

DOCUMENTING THE ALLL: **WHAT EXAMINERS EXPECT**



REGAN CAMP, SENIOR RISK MANAGEMENT CONSULTANT

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INTRODUCTION

Prevailing regulatory guidance concerning the allowance for loan and lease losses (ALLL) [acknowledges](#) the fact that “determining the appropriate level for the [ALLL] is inevitably imprecise and requires a high degree of management judgment.” Consequently, with the latitude given to management to develop and maintain a “comprehensive, systematic, and consistently applied process for determining appropriate reserve levels,” as required by guidance, it is imperative that banks and credit unions generate and maintain appropriate documentation to support those determinations and establish a defensible calculation that will satisfy auditors and examiners alike.

Although a novel could be written to address all of the varieties of information that may be appropriately utilized in [documenting and supporting ALLL conclusions](#), the intended scope of this paper includes the presentation and discussion of the primary and most common documentation to consider when aiming to satisfy examiner expectations.

ALLL NARRATIVE

DID YOU KNOW?

[Sageworks ALLL](#) offers 4 types of reports:

1. Executive Summary
2. FAS 114 Loans
3. FAS 5 Loans
4. Comprehensive Documentation

Often referred to as the “executive summary” of the ALLL, the ALLL Narrative provides examiners with a high-level overview of the results of the comprehensive ALLL calculation, outlines the [ALLL methodology](#), policies and procedures employed in the calculation and highlights other key information the bank determines appropriate to provide further insight into assumptions made.

Remember the early direction we all received in grade school concerning how to structure an essay? It likely went something like this:

1. Tell your intended audience what you’re going to tell them (the ALLL Narrative),
2. Tell them and then
3. Tell them what you told them but in a slightly different manner.

Such an approach has not only proven sufficient for grade school essays, but it has also proven to be an effective approach towards satisfying examiner expectations pertaining to the delivery of ALLL documentation.

Consistent with this approach, the ALLL Narrative should provide, in a succinct manner, an executive summary of how the more high-level calculation determinations were made—essentially, telling the examiners what you’re going to tell them in the remaining, more comprehensive and detailed documentation.

COMPREHENSIVE DOCUMENTATION

After we've told the examiners what we're going to tell them, the next step is to tell them. Accordingly, accompanying the ALLL Narrative should be a compilation of comprehensive documentation providing all the details of the ALLL reserve calculation and substantiation as to how those results were determined. This more comprehensive/detailed documentation may be most effectively outlined within the realm of each respective ALLL calculation component, which primarily includes the following:

NOTE:

An **impaired loan** is collateral dependent if "repayment is expected to be provided solely by the underlying collateral," which includes repayment from the proceeds from the sale of the collateral, cash flow from the continued operation of the collateral, or both.

[Learn more](#)

- [FAS 114 \(ASC 310-10-35\)](#) – Individual loan impairment/reserve evaluations
 - Fair Value of Collateral valuations
 - Present Value of Future Cash Flow valuations
- FAS 5 (ASC 450-20) – General reserve calculations for homogenous loan pools
 - Historical loss rate calculations
 - Qualitative factor adjustments

FAS 114 (ASC 310-10-35)

DOCUMENTATION

Although the documentation examiners look for in support of individual loan impairment/reserve evaluations is contingent upon the valuation method utilized, the objective is the same – determine appropriate model inputs consistent with prevailing regulatory guidance and substantiate the appropriateness of those determinations to the extent possible.

Similarly, documentation should outline the [process used to identify impaired](#) (loans to be evaluated under FAS 114) versus non-impaired loans (loans to be evaluated under FAS 5).


Fair Value of Collateral Valuations

When evaluating a collateral-dependent loan, banks and credit unions must first determine their total recorded investment (TRI) in the loan using the [Fair Value of Collateral valuation](#) and then compare that TRI to the fair value of any and all underlying collateral (net of holding or selling costs).

While the TRI is generally quite transparent, tracked and easily accessed in the bank's core loan system, the fair value of collateral often requires inputs that must be defended. In this effort, banks should consider the most appropriate method of valuation (e.g., appraisal, in-house evaluation, company balance sheet) and demonstrate a review of that valuation, making and supporting any necessary adjustments to the determined value(s).

