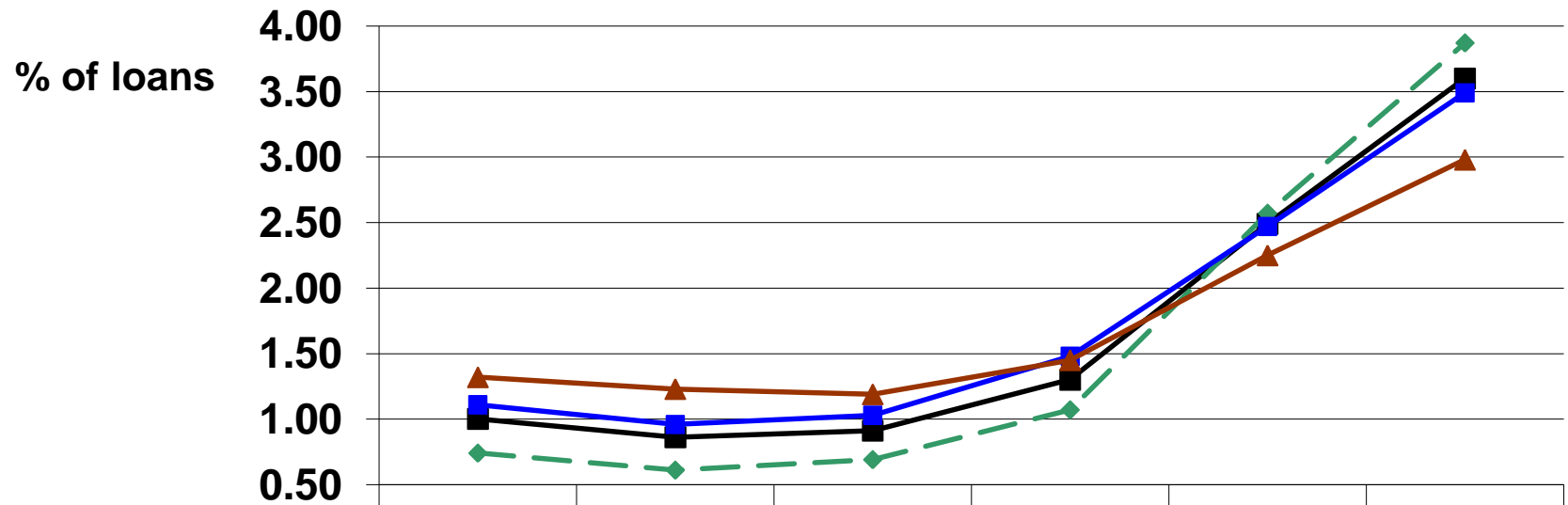
Tenth District Banks - Net Interest Income, as a percentage of average assets.
Source: Reports of Condition and Income

Loan Loss Provision Expenses Are Increasing



Tenth District Banks – Loan loss provision expense, as a percentage of average assets.
Source: Reports of Condition and Income

District Banks' Noncurrent Assets Continue Rising

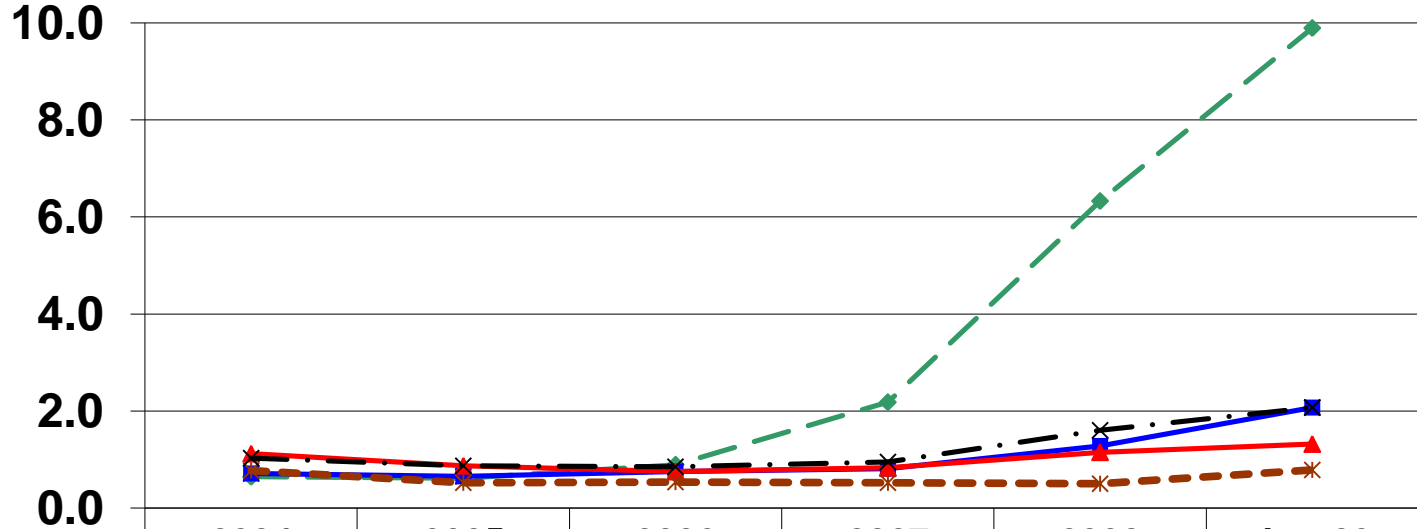


	2004	2005	2006	2007	2008	Jun-09
—■— All District Banks	1.00	0.86	0.91	1.30	2.49	3.60
—◆— Over \$1 Billion	0.74	0.61	0.69	1.07	2.57	3.87
—■— \$100-1,000 Million	1.11	0.96	1.03	1.48	2.47	3.49
—▲— Under \$100 Million	1.32	1.23	1.19	1.45	2.25	2.98

Tenth District Banks - Noncurrent loans + OREO-to-Total Loans.
 Source: Reports of Condition and Income

Noncurrent CLD Loans Have Exploded

% of loan type



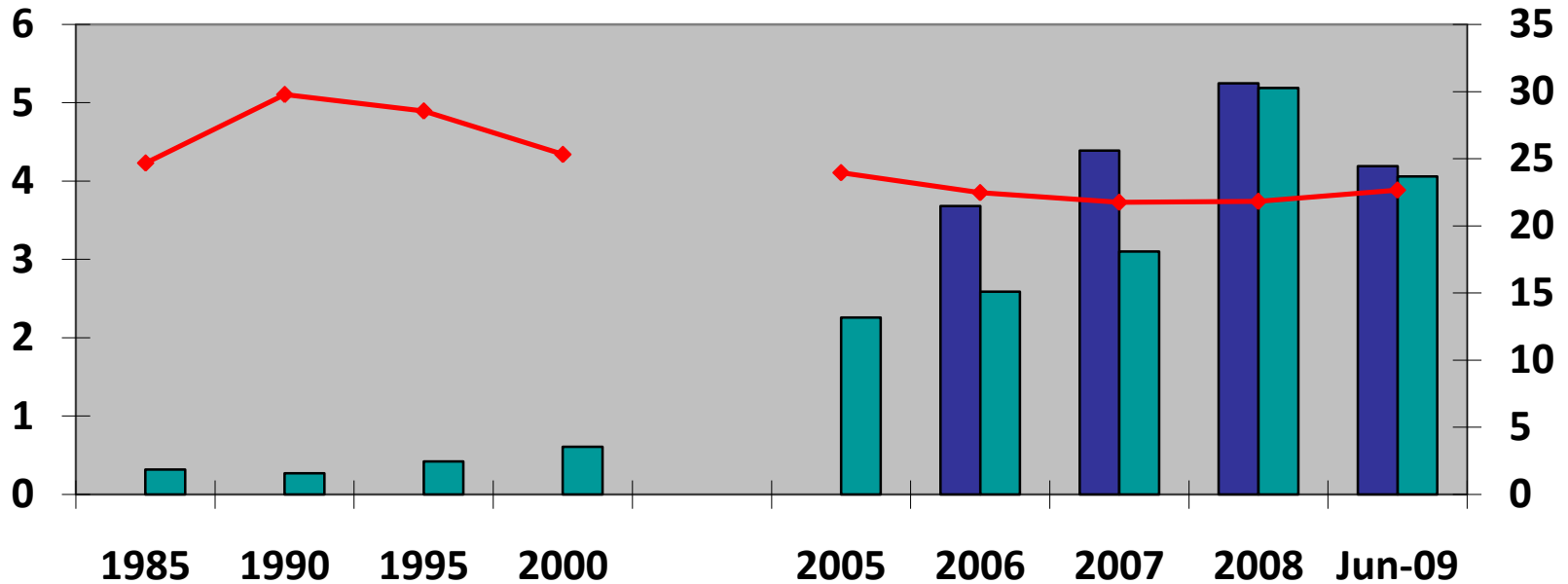
	2004	2005	2006	2007	2008	Jun-09
RE CLD	0.64	0.61	0.89	2.18	6.33	9.9
Other CRE	0.71	0.65	0.75	0.81	1.28	2.07
RE Farm	1.12	0.87	0.75	0.83	1.15	1.32
Farm	0.77	0.52	0.53	0.52	0.5	0.78
C&I	1.03	0.87	0.85	0.95	1.6	2.07

Tenth District Banks - Noncurrent Loans to Loans - By Loan Category.
Source: Reports of Condition and Income

Banks May Be Reducing the Use of Borrowings And Brokered Deposits

FHLB Advances & Brokered Deposits

Securities



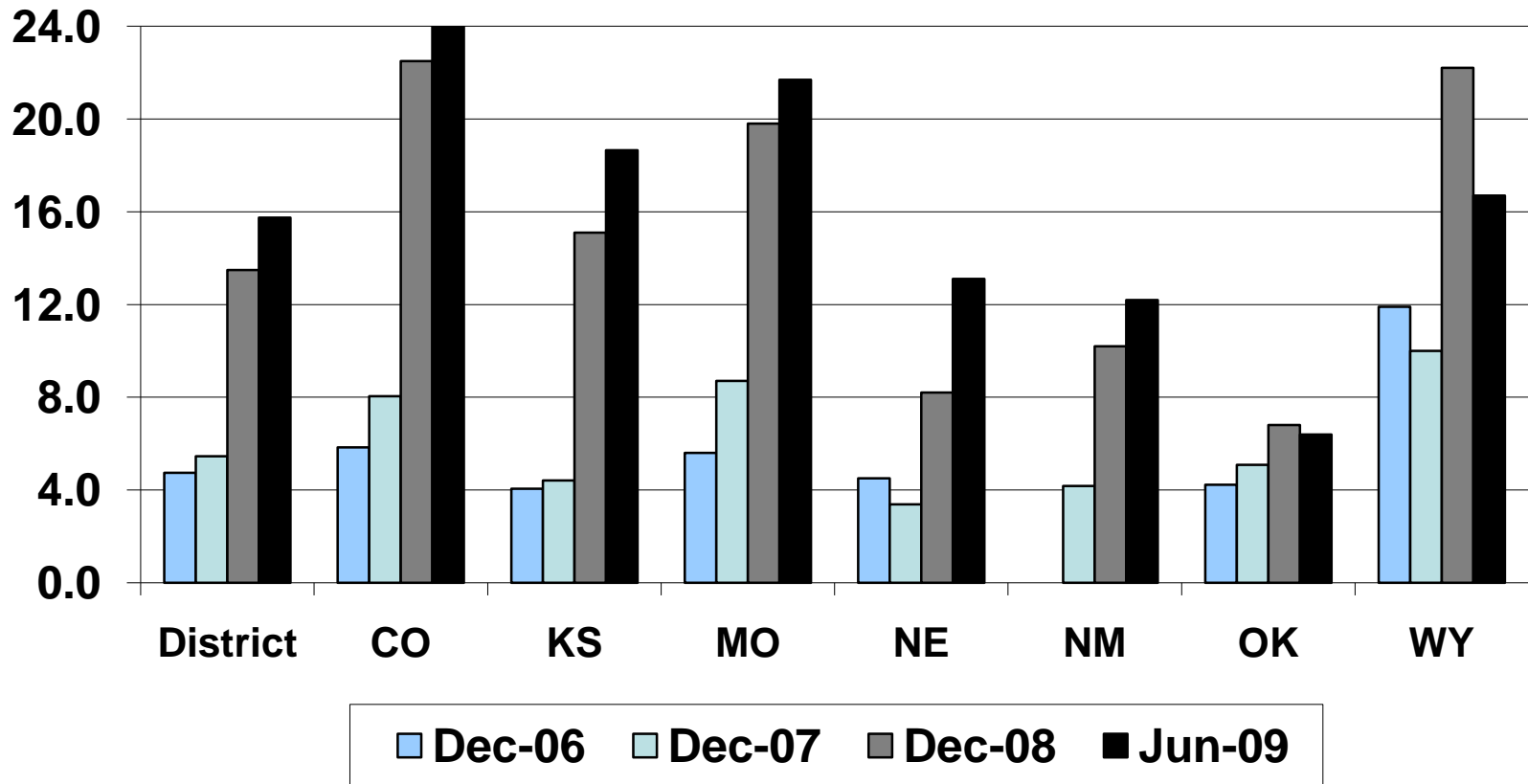
FHLB Advances
 Brokered Deposits
 Securities

Tenth District banks, ratios expressed as a percentage of assets.

