

# How to Justify a Change in Your ALLL

Ed Bayer, Managing Director

Tim McPeak, Senior Risk Management Consultant

**Sageworks**

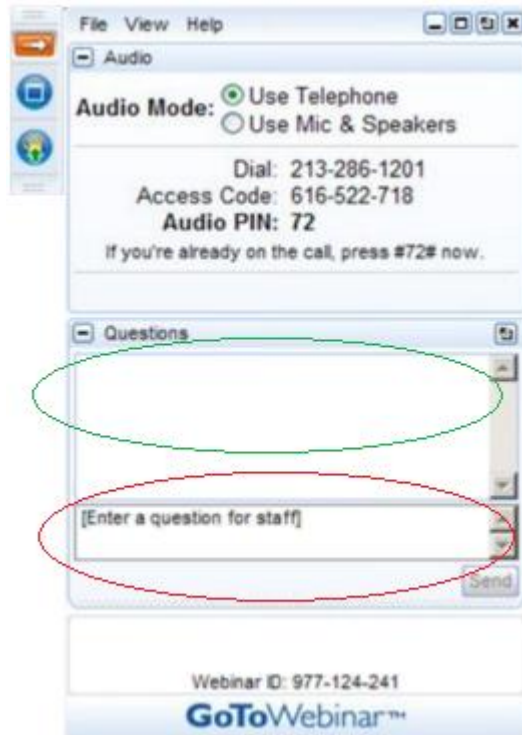
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# Questions

To ask a question during the webinar, feel free to enter it into the chat box along the right hand side of your screen. Slides are available there, too.



Link to download slides

Area to enter questions

# About Sagemworks

- Financial information company that provides credit and risk management solutions to financial institutions
- Data and applications used by thousands of financial institutions and accounting firms across North America
- Provides resources, including whitepapers, webinars, videos, and templates, for bankers—accessible at [www.sagemworksanalyst.com](http://www.sagemworksanalyst.com)

# About the Presenters

## ➤ Ed Bayer

- Ed is the managing director in Sageworks' financial institution division. He previously served as a senior risk management consultant, with a primary focus on ALLL provisions and stress testing loan portfolios. In that role, he consulted with institutions ranging in size from \$50M in assets to several billion, helping them implement defensible and effective methodologies.

## ➤ Tim McPeak

- Tim McPeak is a senior risk management consultant at Sageworks, where he assists financial institution clients with the implementation of our portfolio and risk management solutions.

# Risk Management Summit, Dec. 5-6, 2013

Mark your calendars!

2<sup>nd</sup> Annual Risk Management Summit

**When:** December 5-6, 2013

**Where:** Gaylord Opryland Resort &  
Convention Center in Nashville, TN



*Speakers and panels centered on ALLL and stress testing practices, as well as breakout sessions for Sageworks Surety and Clarity users. The summit will also feature plenty of networking and Q&A sessions.*

*Find out more at [web.sageworks.com/risk-management-summit/](http://web.sageworks.com/risk-management-summit/)*

# Agenda

1. About Sageworks and Our Speaker
2. Poll
3. What's the Big Deal?
4. What Examiners are Looking for in the ALLL
  - Comprehensive
  - Well Documented
  - Consistently Applied
  - Inclusive of Environmental & Qualitative Risk Factors
5. Areas of Scrutiny
6. By the Numbers
7. 6 Ways to Prepare for your Next Exam
8. Q & A

# Quick Poll

1. Quarterly Call Reports
2. Current ALLL Levels

# What's the Big Deal?

## Summary Income Statement

Periods Last Four Years & YTD

Source Location	2009 Y	2010 Y	2011 Y	2012 Y	YTD	
Period End, Adjusted to December Cycle	12/31/2009	12/31/2010	12/31/2011	12/31/2012	6/30/2013	
Last Update Date	1/29/2010	3/14/2011	4/16/2012	7/11/2013	7/12/2013	
(Dollars in Thousands)						
<b>Summary Income Statement</b>						
Total Interest Income	RIAD4107	24,092	22,916	21,668	20,533	9,738
Total Interest Expense	RIAD4073	8,929	7,884	5,118	2,932	1,187
Net Interest Income	RIAD4074	15,163	15,032	16,550	17,601	8,551
Tot Provision Expense	RIAD4230	3,895	6,052	4,204	2,671	1,169
Total Noninterest Income	RIAD4079	5,009	5,295	6,153	6,275	3,233
Total Realzd Gains -Secs		550	1,062	1,151	897	2
Total Noninterest Expense	RIAD4093	14,351	14,666	15,507	16,528	7,908
Inc bef Inc Tax & Extra Items	RIAD4301	2,476	671	4,143	5,574	2,709
Income Taxes	RIAD4302	117	84	188	190	121
Income before Extraord Items	RIAD4300	2,359	587	3,955	5,384	2,588
Extraord Items, Net Tax	RIAD4320	0	0	0	0	0
Bank Net Income	RIAD4340	2,359	587	3,955	5,384	2,588



# What's the Big Deal?

1. Impact on bank earnings and therefore shareholders
2. Impact on capital and leverage ratios
3. Strict regulations surrounding the ALLL and specific guidance
4. Ability to absorb losses for the current year

