

# ALL QUALITATIVE FACTORS: **JUSTIFYING** **IN PERIODS OF LOW** **LOSS**



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## EXECUTIVE SUMMARY

*Qualitative factor adjustments are used in an institution's reserve calculation so it more accurately reflects expected credit losses. These adjustments give management the ability to incorporate environmental factors into their quantitative allowance for loan and lease losses (ALLL) calculation. Due to their subjective nature, qualitative factors must be thoroughly documented to satisfy examiner and auditor scrutiny. Many institutions fail to objectively defend their adjustments, and as a result, these qualitative factors, or "Q factors," are often the subject of much examiner criticism. Although various environmental factors can be interpreted differently by different entities, there are certain measures an institution can take to more objectively defend their assumptions. This whitepaper will outline best practices for qualitative adjustments, especially in a period of low losses.*

# INTRODUCTION: WHAT'S THE CHALLENGE?

Qualitative adjustments are a challenge because they are inherently subjective in nature. The 2006 Interagency Policy Statement on the ALLL provides little direction on how these determinations should be made, advising only that “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.” It further vaguely explains that these determinations are to be “based on a comprehensive, well documented and consistently applied analysis of its loan portfolio.”

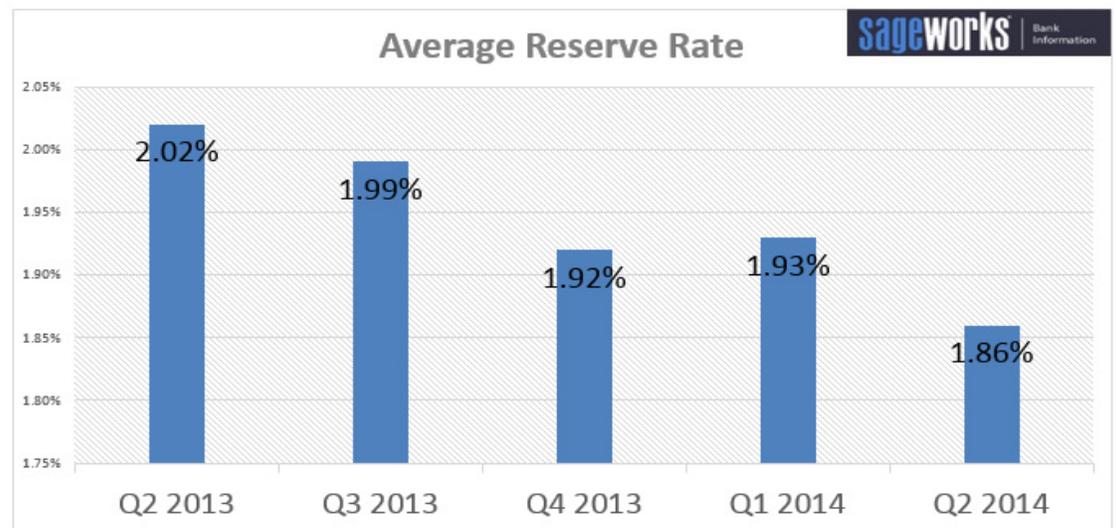
While the lack of specific direction on how these qualitative adjustments are to be made provides management teams with tremendous leeway in manipulating their ALLL calculations, they also expose institutions to significant regulatory scrutiny. Regulators want structure and consistency, but as a modern-day author noted, “Subjectivity measures nothing consistently.”<sup>1</sup>

Management can use the recommendations and suggestions that follow to help add objectivity and structure to this otherwise subjective task and to appropriately justify their assumptions.

