ALLL: 3 WAYS TO PREPARE FOR YEAR-END

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TABLE OF CONTENTS

INTRODUCTION

As the year comes to a close, many financial institutions find themselves unsettled regarding their allowance for loan and lease losses (ALLL) methodologies. With the Financial Accounting Standard Board's (FASB) proposed current expected credit loss model (CECL), banks will be required to "look ahead" in the estimation of credit losses and use of a "life of loan" expected, credit loss estimate. Thomas Curry, Comptroller of the Currency, estimated that with the potential change, reserves could increase anywhere from "30-50 percent."[1]

While banks continue to wait for the final release of the FASB's CECL model, there are three key factors and steps that banks and credit unions should take into consideration while calculating year-end reserves.

DATA **COLLECTION**

ALLL DATA:

Learn more about the data types necessary for the allowance calculation and sources for the data:

Compiling the Best Data for the Reserve Calculation

MADE THE MOVE TO THE OCC?

See what challenges banks faced when transitioning:

Moving from the OTS to the OCC: Impact on the ALLL

Receiving accurate and reliable data has been a major challenge for banks calculating their reserves. Gathering data such as appraisal values, charge-offs or final months' end reconciled numbers can delay the ALLL calculation. As referenced in a previous paper titled Compiling the Best Data for the Reserve Calculation there are four types of data critical within ALLL:

- Loan portfolio information
- Collateral valuations and loan data for FAS 114 (ASC 310-10-35) calculations
- Historical loss data for FAS 5 (ASC 450-20) calculations
- Supporting data for qualitative adjustments to FAS 5 calculations

Since a significant amount of time is spent on the classification of FAS 5 (ASC 450-20) and FAS 114 (ASC 310-10) buckets, it is recommended to acquire as much loan-level detail for the basis of sound financial decisions and justification regarding ALLL reserves.

Historical loss rates are critical for determining ALLL reserves and can have a major impact on the overall firm's methodology for determining FAS 5 impairment. While methodologies vary from bank to bank, it is common for community banks to use an 8-12 quarter look-back. However, with the economy improving, increased regulatory requirements and a refined lending methodology, banks have been able to strengthen their overall loan portfolio and in some cases justify a decrease in their ALLL reserves. In addition, while utilizing the 8-12 quarter look-back period, banks are seeing significant charge-offs from prior periods begin to fall-off from their FAS 5 loss ratios, an even bigger problem for banks that transitioned from the OTS to the OCC.

DATA **COLLECTION** (CONT.)

ALLL RESOURCES:

To find the latest whitepapers, videos and webinars on the ALLL, visit

ALLL Resources

from Sageworks.

Despite the improved economy and lending practices, regulators are still closely monitoring reserves especially in cases where they feel banks are under-estimating their reserves to boost overall earnings.

Thomas Curry explains, "It is to be expected" for some banks to reduce reserves.[2] But, it is well-known that negative provisions and releasing of reserves can raise red flags at exam time.