# What Examiners are Looking for in the ALLL

*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.*

2006 Interagency Policy Statement on the  
Allowance for Loan and Lease Losses

# Comprehensive ALLL

- If you have the ability, move to a more sophisticated analysis
  - *De novo* institutions changing from peer group loss rates to true historical loss rates after their *de novo* status ends
  - Moving from historical loss rates to migration analysis

<u>Migration Analysis vs Historical Loss Rate Method ALLL Provisions</u>							
<i>Migration Analysis For ALLL Provision Using Current Balances</i>				<i>Using Re-Structured Ratings</i>			
C&I - Pass	163	0.08	13.04	183	0.08	14.64	
C&I - Special Mention	57	0.14	7.98	57	0.14	7.98	
C&I - Substandard	30	0.36	10.8	10	0.36	3.6	
Total ALLL Provision			31.82			26.22	
<i>Historical Loss Rate Analysis For ALLL Provision Using Current Balances</i>				<i>Using Re-Structured Ratings</i>			
C&I	250	0.093171	23.29275	250	0.093171	23.29275	
Total ALLL Provision			23.29275			23.29275	

- Consider an automated software that provides more detailed analysis

# Well Documented ALLL

- Loss rate methodology
  - Documenting peer groups and source of data
  - Supporting the calculations
  - Providing documentation and data to support qualitative factors
  
- Loan impairment analysis
  - Including recent and accurate appraisal data
  - Supporting expected cash flow assumptions

# Consistently Applied ALLL

- Consistent historical look-back periods
  - Examiners allow institutions to calculate loss rates using multiple look-back periods in order to find the most conservative loss rates. But, changing look-back periods will limit the defensibility of the calculation.
- Consistent use of loss rate weightings
  - If loss rate weightings are applied, make sure they are consistent.
- Consistent calculation of expected cash flow payment

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- Consistent use of loss rate weightings
  - If loss rate weightings are applied, make sure they are consistent.
- Consistent calculation of expected cash flow payment
- However, improvements in the calculation may merit inconsistent
  - If an institution moves to a more sophisticated model (e.g. migration analysis instead of historical loss rates), inconsistency from the prior period is acceptable.

# Inclusive of Qualitative & Environmental Risk Factors

- Utilize standard factors from Interagency Guidance
- Many are inherently subjective, but use quantitative support where possible
  - Changes in Delinquency
  - Changes in Collateral Values
  - Economic Conditions
- Determine drivers for each factor
- Trend from previous quarter

# Inclusive of Qualitative & Environmental Risk Factors

1. Changes in lending policies and procedures, including changes in underwriting standards and collections, charge offs, and recovery practices
2. Changes in international, national, regional, and local conditions
3. Changes in the nature and volume of the portfolio and terms of loans
4. Changes in the experience, depth, and ability of lending management
5. Changes in the volume and severity of past due loans and other similar conditions
6. Changes in the quality of the institution's loan review system
7. Changes in the value of underlying collateral for collateral-dependent loans



# Inclusive of Qualitative & Environmental Risk Factors

8. The existence and effect of any concentrations of credit and changes in the level of such concentrations
9. The effect of other external factors (i.e. competition, legal and regulatory requirements) on the level of estimated credit losses

# Areas of Scrutiny

- After a significant change in the ALLL, what areas will be viewed with greater scrutiny by examiners?
  1. Showing adequate support for a reduction of the allowance due to improved qualitative factors
  2. Studying impaired loan analysis for excessive optimism for cash flow expectations

# By the Numbers

- What is the average ALLL reserve rate?

Time Period	Average Reserve Rate
2013 Q2	1.81%
2013 Q1	1.86%
2012 Q4	1.84%
2012 Q3	1.88%
2012 Q2	1.91%

*Average from 5,915 banks that continuously reported for the past 4 quarters*

- Decreased by 10 basis points, nationally.

# By the Numbers

- What was the average change in ALLL rates?

Time Period	Absolute Value of the Change	Standard Deviation of the Change
2013 Q2	13 bps	26 bps
2013 Q1	12 bps	19 bps
2012 Q4	17 bps	32 bps
2012 Q3	14 bps	29 bps

*Average from 5,915 banks that continuously reported for the past 4 quarters*

- Volatility may be decreasing slightly.

# 6 Ways to Prepare for your Next Exam

1. Make use of market surveys and feedback (See [Sageworks Bank and Credit Union Exam Survey](#))
2. Beef up documentation
3. Assure chosen loss rates and supporting data points for qualitative factors are directionally consistent
4. Be able to defend your chosen expected cash flow assumptions
5. Charge off loan once impairment is recognized
6. Use an automated solution that provides more detailed analysis

# Quick Polls

1. ALLL content from Sageworks
2. ALLL solution from Sageworks

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# Questions?

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Additional whitepapers and archived webinars available at [www.sageworksanalyst.com](http://www.sageworksanalyst.com)

Featured whitepaper – [How to Calculate your FAS 5 Reserves](#)

Featured whitepaper – [Sageworks Bank and Credit Union Exam Survey](#)