Source: Reports of Condition and Income

Percentage of Banks With Losses Tenth District & District States

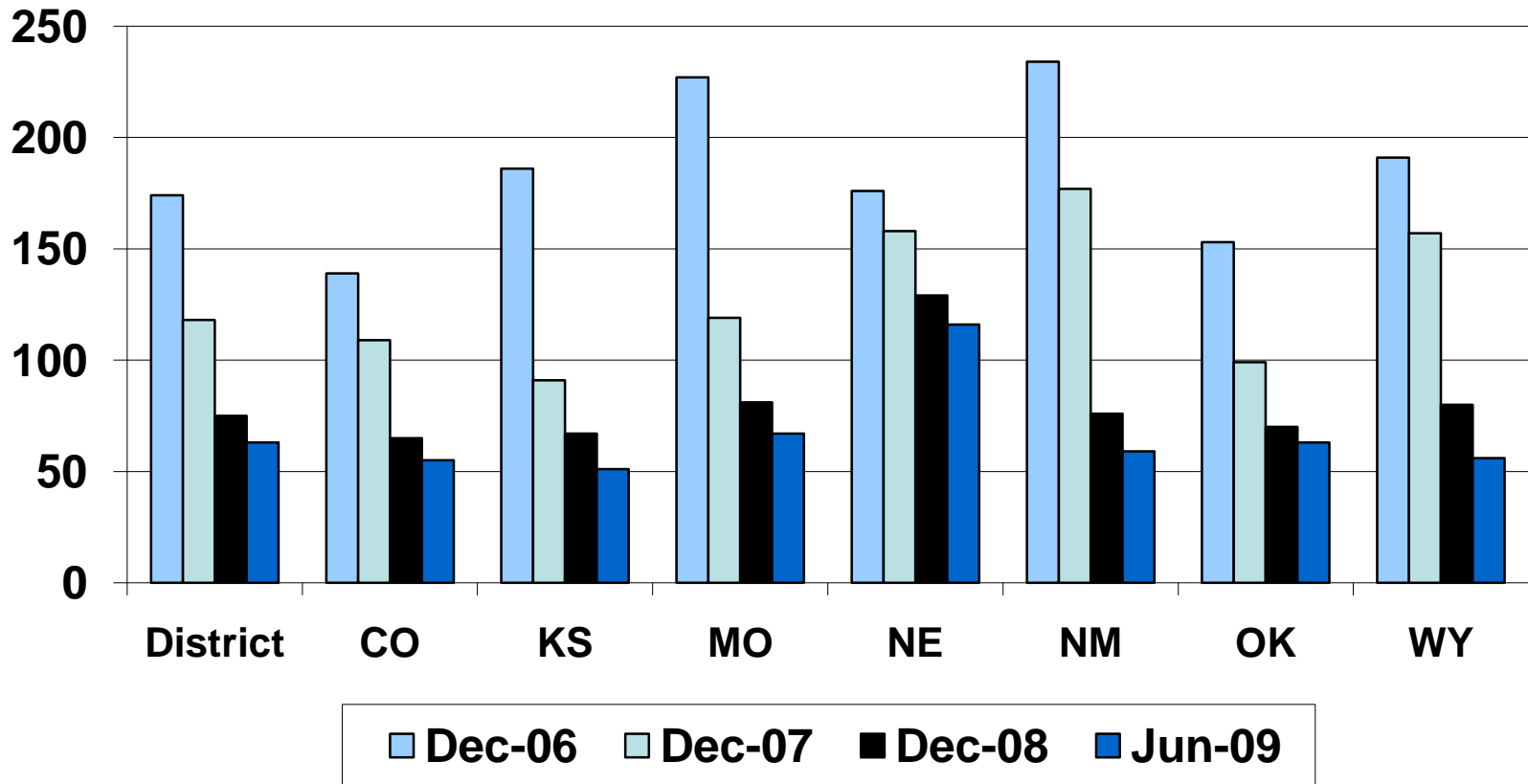
percent



Source: Reports of condition and income.

Coverage Ratio Tenth District & District States

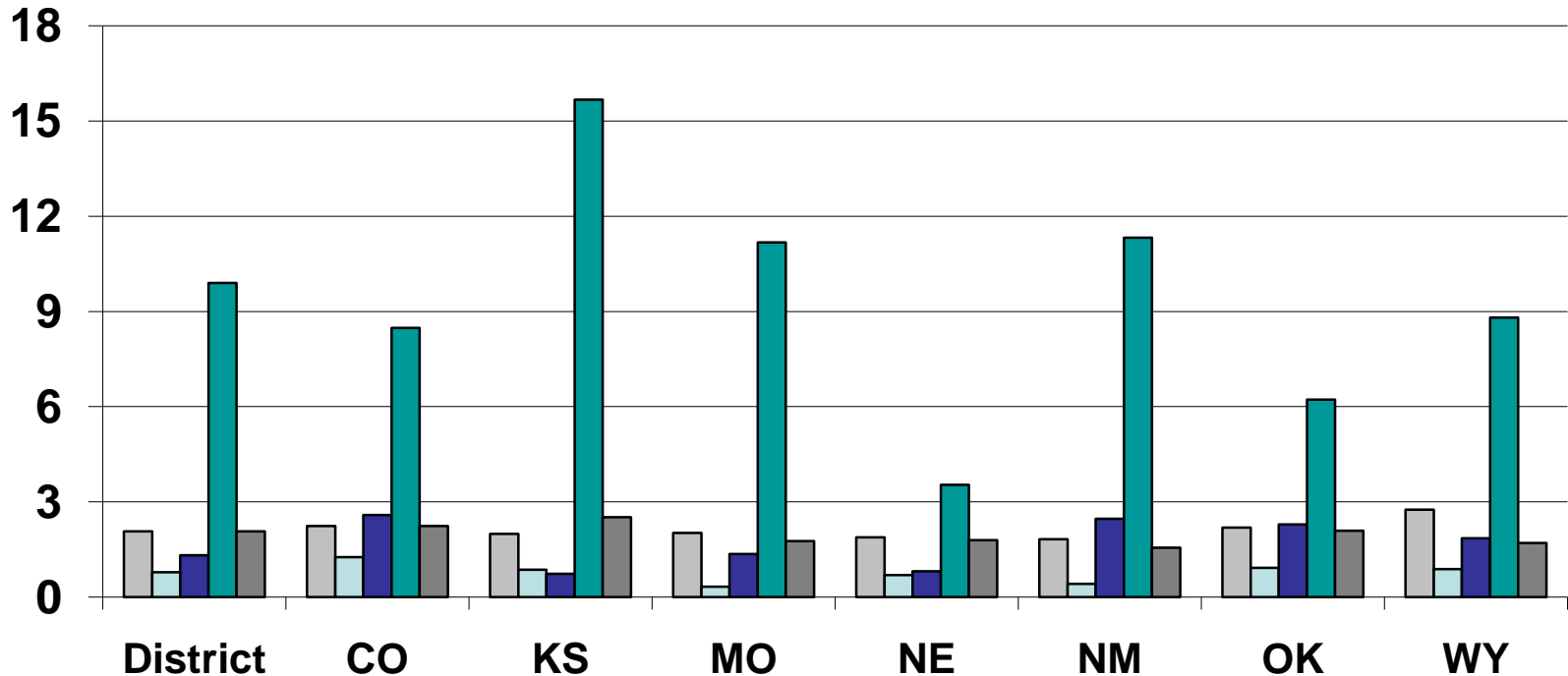
percent



Source: Banks reports of condition and income.

Noncurrent Loans By Loan Type Tenth District & District States

percent



C&I
 Farm
 Farm RE
 CLD
 Other CRE

Source: Banks reports of condition and income – June 2009.



**BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM**

WASHINGTON, D. C. 20551

**DIVISION OF BANKING
SUPERVISION AND REGULATION**

SR 83-24 (FIS)

June 28, 1983

**TO THE OFFICER IN CHARGE OF EXAMINATIONS
AT EACH FEDERAL RESERVE BANK**

SUBJECT: Transfers of Assets between Banks and Bank Holding Companies

It has recently come to our attention that there may be an increasing number of instances in which bank holding companies or their non-bank subsidiaries are purchasing "nonperforming" loans from their subsidiary banks. The Federal Reserve has long held that bank holding companies should serve as a source of strength for their subsidiary banks and the purchase of "nonperforming" loans would appear to be consistent with this principle.

Although such transactions do benefit the bank, holding company inspectors should review them carefully to insure that they are being reflected on the books of the banks and bank holding companies at "fair market" value. A determination of fair market value of "nonperforming" loans is difficult and often subjective, but as a minimum, the determination should reflect both the rate of return being earned on such loans as well as an appropriate risk premium. In cases where such transactions are material, it may be appropriate to require an independent appraisal of the assets involved in the transaction.

In all cases particular attention should be given to the effect of such transactions on the accuracy of public reports filed by subsidiary banks. Consideration should be given to reversing the transaction and requiring republishing of information disclosed in bank Reports of Condition in those instances when such transactions are made on less than a "fair market" basis.

**JOHN E. RYAN
DIRECTOR**

Note: This letter was cross referenced by [SR 04-5](#).



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 01-17 (SUP)
July 6, 2001

**TO THE OFFICER IN CHARGE OF SUPERVISION AND
APPROPRIATE SUPERVISORY AND EXAMINATION STAFF
AT EACH FEDERAL RESERVE BANK AND TO EACH
BANKING ORGANIZATION SUPERVISED BY THE FEDERAL
RESERVE**

**SUBJECT: Final Interagency Policy Statement on Allowance for Loan and Lease Losses (ALLL)
Methodologies and Documentation for Banks and Savings Institutions**

The Federal Financial Institutions Examination Council (FFIEC) has issued the attached "Interagency Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions."¹ This guidance was developed in consultation with Securities and Exchange Commission staff, who are issuing parallel guidance in the form of Staff Accounting Bulletin No. 102. In general, the interagency policy statement clarifies the agencies' expectations on documentation that supports the ALLL methodology. Additionally, the statement emphasizes the need for appropriate ALLL policies and procedures, which should include an effective loan review system. The guidance also provides examples of appropriate supporting documentation as well as illustrations on how to implement this guidance.

The guidance requires that a financial institution's ALLL methodology be consistent with GAAP and all outstanding supervisory guidance. An ALLL methodology should be systematic, consistently applied, and auditable. The methodology should be validated on a periodic basis and modified to incorporate new events or findings, as needed. The guidance specifies that management, under the direction of the board of directors, should implement appropriate procedures and controls to ensure compliance with the institution's ALLL policies and procedures. Institution management should segment the portfolio to evaluate credit risks; select loss rates that best reflect the probable loss; and be responsive to changes in the organization, the economy, or the lending environment by changing the methodology, when appropriate. Furthermore, supporting information should be included on summary schedules, whenever feasible. Under this policy, institutions with less complex loan products or portfolios, such as community banks, may use a more streamlined approach to implement this guidance.

This policy statement is consistent with the Federal Reserve's longstanding policy to promote strong internal controls over an institution's ALLL process. It is intended to supplement, not replace, the guidance in the Interagency Policy Statement on the ALLL issued in December 1993 ([SR letter 93-70](#)) and does not change GAAP. In this regard, this new policy statement recognizes that determining an appropriate allowance involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. In accordance with GAAP, an institution should record its best estimate within the range of credit losses. The Federal

Reserve is adopting the FFIEC policy, effective immediately.

While this policy statement, by its terms, applies only to depository institutions insured by the Federal Deposit Insurance Corporation, the Federal Reserve believes the guidance it contains is broadly applicable to bank holding companies. Accordingly, examiners should apply the policy, as appropriate, in the inspection of bank and holding companies and their nonbank subsidiaries. However, this policy does not apply to federally-insured branches and agencies of foreign banks. Federally-insured branches and agencies of foreign banks continue to be subject to separate guidance issued by their primary supervisory agency.

Reserve Banks are asked to distribute a copy of this SR letter and the policy statement to appropriate members of senior management of all bank holding companies and state member banks. If you have any questions pertaining to this policy statement, please contact Linda V. Griffith, Supervisory Financial Analyst, at 202-452-3506.