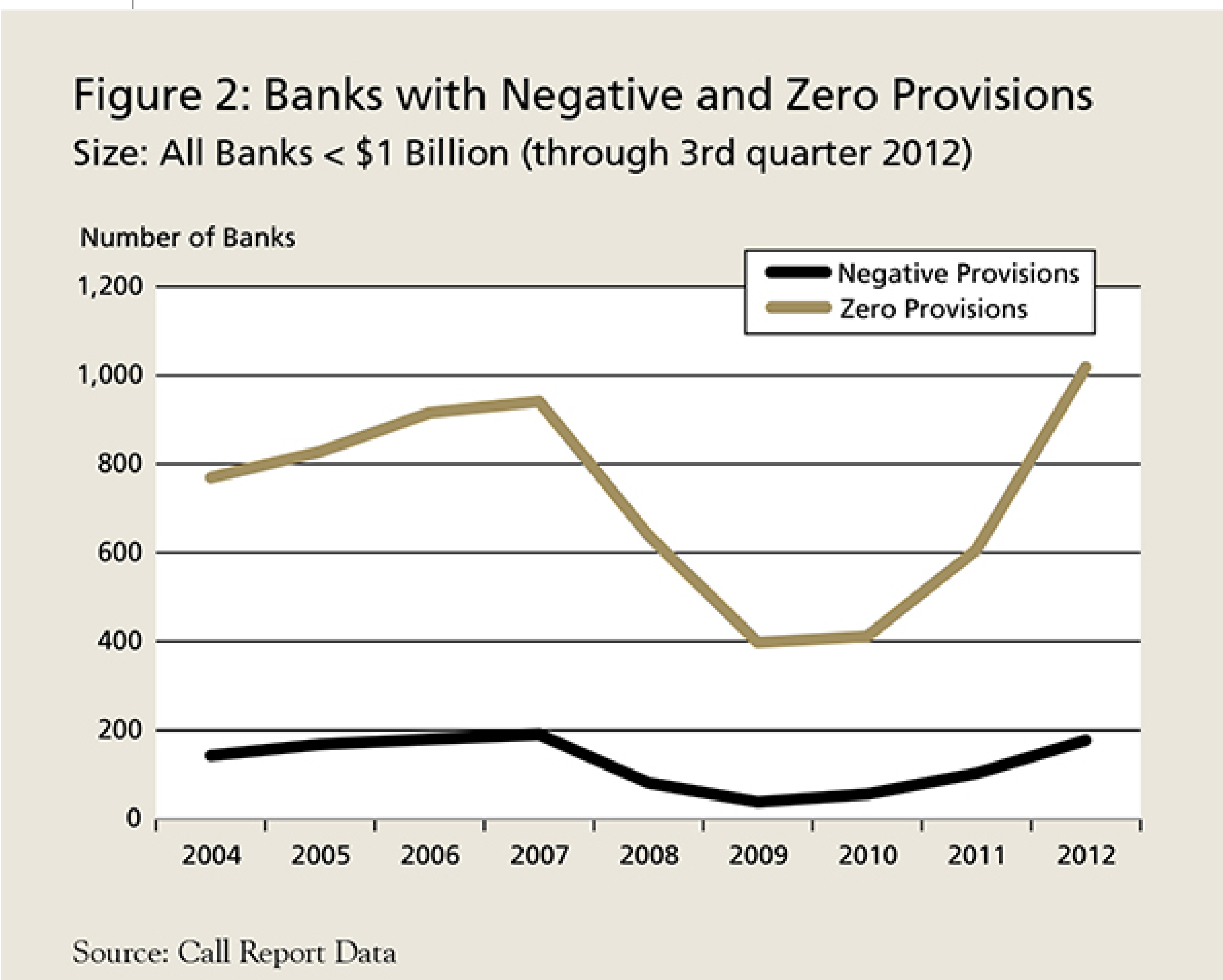

Chart from Community Banking Connections, The Federal Reserve Bank of Chicago.

DATA **COLLECTION** (CONT.)

E-BOOK:

For a comprehensive reference of the ALLL reserve estimation process, download the e-Book:

[The Complete Guide to the ALLL]

Banks must be prudent and document historical data to justify their ALLL reserves, which is why the first year-end recommendation for banks and credit unions is to shore up data collection processes to provide for more granular analysis. Obtaining such data for the ALLL reserve calculation can be a time-consuming and error-prone process.

Archiving historical data and capturing loan level detail is essential for financial institutions in forecasting related loss reserves and explaining trends in recoveries, deviations from historical patterns, sensitivity to variation and trends in delinquencies. By storing key data, it will inherently support the institution's overall ALLL, especially for banks utilizing a migration analysis model. Yet, banks working off spreadsheets through time find it difficult to track changes in data and are more prone to data manipulability, which can compromise the integrity of the derived analysis.