Additionally, although not typically required with each submission, banks should have [valuation support documentation](#) (e.g.; appraisal reports) on-hand to accommodate any examiner request and defend any and all determined values.

FAS 114 (ASC 310-10-35) DOCUMENTATION (CONT.)

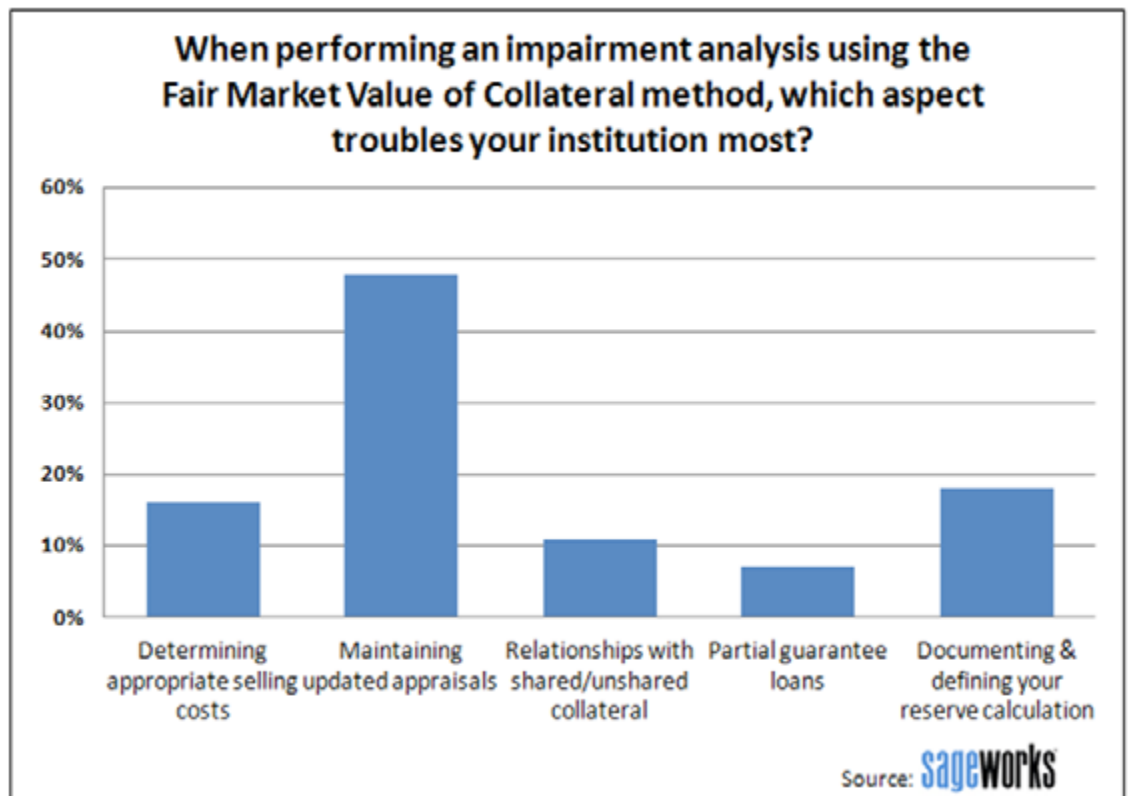
Shared Collateral										
Attached Documents	Collateral	Appraisal Value	Appraisal Adjustment	Current Value	Prior Liens	Equity	Selling Costs	Fair Value	Appraisal Date	Expand All
 1	245 Elm St	\$ 800,000.00	5.00%	\$ 760,000.00	\$50,000.00	\$710,000.00	\$60,000.00	\$ 650,000.00	09/01/2011	Expand 
Total:		\$ 800,000.00		\$ 760,000.00				\$ 650,000.00		

Example of collateral data necessary for documented FAS 114 analysis on a collateral-dependent loan.

Moreover, when determining appropriate holding or selling costs to be netted against equity in existing collateral, banks and credit unions must consider whether it's more appropriate to itemize individual costs or to simply apply a standard percentage across the board.