Richard Spillenkothen
Director

Attachment:

[Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions](#) (2,613 KB PDF)
Federal Financial Institutions Examination Council

Notes:

1. The FFIEC published the policy statement in the Federal Register on July 6, 2001. See Vol. 66, No. 130, pages 35629 to 35639. [Return to text](#)

***POLICY STATEMENT ON ALLOWANCE FOR LOAN AND LEASE LOSSES
METHODOLOGIES AND DOCUMENTATION FOR BANKS AND SAVINGS
INSTITUTIONS
JULY 2, 2001***

Boards of directors of banks and savings institutions are responsible for ensuring that their institutions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.¹ To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and underlying controls, the board of directors should assure themselves that the policies specifically address the institution's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the institution, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the audit committee² should oversee and monitor the internal controls over the ALLL determination process.³

The banking agencies'⁴ have long-standing examination policies that call for examiners to review an institution's lending and loan review functions and recommend improvements, if needed. Additionally, in 1995 and 1996, the banking agencies adopted

¹ A bibliography is attached that lists applicable ALLL GAAP guidance, interagency statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See Appendix B for additional information on applying GAAP to determine the ALLL.

² All institutions are encouraged to establish audit committees; however, at small institutions without audit committees, the board of directors retains this responsibility.

³ Institutions and their auditors should refer to Statement on Auditing Standards No. 61, *Communication With Audit Committees* (as amended by Statement on Auditing Standards No. 90, *Audit Committee Communications*), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties that have a significant impact on the accounting information included in the financial statements.

⁴ The banking agencies are the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

interagency guidelines establishing standards for safety and soundness, pursuant to Section 39 of the Federal Deposit Insurance Act (FDI Act).⁵ The interagency asset quality guidelines and the guidance in this paper assist an institution in estimating and establishing a sufficient ALLL supported by adequate documentation, as required under the FDI Act. Additionally, the guidelines require operational and managerial standards that are appropriate for an institution's size and the nature and scope of its activities.

For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.⁶ This Policy Statement describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound banking practice.⁷

This guidance applies equally to all institutions, regardless of the size. However, institutions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal approval processes) while continuing to ensure the institution has a consistent and appropriate methodology. Thus, much of the supporting documentation required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios. For example, simplified documentation can include spreadsheets, check lists, and other summary documents that many institutions currently use. Illustrations A and C provide specific examples of how less complex institutions may determine and document portions of their loan loss allowance.

Documentation Standards

Appropriate written supporting documentation for the loan loss provision and allowance facilitates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL determination process, and improves the process for

⁵ Institutions should refer to the guidelines adopted by their primary federal regulator as follows: For national banks, Appendix A to Part 30; for state member banks, Appendix D to Part 208; for state nonmember banks, Appendix A to Part 364; for savings associations, Appendix A to Part 570.

⁶ The documentation guidance within this Policy Statement is predominantly based upon the GAAP guidance from Financial Accounting Standards Board (FASB) Statement Numbers 5 and 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (which includes the *Viewpoints* Article – an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate), Chapter 7 - *Credit Losses*, the American Institute of Certified Public Accountants' (AICPA) *Audit and Accounting Guide, Banks and Savings Institutions*- 2000 edition (AICPA Audit Guide); and the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28).

⁷ Failure to maintain adequate supporting documentation does not relieve an institution of its obligation to record an appropriate ALLL.

estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. An institution should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.⁸

At a minimum, institutions should maintain written supporting documentation for the following decisions, strategies, and processes:

- Policies and procedures:
 - Over the systems and controls that maintain an appropriate ALLL and
 - Over the ALLL methodology,
- Loan grading system or process,
- Summary or consolidation of the ALLL balance,
- Validation of the ALLL methodology, and
- Periodic adjustments to the ALLL process.

The following sections of this Policy Statement provide guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, the paper provides documentation guidance on:

- Policies and Procedures,
- Methodology,
- ALLL Under FASB Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114),
- ALLL Under FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5),
- Consolidating the Loss Estimates, and
- Validating the ALLL Methodology.

POLICIES AND PROCEDURES

Financial institutions utilize a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio.

In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to:

⁸ This position is fully described in the SEC's FRR 28, in which the SEC indicates that the books and records of public companies engaged in lending activities should include documentation of the rationale supporting each period's determination that the ALLL and provision amounts reported were adequate.

- The roles and responsibilities of the institution's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- The institution's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;
- The description of the institution's systematic methodology, which should be consistent with the institution's accounting policies for determining its ALLL;⁹ and
- The system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal control system for the ALLL estimation process should:

- Include measures to provide assurance regarding the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- Reasonably assure that the institution's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance;¹⁰ and
- Include a well-defined loan review process containing:
 - An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
 - Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and

⁹ Further explanation is presented in the Methodology section that appears below.

¹⁰ In addition to the supporting documentation requirements for financial institutions, as described in interagency asset quality guidelines, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under Sections 13(b)(2)-(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. See also SEC Staff Accounting Bulletin No. 99, *Materiality*.

- Clear formal communication and coordination between an institution's credit administration function, financial reporting group, management, board of directors, and others who are involved in the ALLL determination or review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

METHODOLOGY

An ALLL methodology is a system that an institution designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

An institution's ALLL methodology is influenced by institution-specific factors, such as an institution's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. However, there are certain common elements an institution should incorporate in its ALLL methodology. A summary of common elements is provided in Appendix B.¹¹

Documentation of ALLL Methodology in Written Policies and Procedures

An institution's written policies and procedures should describe the primary elements of the institution's ALLL methodology, including portfolio segmentation and impairment measurement. In order for an institution's ALLL methodology to be effective, the institution's written policies and procedures should describe the methodology:

- For segmenting the portfolio:
 - How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
 - When a loan grading system is used to segment the portfolio:
 - ◆ The definitions of each loan grade,
 - ◆ A reconciliation of the internal loan grades to supervisory loan grades, and
 - ◆ The delineation of responsibilities for the loan grading system.
- For determining and measuring impairment under FAS 114:
 - The methods used to identify loans to be analyzed individually;

¹¹ Also, refer to paragraph 7.05 of the AICPA Audit Guide.

- For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:
 - ◆ Procedures describing the impairment measurement techniques available and
 - ◆ Steps performed to determine which technique is most appropriate in a given situation.
- The methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.
- For determining and measuring impairment under FAS 5:
 - How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
 - How loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
 - Descriptions of qualitative factors (e.g., industry, geographical, economic, and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in an institution's credit files, loan review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

ALL UNDER FAS 114

An institution's ALLL methodology related to FAS 114 loans begins with the use of its normal loan review procedures to identify whether a loan is impaired as defined by the accounting standard. Institutions should document:

- The method and process for identifying loans to be evaluated under FAS 114 and
- The analysis that resulted in an impairment decision for each loan and the determination of the impairment measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once an institution has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- When using the present value of expected future cash flows method:
 - The amount and timing of cash flows,
 - The effective interest rate used to discount the cash flows, and
 - The basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.

- When using the fair value of collateral method:
 - 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
 - Appraisal quality, and the expertise and independence of the appraiser.

- When using the observable market price of a loan method:
 - The amount, source, and date of the observable market price.

Illustration A describes a practice used by a small financial institution to document its FAS 114 measurement of impairment using a comprehensive worksheet.¹² Q&A #1 and #2 in Appendix A provide examples of applying and documenting impairment measurement methods under FAS 114.

ILLUSTRATION A
DOCUMENTING AN ALLL UNDER FAS 114

Comprehensive worksheet for the impairment measurement process

A small institution utilizes a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

¹² The referenced “gray box” illustrations are presented to assist institutions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all institutions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of ALLL Questions and Answers (Q&As) are included in Appendix A of this paper.

Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Q&A #3 in Appendix A presents an example of an institution whose loan portfolio includes fully collateralized loans and describes the documentation maintained by that institution to support its conclusion that no ALLL was needed for those loans.

ALL UNDER FAS 5

Segmenting the Portfolio

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Institutions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller institutions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate in only small institutions offering a narrow range of loan products. Larger institutions typically offer a more diverse and complex mix of loan products. Such institutions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, an institution should maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, institutions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration B presents an example in which an institution refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

ILLUSTRATION B DOCUMENTING SEGMENTING PRACTICES

Documenting a refinement in a segmentation method

An institution with a significant portfolio of consumer loans performed a review of its ALLL methodology. The institution had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the institution decided to evaluate loss rates on an individual product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Institutions use a variety of documents to support the segmentation of their portfolios. Some of these documents include:

- Loan trial balances by categories and types of loans,
- Management reports about the mix of loans in the portfolio,
- Delinquency and nonaccrual reports, and
- A summary presentation of the results of an internal or external loan grading review.

Reports generated to assess the profitability of a loan product line may be useful in identifying areas in which to further segment the portfolio.

Estimating Loss on Groups of Loans

Based on the segmentation of the loan portfolio, an institution should estimate the FAS 5 portion of its ALLL. For those segments that require an ALLL,¹³ the institution should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance. The institution should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation. Regardless of the methods used to measure losses, an institution should demonstrate and document that the loss measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.¹⁴

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect the institution's historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If an institution does not have loss experience of its own, it may be appropriate to reference the loss experience of other institutions, provided that the institution demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the institution providing the loss experience.¹⁵ Institutions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, institutions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of how a small institution performs a comprehensive historical loss analysis is provided as the first item in Illustration C.

¹³ An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending institution.

¹⁴ Refer to paragraph 8(b) of FAS 5. Also, the AICPA is currently developing a Statement of Position that will provide more specific guidance on accounting for loan losses.

¹⁵ Refer to paragraph 23 of FAS 5.

Before employing a loss estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, institutions that use loss estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the support for adjustments to the model or its results.

ILLUSTRATION C

DOCUMENTING THE SETTING OF LOSS RATES

Comprehensive loss analysis in a small institution

A small institution determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The institution also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The institution maintains supporting documentation for its loss factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

An institution develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on commercial real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The institution generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The institution maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

In developing loss measurements, institutions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affected the loss measurements. Factors that should be considered in developing loss measurements include the following:¹⁶

- Levels of and trends in delinquencies and impaired loans;
- Levels of and trends in charge-offs and recoveries;
- Trends in volume and terms of loans;
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- Experience, ability, and depth of lending management and other relevant staff;
- National and local economic trends and conditions;

¹⁶ Refer to paragraph 7.13 in the AICPA Audit Guide.

- Industry conditions; and
- Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, the institution should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in Illustration C provides an example of how an institution adjusts its commercial real estate historical loss rates for changes in local economic conditions. Q&A #4 in Appendix A provides an example of maintaining supporting documentation for adjustments to portfolio segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Q&A #5 in Appendix A describes one institution's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

CONSOLIDATING THE LOSS ESTIMATES

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include:

- The estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- The aggregate probable loss estimated using the institution's methodology;
- A summary of the current ALLL balance;
- The amount, if any, by which the ALLL is to be adjusted;¹⁷ and
- Depending on the level of detail that supports the ALLL analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

¹⁷ Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

Illustration D describes how an institution documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

ILLUSTRATION D

SUMMARIZING LOSS ESTIMATES

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, an institution adds detailed supporting information to its summary schedule. For example, this institution's board of directors receives, within the body of the ALLL summary schedule, a brief description of the institution's policy for selecting loans for evaluation under FAS 114. Additionally, the institution identifies which FAS 114 impairment measurement method was used for each individually reviewed impaired loan. Other items on the schedule include a brief description of the loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Generally, an institution's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Q&A #6 in Appendix A addresses the documentation of the final amount of the ALLL.

VALIDATING THE ALLL METHODOLOGY

An institution's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the institution's methodology should include procedures that adjust loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, an institution's directors should establish internal control policies, appropriate for the size of the institution and the type and complexity of its loan products.

These policies should include procedures for a review, by a party who is independent of the ALLL estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, financial institutions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

- A review of trends in loan volume, delinquencies, restructurings, and concentrations.
- A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- A review by a party that is independent of the ALLL estimation process. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.
- An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The institution's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

APPENDIX A – ALLL QUESTIONS AND ANSWERS

INTRODUCTION

The Questions and Answers (Q&As) presented in this appendix serve several purposes, including (1) to illustrate the banking agencies' views, as set forth in this Policy Statement, about the types of decisions, determinations, and processes an institution should document with respect to its ALLL methodology and amounts; and (2) to illustrate the types of ALLL documentation and processes an institution might prepare, retain, or use in a particular set of circumstances. The level and types of documentation described in the Q&As should be considered neither the minimum acceptable level of documentation nor an all-inclusive list. Institutions are expected to apply the guidance in this Policy Statement to their individual facts, circumstances, and situations. If an institution's fact pattern differs from the fact patterns incorporated in the following Q&As, the institution may decide to prepare and maintain different types of documentation than did the institutions depicted in these Q&As.