Many institutions have been able to streamline the process by utilizing automated systems that integrate with a bank's core to project ALLL reserves before quarter-end and even automate for up-to-date balances. Web-based ALLL solutions allow multiple users to work simultaneously rather than having one static spreadsheet that must be passed back and forth between bank personnel.

By using third-party vendors, banks are able to archive historical data information, eliminate the cascading effect over spreadsheets, increase consistency, provide defensibility and help prepare for future policy changes through greater data granularity.

DISCLOSURE **REPORTING**

The second recommendation for year-end ALLL calculations also pertains to data but, more importantly, to how that data is accessed and reported on through disclosure reports.

With the release of the July 2010 FASB Accounting Standards Update 2010-20, banks increased transparency pertaining to financial reporting. Robert H. Herz, the FASB chairman, stated: "The global financial crisis highlighted the need for additional information about a company's financial instruments, including loans and other financing receivables. This Update proves greater transparency for investors and other users of financial statements by requiring more information from companies about credit risk exposure for financing receivables and the related credit reserves."[3]

The additional disclosure reports required for financing receivables are as follows:

- Aging of past due receivables
- Credit quality indicators
- The landscape and extent of troubled debt restructurings and its impact on the allowance for credit losses
- Significant purchases and sales of financing receivables

Under the guidance, banks need to disaggregate new and existing disclosures based on how the bank develops its allowance for credit and losses as well as how it manages credit risk. As of December 15, 2010, public banks were required to follow the new disclosure reporting standards while private banks had until December 15, 2011. Furthermore, public banks are expected to provide interim and year-end disclosures whereas private banks need only to

HEAR FROM A CLIENT:

Hear about the custom reporting capability Sageworks ALLL users enjoy:

Custom Reporting

DISCLOSURE **REPORTING** (CONT.)

generate disclosure reports on an annual basis. For private banks, this has become a tedious and cumbersome process due to the necessary loan-level detail and trends required, and banks may struggle with retaining, storing and documenting critical information since it is only being required on a yearly basis. For example, banks will need to deliver an in-depth Troubled Debt Restructuring report by loan class as well as a report for any TDR defaults in the past 12 months and its impact on the ALLL reserve. If private banks are not taking the initiative to keep thorough and detailed records throughout the course of the year, constructing disclosure reports can be extremely burdensome.

Accommodating disclosure requirements may not be easy for banks and credit unions, due to limited resources and feedback regarding how to construct the new reports based on the institution's methodology and loan portfolio. It is recommended that institutions seek external assistance and speak to external auditors or loan review firms. Many third-party companies provide users with pre-built templates within an automated solution to expedite the process of generating disclosure reports. This will help lighten the workload as well as provide the necessary transparency and documentation for requirements surrounding the ALLL calculation.

CONSISTENCY IN **METHODOLOGY**

For years, subjectivity has been at the forefront of these calculations; however this does not always sit well with examiners, who look for "directional consistency" and well supported documentation that shows a consistent methodology over time. The 2006 Interagency Policy Statement details the elements and factors needed for boards of directors, management and bank examiners pertaining to the estimation of the ALLL. Furthermore, it explains that there are nine qualitative factors that should be used when estimating credit losses. Financial institutions are encouraged to use and add to this list of qualitative factors below:

- 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 economic conditions
- Changes in the nature and volume of the portfolio and terms of the 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

CONSISTENCY IN **METHODOLOGY** (CONT.)

BLOG POST:

Five Recommendations for Determining Appropriate Qualitative Adjustments

Qualitative Risk Factor Adjustments

Risk Factor	Change from Prior Period	Current Adjustment
Changes in the experience, depth, and ability of lending management.	Improvement	-0.1200
Changes in the volume and severity of past due loans and other similar conditions.	Significant Improvement	-0.1600
Changes in the quality of the organization's loan review system.	Same	0.0000
Changes in the value of underlying collateral for collateral dependent loans.	Same	0.0000
The existence and effect of any concentrations of credit and changes in the levels of such concentrations.		0.0000

By utilizing environmental and qualitative factor matrix that ensures consistent methodology from quarter to quarter, banks are able to increase the amount of objectivity, particularly in FAS 5 pools. Chris McKinley, president of Green Cap Financial in Burlington, NC, states: “What we are seeing from regulatory examinations is a drive to have a consistent, proactive process and an understanding of the trend analysis data.” Several banks have started to switch to an ALLL solution to eliminate human error, reduce subjectivity and construct comprehensive and detailed analysis of ALLL provisions.