Either way, institutions would be prudent to supplement with as much support documentation as is available to substantiate those determinations (e.g., tax bills, hazard insurance quotes, realtor commission agreements).

Poll conducted during Sageworks' webinar, [How to Calculate Your FAS 114 Reserves](#). Over 160 bankers responded to the poll question. [View the webinar recording](#).



FAS 114 (ASC 310-10-35) DOCUMENTATION (CONT.)

In addition to supporting the calculation assumptions, it is also recommended to document a course-of-action plan for each impaired credit, explaining recent and/or anticipated developments with the credit. This provides examiners with insight into the efforts put towards minimizing and/or recovering anticipated or recognized losses.

Present Value of Future Cash Flow Valuations

Next, when the [Present Value of Future Cash Flow method](#) is determined to be the most appropriate method of individual impairment evaluation, rather than looking to support a fair value of collateral, banks and credit unions must [support a projected cash flow schedule](#), which can easily introduce subjectivity into the reserve calculation.

Although subjective, these cash flow estimations should be based upon reasonable, supportable and documented assumptions and projections. Regulatory guidance reiterates, “All available evidence should be considered in developing the estimate of expected future cash flows. The weight given to the 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.”

Documentation should thus include the estimated timing and amount of cash flows, the effective interest rate used in discount calculations and the basis for determining cash flow payments, which might include environmental factors or past payment history.

ADDITIONAL RESOURCE:

Whitepaper: Compiling the
Best Data for the Reserve
Calculation

[Access the whitepaper](#)

FAS 5 (ASC 450-20)

DOCUMENTATION

Historical Loss Rates

Prevailing regulatory guidance does not mandate the use of any specific methodology when determining appropriate historical loss experience. Regardless of the method used, banks and credit unions should maintain supporting documentation for the techniques used and the rationale behind those selections.

Documentation should outline the import source used for [historical loss rates](#), the selected historical time horizon and loss period weightings, if used.

The rationale should reflect management's best assessment of estimated credit losses in the current loan portfolio, and it should be documented to the extent possible.

Qualitative Factors

Many banks have found that [qualitative factor adjustments in the ALLL](#) can be the area of most focus during an exam. This is largely due to the fact that this section of the ALLL calculation is inherently the most subjective. Consequently, it is imperative that banks substantiate these adjustments to the historical loss rates and explain how the adjustments reflect current information, events, circumstances and conditions in the loss measurements.

Reasonable documentation should be maintained to support which factors affected the analysis and the impact of those factors on the loss measurement. [Guidance explains](#), "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

ADDITIONAL RESOURCE:

Whitepaper: Qualitative
Risk Factors - How to Add
Objectivity to an Otherwise
Subjective Task

[Access the whitepaper](#)