Q&A #1 - ALLL Under FAS 114 – Measuring and Documenting Impairment

Facts: Approximately one-third of Institution A's commercial loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Institution A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Institution A determines that certain of the loans are impaired as defined by FAS 114.

Question: For the commercial loans reviewed under FAS 114 that are individually impaired, how should Institution A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

Interpretive Response: For those loans that are reviewed individually under FAS 114 and considered individually impaired, Institution A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Institution A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

Institution A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If Institution A uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors¹ and other information reflecting past events and current conditions. If Institution A uses the fair value of collateral to measure impairment, it should document how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. Similarly, Institution A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

¹ Question #16 in Exhibit D-80A of EITF Topic D-80 and attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

Q&A #2 – ALLL Under FAS 114 – Measuring Impairment for a Collateral Dependent Loan

Facts: Institution B has a \$10 million loan outstanding to Company X that is secured by real estate, which Institution B individually evaluates under FAS 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Institution B determines that its loan to Company X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Institution B measures impairment of the loan based on the fair value of the collateral. Institution B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Institution B believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Institution B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.² After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million. Given that the recorded investment in the loan is \$10 million, Institution B concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

Question: What type of documentation should Institution B maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Company X?

Interpretive Response: Institution B should document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million. This documentation should include the institution's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Institution B arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.³

² When reviewing collateral dependent loans, Institution B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

³ In accordance with the FFIEC's Federal Register Notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 FR 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

Q&A #3 – ALLL Under FAS 114 – Fully Collateralized Loans

Facts: Institution C has \$10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Institution C's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Institution C perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Institution C's credit administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Institution C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Institution C has historically not incurred any material losses on these loans. Institution C believes these loans are fully-collateralized and therefore does not maintain any ALLL balance for these loans.

Question: What documentation does Institution C maintain to adequately support its determination that no allowance is needed for this group of loans?

Interpretive Response: Institution C's management summary of the ALLL includes documentation indicating that, in accordance with the institution's ALLL policy, the collateral protection on these loans has been verified by the institution, no probable loss has been incurred, and no ALLL is necessary. Documentation in Institution C's loan files includes the two independent market quotes obtained each quarter for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Institution C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. Institution C's policy requires the following factors to be considered and the institution's findings concerning these factors to be fully documented:

- Volatility of the market value of the collateral;
- Recency and reliability of the appraisal or other valuation
- Recency of the institution's or third party's inspection of the collateral
- Historical losses on similar loans;
- Confidence in the institution's lien or security position including appropriate:
 - Type of security perfection (e.g., physical possession of collateral or secured filing);
 - Filing of security perfection (i.e., correct documents and with the appropriate officials); and
 - Relationship to other liens; and
- Other factors as appropriate for the loan type.

Q&A #4 – ALLL Under FAS 5 – Adjusting Loss Rates

Facts: Institution D's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Institution D has yet to confirm an increase in its loss experience as a result of these events, management knows that it lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Institution D's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Institution D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Institution D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How should Institution D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

Interpretive Response: Institution D should document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, Institution D should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Institution D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, economic data, and notes from discussions with individual borrowers.

Because in this case Institution D has had similar situations in the past, its supporting documentation also includes an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, Institution D creates a summary of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Q&A #5 – ALLL Under FAS 5 – Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts: Institution E has outstanding loans of \$2 million to Company Y and \$1 million to Company Z, both of which are paying as agreed upon in the loan documents. The institution's ALLL policy specifies that all loans greater than \$750,000 must be individually reviewed for impairment under FAS 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the institution's loan grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Institution E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1 and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.⁴

In its determination of the ALLL under FAS 5, Institution E includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (i.e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors provides a reasonable estimate of the institution's probable loan losses in these segments.

Question: How does Institution E adequately document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response:

As part of Institution E's effective ALLL methodology, it documents the decision to include its loans to Company Y and Company Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Institution E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its

⁴These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

historical loss rates. The institution also maintains copies of the economic and other reports that provided source data.

Q&A #6 - Consolidating the Loss Estimates – Documenting the Reported ALLL

Facts: Institution F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the Credit Committee, and, ultimately, the board of directors. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes that are required by GAAP to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by senior management and the Credit Committee, as well as a verbal explanation of the changes made by senior management and the Credit Committee when they met to discuss the loan loss allowance.

Question: Are Institution F's documentation practices related to the balance of its loan loss allowance in compliance with existing documentation guidance in this area?

Interpretive Response: No. An institution must maintain supporting documentation for the loan loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For institutions subject to external audit, this documentation should also be made available to the independent accountants. If changes frequently occur during management or credit committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the institution uses.

APPENDIX B--APPLICATION OF GAAP

An ALLL recorded pursuant to GAAP is an institution's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.¹ A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. An institution should record its best estimate within the range of loan losses.²

Under GAAP, Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.³ Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. The following Illustration provides an example of an institution estimating a loan's impairment when the loan has been partially charged-off.

¹ This Appendix provides guidance on the ALLL and does not address allowances for credit losses for off-balance sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Institutions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Banks and Savings Institutions*, 2000 edition (AICPA Audit Guide). Additionally, this Appendix does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a Replacement of FASB Statement No. 125* (FAS 140).

² Refer to FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and Emerging Issues Task Force Topic No. D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF Topic D-80).

³ EITF Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other. The AICPA is currently developing a Statement of Position (SOP) that will provide more specific guidance on accounting for loan losses.

ILLUSTRATION

INTERACTION OF FAS 114 WITH AN ADVERSELY CLASSIFIED LOAN, PARTIAL CHARGE-OFF, AND THE OVERALL ALLL

An institution determined that a collateral dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the institution classified as “Loss,” the portion of the recorded investment deemed to be the confirmed loss and classified the remaining recorded investment as “Substandard.” For this loan, the amount classified “Loss” was less than the impairment amount (as determined under FAS 114). The institution charged off the “Loss” portion of the loan. After the charge-off, the portion of the ALLL related to this “Substandard” loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution’s overall ALLL.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are *not* included in the scope of FAS 114.⁴ Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired.

Institutions should ensure that they do not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when an institution includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.⁵

While different institutions may use different methods, there are certain common elements that should be included in any loan loss allowance methodology. Generally, an institution’s methodology should:⁶

⁴ In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

⁵ According to the Federal Financial Institutions Examination Council’s Federal Register Notice, *Implementation Issues Arising from FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*, published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

⁶ Refer to paragraph 7.05 of the AICPA Audit Guide.

- Include a detailed analysis of the loan portfolio, performed on a regular basis;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- Consider the particular risks inherent in different kinds of lending;
- Consider current collateral values (less costs to sell), where applicable;
- Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
- Be based on current and reliable data;
- Be well documented, in writing, with clear explanations of the supporting analyses and rationale; and
- Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.⁷

⁷ Institutions should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality*.

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BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM
WASHINGTON, D. C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 06-17
December 13, 2006

**TO THE OFFICER IN CHARGE OF SUPERVISION AND
APPROPRIATE SUPERVISORY AND EXAMINATION STAFF
AT EACH FEDERAL RESERVE BANK AND BANKING
ORGANIZATIONS SUPERVISED BY THE FEDERAL
RESERVE**

SUBJECT: Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)

On December 13, 2006, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Office of Thrift Supervision (the "banking agencies"), and the National Credit Union Administration (NCUA) issued the attached *Interagency Policy Statement on the Allowance for Loan and Lease Losses*. This guidance updates and replaces the 1993 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (SR Letter 93-70). The agencies revised the prior policy to ensure consistency with generally accepted accounting principles (GAAP) and more recent supervisory guidance. Additionally, the agencies issued a supplemental Frequently Asked Questions document to assist with application of the revised policy statement.

The revision updates the previous policy statement's description of the responsibilities of boards of directors, management, and examiners of banking organizations regarding the allowance for loan and lease losses (ALLL); factors to be considered in the estimation of the ALLL; and the objectives and elements of an effective loan review system, including a sound credit grading system. The revised policy statement emphasizes that each institution is responsible 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. To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution's stated policies and procedures, management's best judgment, and relevant supervisory guidance.

The revised policy reiterates the points of agreement between the Securities and Exchange Commission and the banking agencies since 1999: the need for management to exercise significant judgment when estimating the ALLL, the concept of a range of losses, and the appropriateness of a properly developed and documented ALLL. Accordingly, the policy emphasizes that an institution should provide reasonable support and documentation of its ALLL estimates, including adjustments to the allowance for qualitative or environmental factors and unallocated portions of the allowance. This emphasis on support and documentation supplements, but does not replace, the guidance in the *Interagency Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* ([SR Letter 01-17](#)).

Additionally, the policy reminds institutions that the allowance is an institution-specific estimate and generally should not be based solely on a "standard percentage" of loans. While peer

group or other benchmark averages are an appropriate tool to evaluate the reasonableness of the allowance, it is the institution's responsibility to analyze the collectibility of the loan portfolio to estimate the allowance. To that end, the policy statement will no longer reference standardized loss estimates (i.e., 15% for loans classified as substandard and 50% for loans classified as doubtful).

The revised policy also includes guidance on SFAS 114, *Accounting by Creditors for Impairment of a Loan*, which describes the evaluation and measurement of impairment for loans that are impaired on an individual basis, and SFAS 5, *Accounting for Contingencies*, which describes the same for pools of loans grouped according to risk factors. The revised language describes the relationship between the two standards as well as the application of each standard in estimating the ALLL.

The policy also reminds institutions that allowances related to off-balance sheet financial instruments such as loan commitments or letters of credit should not be reported as part of the ALLL. Any allowance for these types of instruments is recorded as an Other Liability.

Although the revised policy statement reiterates key concepts and requirements in GAAP and existing supervisory guidance on the ALLL, the agencies recognize that institutions may not have sufficient time to complete any enhancements needed to bring their ALLL processes and documentation into full compliance with the revised guidance for year-end 2006 reporting purposes. Nevertheless, these enhancements should be completed in the near term.

This policy statement applies to all depository institutions supervised by the banking agencies and to institutions insured and supervised by the NCUA, except for U.S. branches and agencies of foreign banks. In addition, the Federal Reserve believes the guidance is broadly applicable to bank holding companies as well. Accordingly, examiners should apply the policy, as appropriate, in the inspection of bank holding companies and their nonbank subsidiaries, in addition to the examination of state member banks. Examiner training materials are being updated to reflect the new policy statement. U.S. branches and agencies of foreign banks continue to be subject to any separate guidance that has been issued by their primary supervisory agency.

Reserve Banks are asked to distribute a copy of this SR letter and the policy statement to appropriate members of senior management of all bank holding companies and state member banks. Questions pertaining to this policy statement may be directed to Sharon Ramsay, Supervisory Financial Analyst, at (202) 452-2028, Arthur Lindo, Deputy Associate Director, at (202) 452-2695, or Charles Holm, Associate Director and Chief Accountant, at (202) 452-3502.

Roger T. Cole
Director

- Attachments: [Interagency Policy Statement on the Allowance for Loan and Lease Losses](#)
(1,539 KB PDF)
[Questions and Answers on Accounting for Loan and Lease Losses](#)
(848 KB PDF)
- Supersedes: SR 93-70
- Cross Reference: [SR 01-17](#)
- Manual Sections: [Commercial Bank Examination Manual](#), 2070.1 and 2072.1

[Bank Holding Company Supervision Manual](#), 2065.2 and 2065.3

**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of Thrift Supervision**

**Interagency Policy Statement on the
Allowance for Loan and Lease Losses¹**

Purpose

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, jointly with the National Credit Union Administration, have revised the banking agencies' 1993 policy statement on the allowance for loan and lease losses (ALLL) to ensure consistency with generally accepted accounting principles (GAAP) and more recent supervisory guidance. The banking agencies originally issued the 1993 policy statement to describe the responsibilities of the boards of directors and management of banks and savings associations and of examiners regarding the ALLL. This revision replaces the 1993 policy statement and also makes it applicable to credit unions. In addition, the agencies are issuing the attached frequently asked questions (FAQs) to assist institutions in complying with GAAP and ALLL supervisory guidance.

Background

This policy statement reiterates key concepts and requirements included in GAAP and existing ALLL supervisory guidance.²

The principal sources of guidance on accounting for impairment in a loan portfolio under GAAP are Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114). In addition, the Financial Accounting Standards Board *Viewpoints* article that is included in Emerging Issues Task Force Topic D-80 (EITF D-80), *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio*, presents questions and answers that provide specific guidance on the interaction between these two FASB statements and may be helpful in applying them.

¹ This policy statement applies to all depository institutions (institutions), except U.S. branches and agencies of foreign banks, supervised by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision (the "banking agencies") and to institutions insured and supervised by the National Credit Union Administration (NCUA) (collectively, the "agencies"). U.S. branches and agencies of foreign banks continue to be subject to any separate guidance that has been issued by their primary supervisory agency.