CONCLUSION

With the looming changes from the FASB, it is vital for banks to be proactive instead of being reactive, and that includes three considerations to keep in mind for this year's yearend calculation. It is clear that precise, granular and justifiable data is necessary for year-end ALLL reserve estimations, so banks need a process in place to streamline collection and management of data. By archiving loan level data, banks are able to mitigate risk while supporting their methodology in the ALLL calculation. Disclosure reports, though labor intensive, will help with transparency and assist in adding credibility with examiners; consequently any systemization that reduces prep time with these reports would be a sound investment for long term risk management. Similarly, banks should create a standard process of review to maintain directional consistency by making use of a qualitative risk factor matrix to add objectivity to the ALLL reserve. An ALLL solution might make these process modifications easier, but similar process improvements can be achieved with just due attention and documentation.

ABOUT **SAGEWORKS & THE AUTHOR**

Sageworks (www.sageworks.com) is a financial information company working with financial institutions, accountants and private-company executives across North America to collect and interpret financial information. Thousands of bankers rely on Sageworks' credit risk management solutions to streamline credit analysis, risk rating, portfolio stress testing, loan administration and ALLL calculation. Sageworks is also an industry thought leader, regularly publishing whitepapers and hosting webinars on topics important to bankers.

sageworks® | ALLL

Sageworks ALLL is the premiere automated solution for estimating a financial institution's reserve. It helps bankers automate their ALLL process and increase consistency in their methodology, making it defensible to auditors and examiners. Sageworks' risk management consultants also assist clients with the implementation of their ALLL models and guidance interpretation. To find out more, visit www.sageworksanalyst.com.

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ENDNOTES

[1] "FASB's Plan to Boost Reserves Supported by the OCC." *Sageworks*. September 19, 2013. http://www.sageworks.com/blog/post/2013/09/19/FASB-proposal-to-boost-reserves-supported-by-OCC.aspx.

[2] "Remarks by Thomas J. Curry Comptroller of the Currency Before the AICPA Conference." *OCC*. September 16, 2013. http://www.occ.gov/news-issuances/speeches/2013/pub-speech-2013-136.pdf.

[3] "FASB Issues Accounting Standards Update No. 2010-10, *Disclosures About the Credit Quality of Financing Receivables and the Allowance for Credit Losses*." *FASB*. July 21, 2010. http://www.fasb.org/cs/ContentServer?c=FASBContent_C&pagename=FASB/FASBContent_C/NewsPage&cid=1176157124316.

ADDITIONAL **RESOURCES**

"e-Book: The Complete Guide to the ALLL," *Sageworks.*

http://web.sageworks.com/complete-guide-ALLL-reserves/

Bayer, Ed and Regan Camp, "Qualitative Risk Factors: How to Add Objectivity to an Otherwise Subjective Task," *Sageworks*.

http://web.sageworks.com/qualitative-risk-factors/

Lubansky, Mike, "Challenges in the Estimation of the ALLL," *Sageworks.*

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Camp, Regan, "How to Calculate Your FAS 5 Reserves," *Sageworks.*

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Morris, Garrett, "Compiling the Best Data for the Reserve Calculation" *Sageworks.*

http://web.sageworks.com/best-data-for-reserve-calculations/

ALLL Forum for Bankers, *LinkedIn.*

http://www.linkedin.com/groups?gid=4844399

"ALLL 101: Infographic on Calculating a Bank's Reserves," *Sageworks*

http://www.sageworks.com/blog/post/2013/02/18/ALLL-101-Calculating-a-banks-reserves.aspx