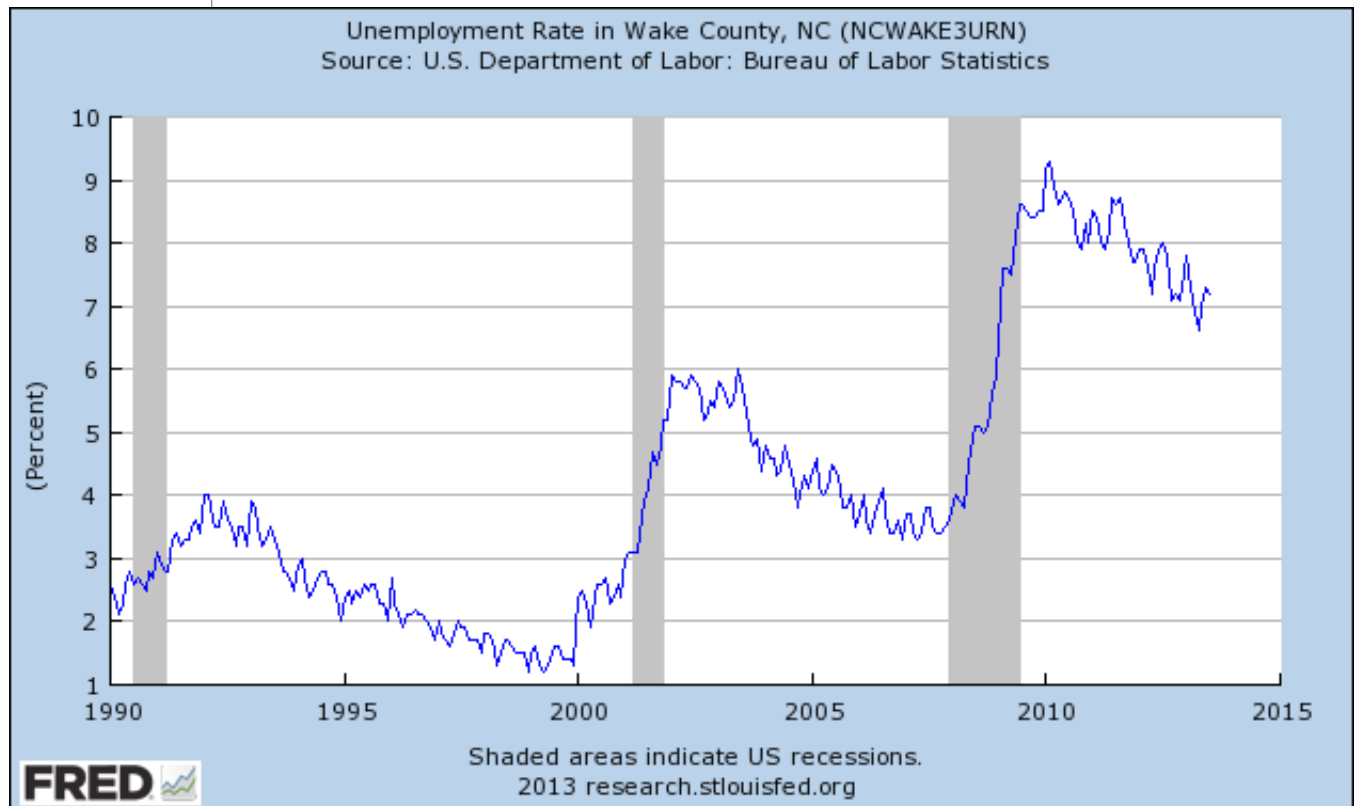
FAS 5 (ASC 450-20) DOCUMENTATION (CONT.)

FACT

Users of [Sageworks ALLL](#) have access to FRED charts and graphs to embed directly into their documentation.

management estimated the impact, and other available data that supports the reasonableness of the adjustments.”

This can often be accomplished through the inclusion of supporting materials: [Federal Reserve Economic Data](#) (FRED), portfolio performance metrics, economic reports, other publications outlining economic or business trends, etc.



DISCLOSURE REPORTING WITH ASU 2010-20

ADDITIONAL RESOURCE:

Whitepaper with sample reports: 6 Key Items to Know About Disclosure Reports

[Access the whitepaper](#)

Having already used the ALLL Narrative to communicate an executive summary and then providing the detailed information, we're left with the final step – reiterating, in a slightly different manner than originally offered, what the detailed documentation should have told them.

[Required disclosure reports and financial footnotes](#) do just that.

In July 2010, in response to a global financial crisis that highlighted the need for greater transparency and additional disclosure of information about the credit quality of an institution's financial instruments and the adequacy of its ALLL, the Federal Accounting Standards Board (FASB) issued [Accounting Standards Update \(ASU\) 2010-20, Disclosures about the Credit Quality of Financing Receivables and the Allowance for Credit Losses](#). This update was intended to enhance prevailing disclosure requirements, as well as “provide greater transparency for investors and other users of financial statements, by requiring more information from companies about credit risk exposures for financing receivable and the related credit reserves,” according to FASB Chairman Robert H. Herz.

More specifically, ASU 2010-20 requires institutions to disclose a greater level of disaggregated information, including the following additional disclosures about financing receivables:

- [Credit quality indicators](#) of financing receivables at the end of the reporting period, by class of financing receivables
- The aging of past due financing receivables at the end of the reporting period, by class of financing receivables

DISCLOSURE REPORTING WITH ASU 2010-20 (CONT.)