² As discussed more fully in the "Nature and Purpose of the ALLL" section below, this policy statement and the ALLL generally do not address loans carried at fair value or loans held for sale. In addition, this policy statement provides only limited guidance on "purchased impaired loans."

In July 1999, the banking agencies and the Securities and Exchange Commission (SEC) issued a Joint Interagency Letter to Financial Institutions. The letter stated that the banking agencies and the SEC agreed on the following important aspects of loan loss allowance practices:

- 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;
- 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 environmental factors such as industry, geographical, economic, and political factors.

In July 2001, the banking agencies issued a *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* (2001 Policy Statement). It is designed to assist institutions in establishing a sound process for determining an appropriate ALLL and documenting that process in accordance with GAAP.³ The guidance in the 2001 Policy Statement was substantially adopted by the NCUA through its Interpretative Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions* in May 2002 (NCUA's 2002 IRPS).

In March 2004, the agencies issued an *Update on Accounting for Loan and Lease Losses*. This guidance provided reminders of longstanding supervisory guidance as well as a listing of the existing allowance guidance that institutions should continue to apply.

Nature and Purpose of the ALLL

The ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. Because of its significance, each institution has a

³ The 2001 Policy Statement and the 2002 NCUA IRPS are available on the agencies' Web sites. In addition, the SEC staff issued parallel guidance in July 2001 in Staff Accounting Bulletin No. 102 – *Selected Loan Loss Allowance Methodology and Documentation Issues* (SAB 102), which has been codified as Topic 6.L. in the SEC's Codification of Staff Accounting Bulletins. Both SAB 102 and the Codification are available on the SEC's Web site.

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). To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution's stated policies and procedures, management's best judgment and relevant supervisory guidance.

As of the end of each quarter, or more frequently if warranted, each institution must analyze the collectibility of its loans and leases held for investment⁴ (hereafter referred to as "loans") and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. The ALLL does not apply, however, to loans carried at fair value, loans held for sale,⁵ off-balance sheet credit exposures⁶ (e.g. financial instruments such as off-balance sheet loan commitments, standby letters of credit, and guarantees), or general or unspecified business risks.

For purposes of this policy statement, the term "estimated credit losses" means 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.⁷ When available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL.

⁴ Consistent with the American Institute of Certified Public Accountants' (AICPA) Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, loans and leases held for investment are those loans and leases that the institution has the intent and ability to hold for the foreseeable future or until maturity or payoff.

⁵ Refer to the "Interagency Guidance on Certain Loans Held for Sale" (March 26, 2001) for the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held-for-sale account. Loans held for sale are reported at the lower of cost or fair value. Declines in value occurring after the transfer of a loan to the held-for-sale portfolio are accounted for as adjustments to a valuation allowance for held-for-sale loans and not as adjustments to the ALLL.

⁶ Credit losses on off-balance sheet credit exposures should be estimated in accordance with FAS 5. Any allowance for credit losses on off-balance sheet exposures should be reported on the balance sheet as an "Other Liability," not as part of the ALLL.

⁷ FAS 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 in relation to 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 FAS 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 will occur confirming the fact of the loss. Thus, under GAAP, the purpose of the ALLL is not to absorb all of the risk in the loan portfolio, but to cover probable credit losses that have already been incurred.

For “purchased impaired loans,”⁸ GAAP prohibits “carrying over” or creating an ALLL in the initial recording of these loans. However, if, upon evaluation subsequent to acquisition, it is probable that the institution will be unable to collect all cash flows expected at acquisition on a purchased impaired loan (an estimate that considers both timing and amount), the loan should be considered impaired for purposes of applying the measurement and other provisions of FAS 5 or, if applicable, FAS 114.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For loans within the scope of FAS 114 that are individually evaluated and determined to be impaired,⁹ these estimates should reflect consideration of one of the standard’s three impairment measurement methods as of the evaluation date: (1) the present value of expected future cash flows discounted at the loan’s effective interest rate,¹⁰ (2) the loan’s observable market price, or (3) the fair value of the collateral if the loan is collateral dependent.

An institution may choose the appropriate FAS 114 measurement method on a loan-by-loan basis for an individually impaired loan, except for an impaired collateral-dependent loan. The agencies require impairment of a collateral-dependent loan to be measured using the fair value of collateral method. As defined in FAS 114, a loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral. In general, any portion of the recorded investment in a collateral-dependent loan (including any capitalized accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible, and is therefore deemed a confirmed loss, should be promptly charged off against the ALLL.¹¹

⁸ A “purchased impaired loan” is defined as a loan that an institution has purchased, including a loan acquired in a purchase business combination, that has evidence of deterioration of credit quality since its origination and for which it is probable, at the purchase date, that the institution will be unable to collect all contractually required payments. When reviewing the appropriateness of the reported ALLL of an institution with purchased impaired loans, examiners should consider the credit losses factored into the initial investment in these loans when determining whether further deterioration, e.g., decreases in cash flows expected to be collected, has occurred since the loans were purchased. The agencies’ regulatory reports and disclosures in financial statements may provide useful information for examiners in reviewing these loans. Refer to the AICPA’s Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, for further guidance on the appropriate accounting.

⁹ FAS 114 does not specify how an institution should identify loans that are to be evaluated for collectibility nor does it specify how an institution should determine that a loan is impaired. An institution should apply its normal loan review procedures in making those judgments. Refer to the FAQs for further guidance.

¹⁰ The effective interest rate on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan).

¹¹ For further information, banks and savings associations should refer to the Illustration in Appendix B of the 2001 Policy Statement. Credit unions should refer to the section heading “Application of GAAP” in the NCUA’s 2002 IRPS.

All other loans, including individually evaluated loans determined not to be impaired under FAS 114, should be included in a group of loans that is evaluated for impairment under FAS 5.¹² While an institution may segment its loan portfolio into groups of loans based on a variety of factors, the loans within each group should have similar risk characteristics. For example, a loan that is fully collateralized with risk-free assets should not be grouped with uncollateralized loans. When estimating credit losses on each group of loans with similar risk characteristics, an institution should consider its historical loss experience on the group, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans as of the evaluation date.

For analytical purposes, an institution should attribute portions of the ALLL to loans that it evaluates and determines to be impaired under FAS 114 and to groups of loans that it evaluates collectively under FAS 5. However, the ALLL is available to cover all charge-offs that arise from the loan portfolio.

Responsibilities of the Board of Directors and Management

Appropriate ALLL Level

Each institution's management is responsible for maintaining the ALLL at an appropriate level and for documenting its analysis according to the standards set forth in the 2001 Policy Statement or the NCUA's 2002 IRPS, as applicable. Thus, management should evaluate the ALLL reported on the balance sheet as of the end of each quarter (and for credit unions, prior to paying dividends), or more frequently if warranted, and charge or credit the PLLL to bring the ALLL to an appropriate level as of each evaluation date. The determination of the amounts of the ALLL and the PLLL should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the evaluation date. Management's evaluation is subject to review by examiners. An institution's failure to analyze the collectibility of the loan portfolio and maintain and support an appropriate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound practice.

In carrying out its responsibility for maintaining an appropriate ALLL, management is expected to adopt and adhere to written policies and procedures that are appropriate to the size of the institution and the nature, scope, and risk of its lending activities. At a minimum, these policies and procedures should ensure that:

- The institution's process for determining an appropriate level for the ALLL is based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio.¹³ The analysis should consider all significant factors that affect the

¹² An individually evaluated loan that is determined not to be impaired under FAS 114 should be evaluated under FAS 5 when specific characteristics of the loan indicate that it is probable there would be estimated credit losses in a group of loans with those characteristics. Refer to the FAQs for further guidance.

¹³ As noted in the 2001 Policy Statement and the NCUA's 2002 IRPS, an institution with less complex lending activities and products may find it more efficient to combine a number of procedures while continuing to ensure that the institution has a consistent and appropriate ALLL methodology. Thus, much of the supporting documentation

collectibility of the portfolio and should support the credit losses estimated by this process.

- The institution has an effective loan review system and controls (including an effective loan classification or credit grading system) that identify, monitor, and address asset quality problems in an accurate and timely manner.¹⁴ To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.
- The institution has adequate data capture and reporting systems to supply the information necessary to support and document its estimate of an appropriate ALLL.
- The institution evaluates any loss estimation models before they are employed and modifies the models' assumptions, as needed, to ensure that the resulting loss estimates are consistent with GAAP. To demonstrate this consistency, the institution should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with the models or other estimation tools. The institution should also document and support any adjustments made to the models or to the output of the models in determining the estimated credit losses.
- The institution promptly charges off loans, or portions of loans, that available information confirms to be uncollectible.
- The institution periodically validates the ALLL methodology. This validation process should include procedures for a review, by a party who is independent of the institution's credit approval and ALLL estimation processes, of the ALLL methodology and its application in order to confirm its effectiveness. A party who is independent of these processes could be the internal audit staff, a risk management unit of the institution, an external auditor (subject to applicable auditor independence standards), or another contracted third party from outside the institution. One party need not perform the entire analysis as the validation can be divided among various independent parties.

The board of directors is responsible for overseeing management's significant judgments and estimates pertaining to the determination of an appropriate ALLL. This oversight should include but is not limited to:

- Reviewing and approving the institution's written ALLL policies and procedures at least annually.

required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios.

¹⁴ Loan review and loan classification or credit grading systems are discussed in Attachment 1. In addition, banks and savings associations should refer to the asset quality standards in the Interagency Guidelines Establishing Standards for Safety and Soundness adopted by their primary federal regulator, as follows: for national banks, Appendix A to Part 30; for state member banks, Appendix D-1 to Part 208; for state nonmember banks, Appendix A to Part 364; and for savings associations, Appendix A to Part 570.

- 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 justification for the amounts estimated and reported each period for the PLLL and the ALLL.
- Requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

For purposes of the Reports of Condition and Income (Call Report), the Thrift Financial Report (TFR), and the NCUA Call Report (5300) an appropriate ALLL (after deducting all loans and portions of loans confirmed loss) should consist only of the following components (as applicable),¹⁵ the amounts of which take into account *all relevant facts and circumstances as of the evaluation date*:

- For loans within the scope of FAS 114 that are individually evaluated and found to be impaired, the associated ALLL should be based upon one of the three impairment measurement methods specified in FAS 114.¹⁶
- For all other loans, including individually evaluated loans determined not to be impaired under FAS 114,¹⁷ the associated ALLL should be measured under FAS 5 and should provide for all estimated credit losses that have been incurred on groups of loans with similar risk characteristics.
- For estimated credit losses from transfer risk on cross-border loans, the impact to the ALLL should be evaluated individually for impaired loans under FAS 114 or evaluated on a group basis under FAS 5. See Attachment 2 for further guidance on considerations of transfer risk on cross-border loans.
- For estimated credit losses on accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution's balance sheet, the associated ALLL should be evaluated under FAS 114 or FAS 5 as appropriate, if not already included in one of the preceding components.

Because deposit accounts that are overdrawn (i.e. overdrafts) must be reclassified as loans on the balance sheet, overdrawn accounts should be included in one of the first two components above, as appropriate, and evaluated for estimated credit losses.

¹⁵ A component of the ALLL that is labeled "unallocated" is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported and documented.

¹⁶ As previously noted, the use of the fair value of collateral method is required for an individually evaluated loan that is impaired if the loan is collateral dependent.

¹⁷ See footnote 12.

Determining the appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment. Management's analysis should reflect a prudent, conservative, but not excessive ALLL that falls within an acceptable range of estimated credit losses. When a range of losses is determined, institutions should maintain appropriate documentation to support the identified range and the rationale used for determining the best estimate from within the range of loan losses.

As discussed more fully in Attachment 1, it is essential that institutions maintain effective loan review systems. An effective loan review system should work to ensure the accuracy of internal credit classification or grading systems and, thus, the quality of the information used to assess the appropriateness of the ALLL. The complexity and scope of an institution's ALLL evaluation process, loan review system, and other relevant controls should be appropriate for the size of the institution and the nature of its lending activities. The evaluation process should also provide for sufficient flexibility to respond to changes in the factors that affect the collectibility of the portfolio.

Credit losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. In particular, for banks with cross-border lending exposure, management should determine that the ALLL is appropriate to cover estimated losses from transfer risk associated with this exposure over and above any minimum amount that the Interagency Country Exposure Review Committee requires to be provided in the Allocated Transfer Risk Reserve (or charged off against the ALLL). These estimated losses should meet the criteria for accrual of a loss contingency set forth in GAAP. (See Attachment 2 for factors to consider.)