<sup>1</sup> *My Ancestor Was an Ancient Astronaut*, Toba Beta

# QUALITATIVE FACTORS IN PERIODS OF LOW HISTORICAL LOSSES

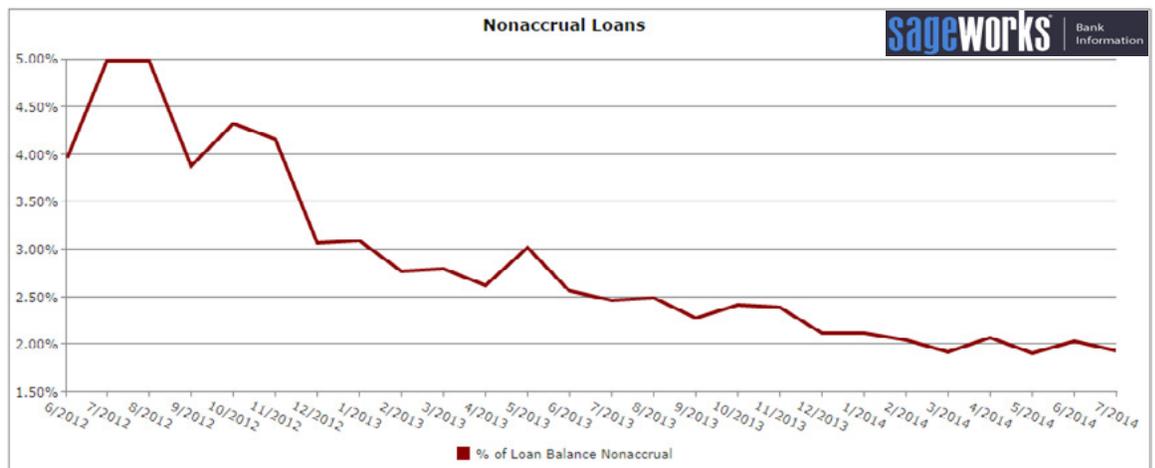
As the following chart illustrates, overall reserve levels on average have continued to decline over the past year (Source: *Sageworks Bank Information*). This would be expected as the modest yet steady recovery from the “Great Recession” continues and lower levels of loss are becoming more fully reflected in financial institutions’ loss rates.



Though lower losses are of course good news for banks overall, it has created some new challenges for bankers in terms of their ALLL. For the FAS 5/ASC 450-20 portion of the calculation, many banks utilize a “rolling” average loss rate methodology that drops off the oldest period as the most recent period is added in. As most institutions incurred their heaviest losses in the period between roughly 2009 and 2011, this historic loss rate component has been dropping significantly as these older periods (typically quarters) are falling out of the calculation.

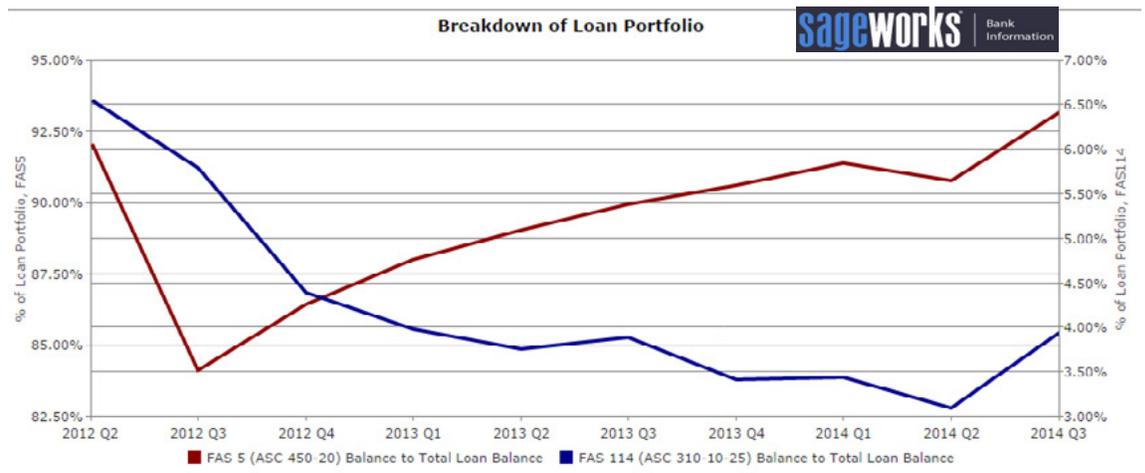
# QUALITATIVE FACTORS IN PERIODS OF LOW HISTORICAL LOSSES (CONT.)

In addition to historic loss rates trending downward, the “specific reserve” portion of the ALLL coming from individual impairments (FAS 114/ASC 310-10-25) has also dropped significantly. Non-performing and other ‘problem’ loans have largely been worked out or charged off at this point in the business cycle, as illustrated by the following chart showing the percentage of non-accruing loans to total loan balances for Sageworks ALLL clients. (Source: Sageworks Bank Information):



# QUALITATIVE FACTORS IN PERIODS OF LOW HISTORICAL LOSSES (CONT.)

As further evidence of this trend, the following chart shows how the percentage of the loan portfolio classified as impaired (FAS 114/ASC 310-10-25) has dropped in recent quarters while the percentage of pooled loans (FAS 5/ASC 450-20) has steadily increased among Sageworks ALLL clients in recent quarters. (Source: Sageworks Bank Information):