- The nature and extent of troubled debt restructurings that occurred during the period, by class of financing receivables, and their effect on the allowance for credit losses

12/31/2012		
Loan Type Code	Number of Contracts	Recorded Investment
Commercial Ln Non-RE	3	\$307,806.48
Commercial RE	2	\$99,845.23
Consumer Ln Non-RE	3	\$55,692.18
Multi Family and Rental RE	0	\$0.00
Residential RE	1	\$14,156.00
Totals:	9	\$477,499.89

ADDITIONAL RESOURCE:

Read more about why they changed reporting requirements for the ALLL:

[Why the change?](#)

- The nature and extent of financing receivables modified as troubled debt restructurings within the previous 12 months that defaulted during the reporting period, by class of financing receivables, and their effect on the allowance for credit losses
- Significant purchases and sales of financing receivables during the reporting period, disaggregated by portfolio segment

DISCLOSURE REPORTING WITH ASU 2010-20 (CONT.)

Current disclosure requirements have also been amended to require the following on a disaggregated basis:

- A roll-forward schedule of the allowance for credit losses from the beginning of the reporting period to the end of the reporting period on a portfolio segment basis, with the ending balance further disaggregated on the basis of the impairment method
- For each disaggregated ending balance in the item above, the related recorded investment in financing receivables
- The nonaccrual status of financing receivables, by class of financing receivables
- Impaired financing receivables, by class of financing receivables

Tom Danielson, partner at [CliftonLarsonAllen](#), a top-10 U.S. accounting firm, asserts that ASU 2010-20 now applies to all banks that have audited financial statements. In fact, adherence to this update became required for public institutions for periods ending on or after December 15, 2010, and for non-public institutions one year later, in 2011. Depending on the bank's asset size, this additional disclosure reporting may be either an annual or quarterly requirement.

Many banks and credit unions [find the compilation of these disclosure reports quite burdensome](#), citing time and resource requirements, associated costs and inaccessibility of information from disparate data sources.

Consequently, many have looked to outsource this reporting requirement or have subscribed to third-party software solutions to alleviate these identified burdens while keeping the reporting function in-house.

A FEW DAYS:

In a recent poll, more than 50% of bankers indicated the disclosures take them more than a few days.

More than 15% said more than a few weeks.

[See the poll results](#)

CONCLUSION

According to prevailing regulatory guidance, a bank's or credit union's process for determining an appropriate level for the ALLL should be based on not only a comprehensive and consistently applied analysis of its loan portfolio, but must also be a process that is well-documented.

The extent to which any and all determinations made throughout the calculation are substantiated with recorded and accessible documentation will also determine the extent to which the ALLL can be defended, as well as the extent to which examiners will be satisfied with the corresponding output.

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.

Regan Camp is a senior risk management consultant at Sageworks, where he serves as a specialist in assisting financial institutions with accurately interpreting and applying federal accounting guidance. Regan primarily focuses on allowance for loan and lease loss provisions (ALLL) and stress testing loan portfolios.

Prior to joining Sageworks, he served in various consulting capacities at Deloitte & Touche, L.P. and Dittrich & Associates LLC, where he assisted financial institutions in the administration of FDIC Loss Share Agreements and managed the establishment of special asset divisions and the resolution of troubled portfolios. He also represented the FDIC in overseeing the day-to-day operations and eventual liquidations of failed financial institutions. Regan is a magna cum laude graduate of Brigham Young University's Marriott School of Business, where he studied business management and finance.

ADDITIONAL RESOURCES

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

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

ALLL Glossary, *Sageworks*.

<http://web.sageworks.com/alll-glossary/>

“Challenges in the Estimation of the ALLL,” *Sageworks*.

<http://web.sageworks.com/alll-challenges-whitepaper/>

“How to Calculate Your FAS 114 Reserves,” *Sageworks*.

<http://web.sageworks.com/fas-114-reserves/>

FAS 114 Impairment Analysis Worksheet, *Sageworks*.

<http://web.sageworks.com/federal-fas-114-reserve-all-policy-impairment-analysis/>

“6 Key Items to Know About Disclosure Reports,” *Sageworks*.

<http://web.sageworks.com/disclosure-reports-whitepaper/>