Factors to Consider in the Estimation of Credit Losses

Estimated credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. Normally, an institution should determine the historical loss rate for each group of loans with similar risk characteristics in its portfolio based on its own loss experience for loans in that group. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses, do not by themselves form a sufficient basis to determine the appropriate level for the ALLL. Management should also consider those qualitative or environmental factors that are likely to cause estimated credit losses associated with the institution's existing portfolio to differ from historical loss experience, including but not limited to:

- Changes in lending policies and procedures, including changes in underwriting standards and collection, 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.¹⁸
- 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.¹⁹
- Changes in the quality of the institution's loan review system.
- 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.
- 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.

In addition, changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, keeping in mind the characteristics of an institution's loan portfolio. For example, if declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity. Similarly, if improving credit quality trends are evident, the ALLL level as a percentage of the portfolio should generally decrease.

Measurement of Estimated Credit Losses

FAS 5

When measuring estimated credit losses on groups of loans with similar risk characteristics in accordance with FAS 5, a widely used method is based on each group's historical net charge-off rate adjusted for the effects of the qualitative or environmental factors discussed previously. As

¹⁸ Credit loss and recovery experience may vary significantly depending upon the stage of the business cycle. For example, an over reliance on credit loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

¹⁹ For banks and savings associations, adversely classified or graded loans are loans rated "Substandard" (or its equivalent) or worse under the institution's loan classification system. For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution's credit grading system, i.e., those loans that tend to be included in the credit union's "watch lists."

the first step in applying this method, management generally bases the historical net charge-off rates on the “annualized” historical gross loan charge-offs, less recoveries, recorded by the institution on loans in each group.

Methodologies for determining the historical net charge-off rate on a group of loans with similar risk characteristics under FAS 5 can range from the simple average of, or a determination of the range of, an institution’s annual net charge-off experience to more complex techniques, such as migration analysis and models that estimate credit losses.²⁰ Generally, institutions should use at least an “annualized” or 12-month average net charge-off rate that will be applied to the groups of loans when estimating credit losses. However, this rate could vary. For example, loans with effective lives longer than 12 months often have workout periods over an extended period of time, which may indicate that the estimated credit losses should be greater than that calculated based solely on the annualized net charge-off rate for such loans. These groups may include certain commercial loans as well as groups of adversely classified loans. Other groups of loans may have effective lives shorter than 12 months, which may indicate that the estimated credit losses should be less than that calculated based on the annualized net charge-off rate.

Regardless of the method used, institutions should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans. If a range of historical loss rates is developed instead for a group of loans, institutions should maintain documentation to support the identified range and the rationale for determining which rate is the best estimate within the range of loss rates. The rationale should be based on management’s assessment of which rate is most reflective of the estimated credit losses in the current loan portfolio.

After determining the appropriate historical loss rate for each group of loans with similar risk characteristics, management should consider those current qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group’s historical loss experience. Institutions typically reflect the overall effect of these factors on a loan group as an adjustment that, as appropriate, increases or decreases the historical loss rate applied to the loan group. Alternatively, the effect of these factors may be reflected through separate standalone adjustments within the FAS 5 component of the ALLL.²¹ Both methods are consistent with GAAP provided the adjustments for qualitative or environmental factors are

²⁰ Annual charge-off rates are calculated over a specified time period (e.g., three years or five years), which can vary based on a number of factors including the relevance of past periods’ experience to the current period or point in the credit cycle. Also, some institutions remove loans that become adversely classified or graded from a group of nonclassified or nongraded loans with similar risk characteristics in order to evaluate the removed loans individually under FAS 114 (if deemed impaired) or collectively in a group of adversely classified or graded loans with similar risk characteristics under FAS 5. In this situation, the net charge-off experience on the adversely classified or graded loans that have been removed from the group of nonclassified or nongraded loans should be included in the historical loss rates for that group of loans. Even though the net charge-off experience on adversely classified or graded loans is included in the estimation of the historical loss rates that will be applied to the group of nonclassified or nongraded loans, the adversely classified or graded loans themselves are no longer included in that group for purposes of estimating credit losses on the group.

²¹ An overall adjustment to a portion of the ALLL that is not attributed to specific segments of the loan portfolio is often labeled “unallocated.” Regardless of what a component of the ALLL is labeled, it is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported.

reasonably and consistently determined, are adequately documented, and represent estimated credit losses. For each group of loans, an institution should apply its adjusted historical loss rate, or its historical loss rate and separate standalone adjustments, to the recorded investment in the group when determining its estimated credit losses.

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. Accordingly, institutions 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.

There may be times when an institution does not have its own historical loss experience upon which to base its estimate of the credit losses in a group of loans with similar risk characteristics. This may occur when an institution offers a new loan product or in the case of a newly established (i.e., de novo) institution. If an institution has no experience of its own for a loan group, reference to the experience of other enterprises in the same lending business may be appropriate, provided the institution demonstrates that the attributes of the group of loans in its portfolio are similar to those of the loan group in the portfolio providing the loss experience. An institution should only use another enterprise's experience on a short-term basis until it has developed its own loss experience for a particular group of loans.

FAS 114

When determining the FAS 114 component of the ALLL for an individually impaired loan,²² an institution should consider estimated costs to sell the loan's collateral, if any, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the institution bases its measure of loan impairment on the present value of expected future cash flows discounted at the loan's effective interest rate, the estimates of these cash flows should be the institution's best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the estimate of expected future cash flows. The weight given to the

²² As noted in FAS 114, some individually impaired loans have risk characteristics that are unique to an individual borrower and the institution will apply the measurement methods on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. An institution may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans.

evidence should be commensurate with the extent to which the evidence can be verified objectively. The likelihood of the possible outcomes should be considered in determining the best estimate of expected future cash flows.

Analyzing the Overall Measurement of the ALLL

Institutions are also encouraged to use ratio analysis as a supplemental tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with an institution's peer group and its own historical experience) in the relationship of the ALLL to adversely classified or graded loans, past due and nonaccrual loans, total loans, and historical gross and net charge-offs. Based on such analysis, an institution may identify additional issues or factors that previously had not been considered in the ALLL estimation process, which may warrant adjustments to estimated credit losses. Such adjustments should be appropriately supported and documented.

While ratio analysis, when used prudently, can be helpful as a supplemental check on the reasonableness of management's assumptions and analyses, it is not a sufficient basis for determining the appropriate amount for the ALLL. In particular, because an appropriate ALLL is an institution-specific amount, such comparisons do not obviate the need for a comprehensive analysis of the loan portfolio and the factors affecting its collectibility. Furthermore, it is inappropriate for the board of directors or management to make adjustments to the ALLL when it has been properly computed and supported under the institution's methodology for the sole purpose of reporting an ALLL that corresponds to the peer group median, a target ratio, or a budgeted amount. Institutions that have high levels of risk in the loan portfolio or are uncertain about the effect of possible future events on the collectibility of the portfolio should address these concerns by maintaining higher equity capital and not by arbitrarily increasing the ALLL in excess of amounts supported under GAAP.²³

Estimated Credit Losses in Credit Related Accounts

Typically, institutions evaluate and estimate credit losses for off-balance sheet credit exposures at the same time that they estimate credit losses for loans. While a similar process should be followed to support loss estimates related to off-balance sheet exposures, these estimated credit losses are not recorded as part of the ALLL. When the conditions for accrual of a loss under FAS 5 are met, an institution should maintain and report as a separate liability account, an allowance that is appropriate to cover estimated credit losses on off-balance sheet loan commitments, standby letters of credit, and guarantees. In addition, recourse liability accounts (that arise from recourse obligations on any transfers of loans that are reported as sales in

²³ It is inappropriate to use a "standard percentage" as the sole determinant for the amount to be reported as the ALLL on the balance sheet. Moreover, an institution should not simply default to a peer ratio or a "standard percentage" after determining an appropriate level of ALLL under its methodology. However, there may be circumstances when an institution's ALLL methodology and credit risk identification systems are not reliable. Absent reliable data of its own, management may seek data that could be used as a short-term proxy for the unavailable information (e.g., an industry average loss rate for loans with similar risk characteristics). This is only appropriate as a short-term remedy until the institution creates a viable system for estimating credit losses within its loan portfolio.

accordance with GAAP) should be reported in regulatory reports as liabilities that are separate and distinct from both the ALLL and the allowance for credit losses on off-balance sheet credit exposures.

When accrued interest and fees are reported separately on an institution's balance sheet from the related loan balances (i.e., as other assets), the institution should maintain an appropriate valuation allowance, determined in accordance with GAAP, for amounts that are not likely to be collected unless management has placed the underlying loans in nonaccrual status and reversed previously accrued interest and fees.²⁴

Responsibilities of Examiners

Examiners should assess the credit quality of an institution's loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of the reported ALLL in the institution's regulatory reports. In their review and classification or grading of the loan portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the appropriateness of the ALLL, examiners should:

- Consider the effectiveness of board oversight as well as the quality of the institution's loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's loan review function and credit grading system. Typically, this will involve testing a sample of the institution's loans. The sample size generally varies and will depend on the nature or purpose of the examination.²⁵
- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management's assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management's best estimate within the range. In making these evaluations, examiners should ensure that the institution's historical loss experience and all significant qualitative or environmental factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function and the other factors previously discussed) have been

²⁴ Refer to the agencies' regulatory reporting instructions for the Call Report, TFR, or 5300 for further guidance on placing a loan in nonaccrual status.

²⁵ In an examiner's review of an institution's loan review system, the examiner's loan classifications or credit grades may differ from those of the institution's loan review system. If the examiner's evaluation of these differences indicates problems with the loan review system, especially when the loan classification or credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its loan classifications or credit grades to the loan portfolio and to its estimated credit losses. Furthermore, the institution would be expected to improve its loan review system. (Attachment 1 discusses effective loan review systems.)

appropriately considered and that management has appropriately applied GAAP, including FAS 114 and FAS 5.

- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances this may include a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectibility of loans at the institution and its current environment.
- Review the ALLL amount reported in the institution's regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance reported in the financial statements. Inquire about reasons for any material differences between the results of the institution's ALLL analyses and the institution's reported ALLL to determine whether the differences can be satisfactorily explained.
- Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.
- Review the interest and fee income accounts associated with the lending process to ensure that the institution's net income is not materially misstated.²⁶

As noted in the "Responsibilities of the Board of Directors and Management" section of this policy statement, when assessing the appropriateness of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of management judgment. Even when an institution maintains sound loan administration and collection procedures and an effective loan review system and controls, its estimate of credit losses is not a single precise amount due to the wide range of qualitative or environmental factors that must be considered.

An institution's ability to estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners should generally accept management's estimates when they assess the appropriateness of the institution's reported ALLL, and not seek adjustments to the ALLL, when management has:

²⁶ As noted previously, accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution's balance sheet should be evaluated for estimated credit losses. The accrual of the interest and fee income should also be considered. Refer to GAAP and the agencies' regulatory reporting instructions for further guidance on income recognition.

- Maintained effective loan review systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner.
- Analyzed all significant qualitative or environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner.
- Established an acceptable ALLL evaluation process for both individual loans and groups of loans that meets the GAAP requirements for an appropriate ALLL.
- Incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

If the examiner concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. The examiner's comments should cite any departures from GAAP and any contraventions of this policy statement and the 2001 Policy Statement or the NCUA's 2002 IRPS, as applicable. Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process, including the materiality of any error in the reported amount of the ALLL.

ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement and the 2001 Policy Statement or the NCUA's 2002 IRPS, as applicable, falls within the range of acceptable estimates determined in accordance with GAAP. When the reported amount of an institution's ALLL is not appropriate, the institution will be required to adjust its ALLL by an amount sufficient to bring the ALLL reported on its Call Report, TFR, or 5300 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.

Paperwork Reduction Act

The agencies do not intend this policy statement and the FAQs to create any new information collection requirements under the Paperwork Reduction Act. To the extent this policy statement and the FAQs involve information collection requirements, they are already required by GAAP or existing information collections for which the agencies have jointly or individually received approval.

Attachment 1

Loan Review Systems

The nature of loan review systems may vary based on an institution's size, complexity, loan types, and management practices.²⁷ For example, a loan review system may include components of a traditional loan review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, a problem loan workout group, or other areas of an institution. These responsibilities may range from administering the internal problem loan reporting process to maintaining the integrity of the loan classification or credit grading process (e.g., ensuring that timely and appropriate changes are made to the loan classifications or credit grades assigned to loans) and coordinating the gathering of the information necessary to assess the appropriateness of the ALLL. Additionally, some or all of this function may be outsourced to a qualified external loan reviewer. Regardless of the structure of the loan review system in an institution, an effective loan review system should have, at a minimum, the following objectives:

- To promptly identify loans with potential credit weaknesses.
- To appropriately grade or adversely classify loans, especially those with well-defined credit weaknesses that jeopardize repayment, so that timely action can be taken and credit losses can be minimized.
- To identify relevant trends that affect the collectibility of the portfolio and isolate segments of the portfolio that are potential problem areas.
- To assess the adequacy of and adherence to internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations.
- To evaluate the activities of lending personnel including their compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio.
- To provide management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of an appropriate ALLL.