## ADDITIONAL RESOURCE:

Blog Post:

[Justifying your ALLL in a period of low historical losses](#)

# QUALITATIVE FACTORS IN PERIODS OF LOW HISTORICAL LOSSES (CONT.)

## NOTE:

To learn more about FASB's change to an expected loss model, access our whitepaper, "[CECL: Will Sophisticated Models be Required?](#)"

The impacts of these lower levels of impaired loans and loss rates have put downward pressure on reserve levels. However, many institutions are reluctant to lower their allowance at this time and release reserves back into earnings. This is due to several considerations, including pressure from regulators to maintain current reserve levels to absorb losses in the event of another economic downturn as well as the possible impact of upcoming changes in accounting guidance (specifically the FASB move from an incurred loss to an expected loss model).

This has put bankers in a difficult position, as the "quantitative" aspects of the reserve calculation are working against their efforts to maintain current ALLL levels. This has led many bankers to look to their qualitative factors as a potential means for increasing loss rates. It is certainly understandable why bankers would utilize this method, but it is not without risks.

As noted previously, the subjective nature of qualitative adjustments often draws intense scrutiny from regulators and auditors. By using Q factors to help maintain loss rates (and thus reserve levels) without reasonable justification and supporting documentation, institutions potentially leave themselves open to even more scrutiny.

Additionally, there are potential risks in increasing the proportion of loss rates allocated to qualitative factors during an economic recovery. Not only could it become more difficult to show directionally consistent usage of Q factors over time, but it also sets a precedent of the direction and magnitude of changes that could be difficult to maintain in the case of a downturn in the economy. For these reasons, and as directed by guidance, any increase in Q factors must be clearly justified and documented as well as consistent with past adjustments throughout the business cycle.

# UNALLOCATED RESERVE: ONE OPTION

To address these difficulties, many institutions have started using, or increasing their usage of unallocated reserves. Though showing an unallocated reserve could potentially draw its own scrutiny (particularly from auditors), in the end it may be easier to justify than using qualitative factors to “artificially” increase loss rates and maintain current reserve levels. As always, clearly stated policies and documentation of assumptions and procedures are the best bet in dealing with these challenges.

Rob Ashbaugh, senior risk management consultant at Sageworks, states, “While an unallocated reserve is generally permissible by most regulators and auditors, banks should try to keep that number to no more than 5% - 10% of the total ALLL. Larger percentages may invite review by those regulators or auditors. This makes documenting and supporting the unallocated reserve extremely important.”

# RECOMMENDATIONS TO ADD OBJECTIVITY

The following six recommendations are intended to add objectivity and structure to an otherwise subjective task. They include: follow interagency guidance, create a standard process of review, utilize current market information, provide directional consistency, conduct correlation analysis and backtest your ALLL.

## ***Follow Interagency Guidance:***

The 2006 Interagency Policy Statement explained that nine qualitative factors should be considered when an institution estimates credit losses. Certainly other factors can be added to this list according to the Interagency statement; however, the nine factors that they recommend are<sup>2</sup>:

- Changes in lending policies and procedures, including changes in underwriting standards and collections, charge offs, and recovery practices
- Changes in international, national, regional, and local conditions
- Changes in the nature and volume of the portfolio and terms of loans
- Changes in the experience, depth, and ability of lending management
- Changes in the volume and severity of past due loans and other similar conditions
- Changes in the quality of the organization'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 levels of such concentrations
- The effect of other external factors (i.e., competition, legal and regulatory requirements) on the level of estimated credit losses

Using the nine recommended factors will add objectivity to the qualitative risk factor analysis but must be part of the institution's overall standard process of review.

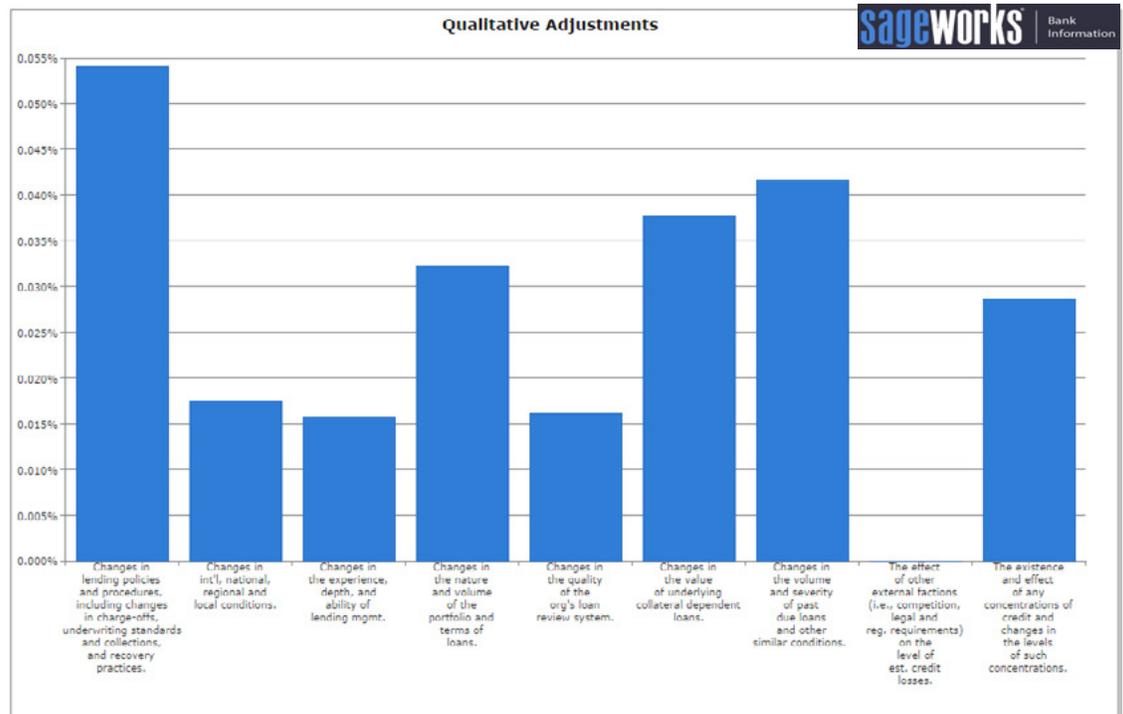
# RECOMMENDATIONS TO ADD OBJECTIVITY (CONT.)

**NOTE:**

These charts are generated from Sageworks' proprietary bank information tool. For more information, visit

[bankinfo.sageworks.com](http://bankinfo.sageworks.com)

For reference, the following chart shows the average basis-point adjustments used by the Sageworks ALLL clients across these nine standard factors as of the 6/30/2014 quarter end. (Source: Sageworks Bank Information):



Lending policies and procedures	International, regional, local conditions	Lending management	Nature and volume of portfolio	Quality of organization's loan review system	Value of collateral dependent loans	Volume and severity of past due loans	Other external factors	Changes in concentration of credit
0.054%	0.017%	0.016%	0.032%	0.016%	0.037%	0.042%	0.0%	0.028%

# RECOMMENDATIONS TO ADD OBJECTIVITY (CONT.)

## *Create a Standard Process of Review:*

Creating an institution-wide standard process of review regarding proper procedure and application of qualitative risk factors will ensure consistency and limit the amount of subjectivity. Part of the institution's standard process of review should include the Interagency guidance factors when determining loss rates. Moreover, default rate adjustments should be developed and implemented to prevent subjective rate changes from prior periods. The default rates should be developed in a matrix grounded on the institution's previous loss experience. Below is a matrix example:

Change from Prior Period	Adjustment
Significant Improvement from Prior Period	-0.16
Improvement from Prior Period	-0.12
Moderate Improvement from Prior Period	-0.08
Slight Improvement from Prior Period	-0.04
Same Compared to Prior Period	0.00
Slight Decline from Prior Period	0.04
Moderate Decline from Prior Period	0.08
Decline from Prior Period	0.12
Significant Decline from Prior Period	0.16

### NOTE:

If you haven't already, you may wish to [consider using a qualitative scoring matrix](#)

This example is merely a starting point for a financial institution's matrix as basis point ranges may be adjusted depending upon the loan category, risk rating, or other factors.

# RECOMMENDATIONS TO ADD OBJECTIVITY (CONT.)

Another recommended standard process of review procedure involves attaching comments to each adjustment. These comments will document the reasoning for the rate change from the prior period and decrease the likelihood of examiners finding the rate adjustments to be without sound reason or too subjective.