²⁷ The loan review function is not intended to be performed by an institution's internal audit function. However, as discussed in the banking agencies' March 2003 *Interagency Policy Statement on the Internal Audit Function and its Outsourcing*, some institutions seek to coordinate the internal audit function with several risk monitoring functions such as loan review. The policy statement notes that coordination of loan review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. However, the internal audit function should maintain the ability to independently audit other risk monitoring functions, including loan review, without impairing its independence with respect to these other functions.

Loan Classification or Credit Grading Systems

The foundation for any loan review system is accurate and timely loan classification or credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective loan classification or credit grading system provides important information on the collectibility of the portfolio for use in the determination of an appropriate level for the ALLL.

Regardless of the type of loan review system employed, an effective loan classification or credit grading framework generally places primary reliance on the institution's lending staff to identify emerging loan problems. However, given the importance and subjective nature of loan classification or credit grading, the judgment of an institution's lending staff regarding the assignment of particular classification or grades to loans should be subject to review by: (i) peers, superiors, or loan committee(s); (ii) an independent, qualified part-time or full-time employee(s); (iii) an internal department staffed with credit review specialists; or (iv) qualified outside credit review consultants. A loan classification or credit grading review that is independent of the lending function is preferred because it typically provides a more objective assessment of credit quality. Because accurate and timely loan classification or credit grading is a critical component of an effective loan review system, each institution should ensure that its loan review system includes the following attributes:

- A formal loan classification or credit grading system in which loan classifications or credit grades reflect the risk of default and credit losses and for which a written description is maintained, including a discussion of the factors used to assign appropriate classifications or credit grades to loans.²⁸
- Identification or grouping of loans that warrant the special attention of management²⁹ or other designated "watch lists" of loans that management is more closely monitoring.
- Documentation supporting the reasons why particular loans merit special attention or received a specific adverse classification or credit grade and management's adherence to approved work out plans.
- A mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention or adversely classified or graded and the actions taken by management.

²⁸ A bank or savings association may have a loan classification or credit grading system that differs from the framework used by the banking agencies. However, each institution that maintains a loan classification or credit grading system that differs from the banking agencies' framework should maintain documentation that translates its system into the framework used by the banking agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various loan classifications or credit grades under the institution's system to the banking agencies' categories.

²⁹ For banks and savings associations, loans that have potential weaknesses that deserve management's close attention are designated "Special Mention" loans.

- Appropriate documentation of the institution's historical loss experience for each of the groups of loans with similar risk characteristics into which it has segmented its loan portfolio.³⁰

Elements of Loan Review Systems

Each institution should have a written policy that is reviewed and approved at least annually by the board of directors to evidence its support of and commitment to maintaining an effective loan review system. The loan review policy should address the following elements which are described in more detail below: the qualifications and independence of loan review personnel; the frequency, scope and depth of reviews; the review of findings and follow-up; and workpaper and report distribution.

Qualifications of Loan Review Personnel

Persons involved in the loan review or credit grading function should be qualified based on their level of education, experience, and extent of formal credit training. They should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, they should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of Loan Review Personnel

An effective loan review system uses both the initial identification of emerging problem loans by loan officers and other line staff, and the credit review of loans by individuals independent of the credit approval process. An important requirement for an effective system is to place responsibility on loan officers and line staff for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of frequent contact with borrowers, loan officers and line staff can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over-reliance upon loan officers and line staff for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals who do not have control over the loans they review and who are not part of, and are not influenced by anyone associated with the loan approval process.

While larger institutions typically establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. In some smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan review department, the loan review function should report *directly* to the board of directors or a committee thereof (although senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan review function).

³⁰ In particular, institutions with large and complex loan portfolios are encouraged to maintain records of their historical loss experience for credits in each of the categories in their loan classification or credit grading framework. For banks and savings associations, these categories should either be those used by, or should be categories that can be translated into those used by, the banking agencies.

Some institutions may choose to outsource the credit review function to an independent outside party. However, the responsibility for maintaining a sound loan review process cannot be delegated to an outside party. Therefore, institution personnel who are independent of the lending function should assess control risks, develop the credit review plan, and ensure appropriate follow-up of findings. Furthermore, the institution should be mindful of special requirements concerning independence should it consider outsourcing the credit review function to its external auditor.

Frequency of Reviews

Loan review personnel should review significant credits³¹ at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular loan, loan product, or group of loans. Optimally, the loan review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process because this process is dependent on the accurate and timely identification of problem loans.

Scope of Reviews

Reviews by loan review personnel should cover all loans that are significant and other loans that meet certain criteria. Management should document the scope of its reviews and ensure that the percentage of the portfolio selected for review provides reasonable assurance that the results of the review have identified any credit quality deterioration and other unfavorable trends in the portfolio and reflect its quality as a whole. Management should also consider industry standards for loan review coverage consistent with the size and complexity of its loan portfolio and lending operations to verify that the scope of its reviews is appropriate. The institution's board of directors should approve the scope of loan reviews on an annual basis or when any significant interim changes to the scope of reviews are made. Reviews typically include:

- Loans over a predetermined size.
- A sufficient sample of smaller loans.
- Past due, nonaccrual, renewed and restructured loans.
- Loans previously adversely classified or graded and loans designated as warranting the special attention of management³² by the institution or its examiners.
- Insider loans.
- Loans constituting concentrations of credit risk and other loans affected by common repayment factors.

³¹ Significant credits in this context may or may not be loans individually evaluated for impairment under FAS 114.

³² See footnote 29.

Depth of Reviews

Reviews should analyze a number of important aspects of the loans selected for review, including:

- Credit quality, including underwriting and borrower performance.
- Sufficiency of credit and collateral documentation.
- Proper lien perfection.
- Proper approval by the loan officer and loan committee(s).
- Adherence to any loan agreement covenants.
- Compliance with internal policies and procedures (such as aging, nonaccrual, and classification or grading policies) and laws and regulations.
- Appropriate identification of individually impaired loans, measurement of estimated loan impairment, and timeliness of charge-offs.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of Findings and Follow-Up

Loan review personnel should discuss all noted deficiencies and identified weaknesses and any existing or planned corrective actions, including time frames for correction, with appropriate loan officers and department managers. Loan review personnel should then review these findings and corrective actions with members of senior management. All noted deficiencies and identified weaknesses that remain unresolved beyond the scheduled time frames for correction should be promptly reported to senior management and the board of directors.

Credit classification or grading differences between loan officers and loan review personnel should be resolved according to a pre-arranged process. That process may include formal appeals procedures and arbitration by an independent party or may require default to the assigned classification or grade that indicates lower credit quality. If an outsourced credit review concludes that a borrower is less creditworthy than is perceived by the institution, the lower credit quality classification or grade should prevail unless internal parties identify additional information sufficient to obtain the concurrence of the outside reviewer or arbiter on the higher credit quality classification or grade.

Workpaper and Report Distribution

The loan review function should prepare a list of all loans reviewed (including the date of the review) and documentation (including a summary analysis) that substantiates the grades or classifications assigned to the loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors at least quarterly.³³ In addition to reporting current credit quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies and procedures, as well as compliance with laws and regulations, in order to facilitate timely correction of any noted deficiencies.

³³ The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

Attachment 2

International Transfer Risk Considerations

With respect to international transfer risk, an institution with cross-border exposures should support its determination of the appropriateness of its ALLL by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

- The institution's loan portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors).
- The institution's business strategy and its debt management plans for each country.
- Each country's balance of payments position.
- Each country's level of international reserves.
- Each country's established payment performance record and its future debt servicing prospects.
- Each country's socio-political situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt servicing capacity.
- Each country's current standing with multilateral and official creditors.
- The status of each country's relationships with other creditors, including institutions.
- The most recent evaluations distributed by the banking agencies' Interagency Country Exposure Review Committee.

**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of Thrift Supervision**

Questions and Answers on Accounting for Loan and Lease Losses

Purpose

The staffs of the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration (NCUA), and the Office of Thrift Supervision (collectively, the “agencies”) are providing interpretive answers to frequently asked questions regarding the accounting for loan and lease losses and troubled loans for regulatory reporting purposes by federally insured depository institutions (“institutions”). The agencies are issuing these questions and answers in conjunction with the issuance of a revised “Interagency Policy Statement on the Allowance for Loan and Lease Losses” (2006 Policy Statement). These questions and answers focus on topics about which examiners, institutions, and accountants frequently inquire concerning the allowance for loan and lease losses (ALLL). The questions and answers are grouped into subject areas that are presented in the same order as the sections in the 2006 Policy Statement as follows.

<u>Section of the 2006 Policy Statement:</u>	<u>Questions:</u>	<u>Page Numbers:</u>
Nature and Purpose of the ALLL	1	2
Responsibilities of the Board of Directors and Management:		
Appropriate ALLL Level	2-8	2-6
Factors to Consider in the Estimation of Credit Losses	9-10	7-8
Measurement of Estimated Credit Losses	11-16	8-12

The staffs’ interpretive answers are based on existing sources of generally accepted accounting principles (GAAP) and related supervisory policies. The answers are not intended to establish new accounting guidance. Readers should refer to the accounting literature and supervisory policies cited in the responses for complete guidance and information. As mentioned in the 2006 Policy Statement, the principal sources of guidance on accounting for impairment in a loan portfolio under GAAP are Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114), and Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5) as well as the Financial Accounting Standards Board (FASB) *Viewpoints* article included in Emerging Issues Task Force (EITF) Topic D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF D-80).

Nature and Purpose of the ALLL

Question # 1

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

Answer:

No. In developing loss measurements for groups of loans with similar risk characteristics, an institution should consider the impact of current qualitative or environmental factors that exist as of the balance sheet date, and should 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, an institution should support and reasonably document the amount of its adjustments and how the adjustments reflect current information, events, circumstances, and conditions.

For example, assume an institution's borrowers depend upon revenues and personal incomes generated from a local military base. If a public announcement was made prior to the balance sheet date that the base would be closed within the next six to eight months, the event of the impending closure changes the collectibility of, and the estimated credit losses within, the loan portfolio in the current period. Therefore, the ALLL level would likely require adjustment based upon the event of the announcement. As the institution is able to obtain additional information about its loans to borrowers affected by the impending military base closure, the estimated credit losses would likely change over time. The institution should not, however, wait until the actual closure to estimate the credit losses resulting from this event.

In contrast, suppose there is a rumor circulating that a local military base *may* close. However, the institution has not been able to substantiate the rumor as of the balance sheet date. Since the rumor is unsubstantiated, it is not an event that would likely require adjustments to the ALLL level.

Responsibilities of the Board of Directors and Management

Appropriate ALLL Level

Question # 2

How should an institution identify loans that should be individually evaluated for impairment under FAS 114?

Answer:

An institution should apply its normal review procedures when identifying which loans should be individually evaluated under FAS 114. Footnote 1 of FAS 114 identifies sources of information that are useful in identifying loans for individual evaluation as follows:

Sources of information useful in identifying loans for evaluation ... include 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; and loan documentation and compliance exception reports.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are not included in the scope of FAS 114. Such groups of loans may include, but are not limited to, “smaller” commercial loans, credit card loans, residential mortgages, and consumer installment loans. FAS 114 would apply, however, if the terms of any of such loans are modified in a troubled debt restructuring as defined by Statement of Financial Accounting Standards No. 15, *Accounting by Debtors and Creditors for Troubled Debt Restructuring* (FAS 15). Otherwise, the relevant accounting guidance for these groups of smaller-balance homogeneous loans is contained in FAS 5.

Many examiners and institutions have sought guidance on how to quantify “larger” versus “smaller” balance loans in order to identify which loans should be evaluated for impairment under FAS 114. A single-size test for all loans is impractical because a loan that may be relatively large for one institution may be relatively small for another. Deciding whether to individually evaluate a loan is subjective and requires an institution to consider individual facts and circumstances along with its normal review procedures in making that judgment. In addition, the institution should appropriately document the method and process for identifying loans to be evaluated under FAS 114.

Question # 3

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

Answer:

Yes, generally, that loan should be evaluated under FAS 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, then the loan should be included in the assessment of the ALLL for that group of loans under FAS 5. Institutions should measure estimated credit losses under FAS 114 only for loans individually evaluated and determined to be impaired.

Under FAS 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. (EITF D-80, Question 10).

Question # 4

If an institution assesses an individual loan under FAS 114 and determines that it is impaired, but it measures the amount of impairment as zero, may it include that loan in a group of loans collectively assessed under FAS 5 for estimation of the ALLL?