As part of the standard process of review, management can create a table of metrics, which are drivers to the nine Interagency recommended factors. These factor-driver measurements can be used to support an institution's reason for a qualitative historical-rate adjustment. Applying this procedural process further diminishes subjectivity in the qualitative risk factor calculations. Bank examiner Sharon Wells released a 2010 fourth quarter publication titled, "Qualitative Factors and the Allowance for Loan and Lease Losses in Community Banks," which outlines 3 to 13 drivers for each Interagency recommended factor, noting these drivers "could be considered when evaluating inherent risk that may drive losses in a loan portfolio."<sup>3</sup>

## ***Utilize Current Market Information:***

Considering current market information, economic trends, and events within institutions' lending footprints can help add objectivity and structure. External environmental factors include changes in unemployment rates, bankruptcy rates, or foreclosure numbers. Internal factors include changes in portfolio concentrations, bank policies/procedures, or management experience. All these internal and external environmental factors should be identified, analyzed and potentially reflected in the quantitative adjustments. Examiners expect adjustments to mirror the improvement and decline of both internal and external economic factors.

<sup>3</sup> Qualitative Factors and the Allowance for Loan and Lease Losses in Community Banks; Sharon Wells, Examiner; Trevor Gaskins, CPA, Assistant Examiner; Fourth Quarter 2010

# RECOMMENDATIONS TO ADD OBJECTIVITY (CONT.)

## NOTE:

To learn more about providing directional consistency, access a snippet of our webinar on the topic here:

[Ensure Directional Consistency in Q Factors](#)

## ***Provide Directional Consistency:***

Ensuring that determinations are always directionally consistent with credit quality trends is critical. The 2006 Interagency Policy Statement expounds on this suggestion by advising:

*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.*

Simply put, directional consistency validates that as drivers and factors change rate directions, an institution's qualitative rates change directions as well and in accordance with the proper correlation to the driver and factor. Documentation of sequential changes to factor rates, supported with driver graphs and/or measurements, ensures directional consistency has been maintained. Internal management reports can be developed to track and support loan payment delinquencies, collateral values, and loan concentrations which would be very useful in supporting changes in any of the nine factors. Also, the Federal Reserve Economic Data (FRED) is a common resource of graphs and data.

# RECOMMENDATIONS TO ADD OBJECTIVITY (CONT.)

## ***Conduct Correlation Analysis:***

Correlation analysis enables management teams to measure the strength of the relationship between two variables: how well changes in one variable can be predicted by changes in another. Let's suppose management perceives a correlation between changes in commercial vacancy rates and the commercial real estate ("CRE") losses they recognize. By calculating the correlation coefficient (measured on a scale from -1.00 to +1.00, where +/-1.00 equals a perfect correlation between variables), management can determine the degree to which the change in vacancy rates affects CRE losses. With the coefficient calculated, an institution can multiply the coefficient by the actual published vacancy rates to forecast probable changes in future CRE losses. This can aid management in any necessary adjustments to the historic loss rates.

### NOTE:

For more on backtesting, access our whitepaper:

[Backtesting: Measuring the Effectiveness of ALL Methodologies](#)

## ***Use Backtesting as a Method of Validation:***

The use of backtesting allows management to test current assumptions or adjustments against actual historical data, in an effort to use the results to add credibility when making those same assumptions today. After all, as renowned NYSE trader William Gann taught, "The future is but a repetition of the past."

# CONCLUSION

Determining qualitative and environmental rates for ALLL calculations is a subjective task at its core. This subjectivity has allowed examiners to target this area of financial institutions' ALLL calculations as weak points of historical loss rate calculations. These suggestions touch on a few of the ways institutions and their management teams can reduce this subjectivity. Management teams are encouraged to utilize the resources available to them and to make those qualitative adjustments that can be adequately substantiated with relevant, supporting documentation.

# ABOUT SAGEWORKS & THE AUTHORS

[Sageworks](#) is a financial information company that works with financial institutions, accountants and private-company executives across North America to collect and interpret financial information. With almost 700 financial institution clients in the U.S., Sageworks provides a web-based suite of solutions to streamline credit analysis, risk rating, [portfolio stress testing](#), loan administration and [ALLL calculation](#).

## Sageworks ALLL

[Sageworks ALLL](#) is the premier automated solution for allowance calculation used by over 300 financial institutions. It helps bankers automate their ALLL process and adds consistency to their methodology, making it defensible to auditors and examiners. To find out more, visit [www.sageworksanalyst.com](http://www.sageworksanalyst.com).



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# ADDITIONAL RESOURCES

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Interagency Policy Statement on the Allowance for Loan and Lease Losses:  
OCC, FDIC, NCUA, OTS, Fed Board of Governors, 2006

Qualitative Factors and the Allowance for Loan and Lease Losses in Community  
Banks; Sharon Wells, Examiner; Trevor Gaskins, CPA, Assistant Examiner;  
Fourth Quarter 2010