Answer:

No. For a loan that is impaired, no additional loss recognition is appropriate under FAS 5 even if the measurement of impairment under FAS 114 results in no allowance. One example would be when the recorded investment in an impaired loan has been written down to a level where no allowance is required. (EITF Topic D-80, Question 12).

However, before concluding that an impaired FAS 114 loan needs no associated loss allowance, an institution should determine and document that its measurement process was 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 institution's or third party's inspection of the collateral, confidence in the institution's lien on the collateral, historical losses on similar loans, and other factors as appropriate for the loan type. For further information, refer to the banking agencies' 2001 *Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* (2001 Policy Statement), Q&A #3, which is consistent with the Securities and Exchange Commission's Staff Accounting Bulletin No. 102, *Selected Loan Loss Allowance Methodology and Documentation Issues* (SAB 102), Question 7. For credit unions, see the NCUA's May 2002 Interpretive Ruling and Policy Statement 02-3, *Allowance For Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions* (NCUA's 2002 IRPS), Q&A #3.

Question # 5

Is the practice of "layering" an institution's loan loss allowance appropriate?

Answer:

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, institutions should take steps to prevent the layering of loan loss allowances. One situation in which layering inappropriately occurs is when an institution includes a loan in one group of loans, determines its best estimate of loss for that loan group (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount. Another example of inappropriate layering occurs when an allowance has been measured for a loan under FAS 114 after the loan has been individually evaluated for impairment and determined to be impaired, but the loan is then included in a group of loans with similar risk characteristics for which an ALLL is estimated under FAS 5. The allowance provided for a specific individually impaired loan under FAS 114 must not be supplemented by an additional allowance under FAS 5. (2001 Policy Statement, Appendix B; and NCUA's 2002 IRPS, p. 37450).

Question # 6

What documentation should an institution maintain to support its measurement of impairment on an individually impaired loan under FAS 114?

Answer:

The 2001 Policy Statement and the NCUA's 2002 IRPS discuss the supporting documentation needed. In general, the institution 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 an institution must use the fair value of collateral method, the institution should document: (1) how fair value was determined including the use of appraisals, valuation assumptions, and calculations; (2) the supporting rationale for adjustments to appraised values, if any; (3) the determination of costs to sell, if applicable; and (4) appraisal quality and the expertise and independence of the appraiser.

Question # 7

How should an institution evaluate and account for impairment on loans that are within the scope of FAS 15 as "troubled debt restructurings"?

Answer:

Loans that are within the scope of FAS 15 as "troubled debt restructurings" should be evaluated for impairment under FAS 114. This includes loans that were originally not subject to FAS 114 prior to the restructuring, such as individual loans that were included in a large group of smaller-balance homogeneous loans collectively evaluated for impairment. A loan is impaired when, based on current information and events, it is probable that an institution will be unable to collect all amounts due according to the contractual terms of the loan agreement. Usually, a restructured troubled loan that had been individually evaluated under FAS 114 would already have been identified as impaired because the borrower's financial difficulties existed before the formal restructuring. For a restructured troubled loan *all amounts due according to the contractual terms* means the contractual terms specified by the original loan agreement, not the contractual terms specified by the restructuring agreement. Therefore, if impairment is measured using an estimate of the expected future cash flows, the interest rate used to calculate the present value of those cash flows is based on the original effective interest rate on the loan (the original contractual interest rate adjusted for any net deferred loan fees or cost or any premium or discount existing at the origination or acquisition of the loan) and not the rate specified in the restructuring agreement.

Question # 8

If a borrower is current under the modified terms of a restructured troubled loan, how should the loan be reported in the bank Reports of Condition and Income (Call Report), the Thrift Financial Report (TFR) and the NCUA 5300 Call Report (5300)?

Answer:

Call Report

For regulatory reporting purposes on the bank Call Report, a loan that has been formally restructured so as to be reasonably assured of repayment and of performance according to its

modified terms need not be maintained in nonaccrual status, provided the restructuring and any charge-off taken on the loan are supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Otherwise, the restructured loan must remain in nonaccrual status.

The evaluation of the borrower's financial condition and prospects must include consideration of the borrower's sustained historical repayment performance for a reasonable period prior to the date on which the loan is returned to accrual status. A sustained period of repayment performance generally would be a minimum of six months and would involve payments of cash or cash equivalents. Each loan that has undergone a troubled debt restructuring (except a loan secured by a 1-4 family residential property and a loan to an individual for household, family, and other personal expenditures) must be reported as a restructured loan in Schedule RC-C or Schedule RC-N, as appropriate, depending on whether the borrower is in compliance with the loan's modified terms. However, a restructured loan that yields a market rate and on which the borrower is in compliance with the loan's modified terms need not continue to be reported as a troubled debt restructuring in calendar years after the year in which the restructuring took place.

TFR

For regulatory reporting purposes on the TFR, a savings association may remove a restructured troubled loan from nonaccrual status when it is (1) reasonably assured of repayment and is performing according to the modified terms, and (2) the restructured loan is well secured and collection of principal and interest under the revised terms is probable. To determine probability of collection, the savings association must consider the borrower's sustained historical repayment performance for a reasonable period of time. This determination may take into account performance prior to restructuring the loan. A sustained period of repayment performance generally would equal a minimum of six months and would involve payments of cash or cash equivalents.

Loans that have undergone troubled debt restructurings (TDRs) should generally be reported as a TDR (on Schedule VA if in compliance with the restructured terms or on Schedule PD if past due or nonaccrual) until the loans are paid off. However, a restructured loan that is in compliance with its modified terms and yields a market rate at the time of restructuring need not continue to be reported as a TDR beyond the first year after the restructuring.

5300

For regulatory reporting purposes on the 5300, credit unions should report troubled debt restructured loans (as defined in GAAP) as delinquent consistent with the original loan contract terms until the borrower/member has demonstrated an ability to make timely and consecutive monthly payments over a six-month period consistent with the restructured terms. Likewise, such loans may not be returned to full accrual status until the six-month consecutive payment requirement is met.

Factors to Consider in the Estimation of Credit Losses

Question # 9

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

Answer:

An institution 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. (EITF D-80, Question 16)

Question # 10

When an institution writes down an individually impaired loan to the 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, will there be a loan loss allowance under FAS 114 associated with the remaining recorded investment in the loan?

Answer:

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 agencies generally require an institution to charge off any portion of the recorded investment in excess of the fair value of the collateral that can be identified as uncollectible. Estimated costs to sell also must be considered in the measure of the ALLL under FAS 114 if these costs are expected to reduce the cash flows available to satisfy the loan.

Although an institution should consider the appraised value of the collateral as the starting point for determining its fair value, the institution should also consider other factors and events in the environment that may affect the current fair value of the collateral since the appraisal was performed. The institution’s experience with whether the appraised values of impaired collateral-dependent loans are actually realized should also be taken into account. In addition, the timing of when the cash flows are expected to be received from the underlying collateral could affect the fair value of the collateral if the timing was not contemplated in the appraisal. This generally results in the appraised value of the collateral being greater than the institution’s estimate of the collateral’s fair value (less costs to sell).

As a consequence, if the institution’s allowance for the impaired collateral-dependent loan under FAS 114 is based on fair value (less costs to sell), but its charge-off 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.

Appendix B of the 2001 Policy Statement and Appendix A of the NCUA’s 2002 IRPS provide the following illustration of this concept:

An institution determined that a collateral-dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell. Consistent with relevant regulatory guidance, the institution classified as “Loss” the portion of the recorded investment deemed to be the confirmed loss, and classified the remaining recorded investment as “Substandard.” For this loan, the amount classified “Loss” was less than the impairment amount (as determined under FAS 114). The institution charged off the “Loss” portion of the loan. After the charge-off, the portion of the ALLL related to this “Substandard” loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution’s overall ALLL.

Measurement of Estimated Credit Losses

Question # 11

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 institution will sustain some loss if the deficiencies are not corrected. How should an allowance be established for a commercial loan adversely classified as “Substandard” based on this regulatory classification framework?

Answer:

Given the definition, a “Substandard” loan that is individually evaluated for impairment under FAS 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 institution 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 FAS 114.

For “Substandard” loans that are not determined to be impaired in accordance with FAS 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 FAS 5. Many institutions 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 credits.

For an institution whose groups of loans with similar risk characteristics include both loans classified “Substandard” (and not determined to be impaired) and loans that are not adversely classified, the institution 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 the volume and severity of such loans during the period over which

the institution's historical loss experience was developed and, if so, the extent and direction of a qualitative adjustment to the historical loss experience used to estimate the ALLL for the group of loans under FAS 5.

Question # 12

Is it appropriate for banks and savings associations to estimate an allowance for "pass" loans and for credit unions to estimate an allowance for loans that do not raise supervisory concern? (The banking agencies define "pass" loans as loans that are not adversely classified as "Substandard," "Doubtful," or "Loss" nor designated as "Special Mention.")

Answer:

Yes. To determine an appropriate level for the allowance, an institution must analyze the entire loan and lease portfolio for probable losses that have already been incurred that can be reasonably estimated. A loan designated as "pass" or not raising supervisory concern generally would not be found to be impaired if it were individually evaluated for impairment under FAS 114. If the specific characteristics of such a loan indicate that it is probable that there would be an incurred loss in a group of loans with those characteristics, then the loan should be included in the assessment of the ALLL for that group of loans under FAS 5. Under FAS 5, the determination of probable incurred losses that can be reasonably estimated may be considered for individual loans or in relation to groups of similar types of loans. This determination should be made on a group basis even though the particular 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" or not raising supervisory concern, should be measured under FAS 5.

As noted in the 2006 Policy Statement, some institutions remove loans that become adversely classified or graded from a group of "pass" loans with similar risk characteristics in order to evaluate the removed loans individually under FAS 114 (if deemed impaired) or collectively in a group of adversely classified or graded loans with similar risk characteristics under FAS 5. In this situation, the net charge-off experience on the adversely classified or graded loans that have been removed from the group of "pass" loans should be included in the historical loss rates for that group of loans. Even though the net charge-off experience on the adversely classified or graded loans is included in the estimation of the historical loss rates that will be applied to the group of "pass" loans, the adversely classified or graded loans themselves are no longer included in that group for purposes of estimating credit losses on the group.

Question # 13

May an institution include amounts designated as "unallocated" in its ALLL?

Answer:

Yes, the ALLL may include an amount labeled as "unallocated" as long as it reflects estimated credit losses determined in accordance with GAAP and is properly supported.

The term "unallocated" is not defined in GAAP, but is used in practice with various meanings. For example, some institutions refer to the ALLL resulting from the adjustments they make to their historical loss rates for groups of loans for qualitative or environmental factors as

“unallocated.” Others believe that the ALLL resulting from those adjustments is an element of the “allocated” ALLL under FAS 5. Still other institutions 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 an institution 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 # 14

Is there a specific period of time that should be used when developing historical experience for groups of loans with similar risk characteristics for purposes of estimating the FAS 5 portions of the ALLL?

Answer:

There is no fixed period of time that institutions should use to determine historical loss experience. During periods of economic stability in an institution’s market, 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. The period used to develop a historic loss rate should be long enough to capture sufficient loss data. At some institutions, the length of time the institution uses varies by product; high-volume consumer loan products generally use a shorter time period than more specialized commercial loan products.

An institution 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 institutions, this information is often further segmented by originating branch office or geographic area. An institution’s supporting documentation should include an analysis of how

the current conditions compare to conditions during the time period used to develop historical loss rates for each group of loans assessed under FAS 5. An institution should review the range of historical losses over the time period it uses, rather than relying solely on the average historical loss rate over that period, and should identify the appropriate historical loss rate from within that range to use in estimating credit losses for the groups of loans. This would ensure that the appropriate historical experience is captured and is relevant to the institution's current portfolio of loans.

Question # 15

An institution has had very low or zero historical losses in the past several years. How should the institution take this historical loss experience into account in calculating its ALLL?

Answer:

Judgment is important in these situations because each institution's ALLL should be based on an institution-specific analysis of the loans in its portfolio. Management should perform individual loan reviews under FAS 114 to determine whether any individually reviewed loans are impaired and, if impaired, measure its FAS 114 allowance allocations in accordance with that standard.

Individually evaluated loans that are not determined to be impaired that have specific characteristics that indicate it is probable that there would be an incurred loss in a group of loans with those characteristics and all other loans should be evaluated under FAS 5. As noted in the 2006 Policy Statement, historical loss experience provides a reasonable starting point for the institution'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 institution's historical loss experience is minimal, the FAS 5 allowances must be supported 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 or graded loans, changes in local and national economic conditions, and effects of changes in loan concentrations. This will ensure that the ALLL reflects probable incurred losses in the current portfolio.

Question # 16

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

Answer:

As noted in the 2006 Policy Statement, institutions 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 institution 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.