THE **AUDITOR VS. REGULATOR** DILEMMA

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EXECUTIVE **SUMMARY**

The allowance for loan and lease losses (ALLL) reserve is not only "one of the most significant estimates in an institution's financial statements," as the 2006 Interagency Policy Statement on the ALLL asserts[1], but is also one of the more difficult estimations financial institutions are required to calculate and support. Moreover, as if the estimation alone isn't complex enough, the prevailing standards governing this calculation are changing. Institutions are faced with appropriately satisfying the increasingly watchful eyes of both the institution's respective regulatory agency, as well as external auditors.

INTRODUCTION

In order to best balance the demands of - and ultimately satisfy - both regulators and external auditors, it is important to first consider the unique focus of each party. The two parties concurrently strive to ensure the safety and soundness of the financial institution, yet each has different motivations.

This whitepaper will discuss each party's inherent motivations and examine how those motivations can at times yield differing viewpoints with respect to an institution's ALLL levels. It will then offer a viewpoint through which institutions can base their decisions when handling the relationships of external auditors and regulators.

THE UNIQUE FOCUS OF **EXTERNAL AUDITORS AND REGULATORS**

External auditors are primarily concerned with reporting on the institution's financial statements to the institution's shareholders and/or boards of directors, offering such parties an opinion on whether or not the financial statements are free of material misstatement and thus enhancing the degree of confidence in these statements. The auditors may also offer advice for improving financial reporting and internal controls to maximize the institution's performance and efficiency.

Regulators on the other hand, are primarily concerned with maintaining the stability and confidence in the financial system and fostering the safety and soundness of individual institutions in order to protect the interests of depositors and other creditors[2]. In addition, regulators are responsible for verifying compliance with laws and regulations governing financial institutions and their activities.

In so doing, the regulators monitor the present and future viability of institutions and use financial statements in assessing their condition and performance. The OCC's mission statement, for example, reads "[Our mission is] to ensure that national banks and federal savings associations operate in a safe and sound manner, provide fair access to financial services, treat customers fairly, and comply with applicable laws and regulations."[2]

THE **DILEMMA**

WHITEPAPER:

Documenting the ALLL: What Examiners Expect

Considering the differing focus and motivations of both regulators and external auditors, it's no wonder that each party may offer seemingly conflicting feedback as it relates to the ALLL.

For example, given the regulators' focus on fostering the safety and soundness of institutions and the banking system in general, it should seem reasonable that regulators are motivated to ensure institutions set aside as much capital to the ALLL as can be reasonably supported within the constraints of GAAP. After all, the greater the allowance, the better prepared an institution is to absorb potential losses while also promoting greater safety and soundness of the institution.

Alternatively, the philosophy of "the higher the reserve the better" isn't always embraced with the same zeal by external auditors representing the interest and confidence of shareholders and boards of directors. This is because, in part, every dollar provisioned to the ALLL is a dollar of capital that could potentially be distributed to investors. Consequently, bankers calculating the reserve may feel pressure from external auditors to justify every dollar held in reserve, with excess "unallocated reserves" often frowned upon.

Institutions are often caught in the middle of what may feel like a tug-of-war between regulators and external auditors in determining appropriate and defensible ALLL reserve levels.

THE **SOLUTION**

An allowance calculation is unique to each financial institution. Bankers calculating the allowance should realize there is not a universally accepted, precisely right or wrong allowance. There is only the correct allowance that suits each individual institution. In the OCC's Statement of Policy for the ALLL, for instance, the point is driven home, "The appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment."[3]

However, the ALLL should be "prudent, conservative but not excessive," and it should be an amount "that falls within an acceptable range of estimated credit losses."[4] That acceptable range needs only to be supported by appropriate documentation and rationale. This means your allowance must be a reasonable and defensible number, based on accounting standards, which falls within a generally acceptable range of losses.

Most institutions measure their Allowance to Total Loans percentage against their peers because it is generally the most accepted measure by regulators. Figure 1 below shows a simple comparison.

Figure 1: Peer Data Comparison

Year to Date Data		Quarterly Data			
12/31/2014	*5 Peer Banks*	**12/31/2014**	**9/30/2014**	**6/30/2014**	**3/31/2014**
1.23%	*1.22%*	1.23%	1.25%	1.25%	1.36%

THE **SOLUTION** (CONT.)

But what if an institution is leading, or even lagging, their peers? Going the other way, what if the institution, after backtesting against net losses, determines the allowance is too high and needs to be released to net income? How does an institution balance the needs of the auditor with the requirements of the regulator?

RELATED VIDEO:

[When Should You Use a Range for the ALLL?]

The first step is the preparation of a statement by management that relays the acceptable allowance range based upon a defined methodology that reflects the risks of the institution and its loss history. This statement should be written into the board meeting minutes and also placed into an institution's policies and procedures statement. Further, it should be re-visited periodically - no less frequent than annually - for appropriateness and adequacy. Figure 2 below depicts a sample institution's ALLL ending figure with respect to a range.

Figure 2: Period Ending Balance with Range

Actual Current Period Ending Balance:			$ 29,086,165.39
ALLL Range:	$ 28,352,902.77	to	$ 31,224,054.89

Having this range codified into the rules of the institution is a major step in the documentation and support for the allowance. There is no doubt that consultation will occur with regulators and auditors in defining this range, but the allowance and its range are ultimately determined by what the institution calculates to be the appropriate figure, provided it is reasonable and well-documented.

THE **SOLUTION** (CONT.)

Next, institutions need to clearly define within the allowance narrative the steps taken to calculate the allowance. Whether the calculation is a manual process or an automated one, a well-thought-out narrative should explain all assumptions institutions make within the allowance calculation.

The narrative should be supported by any relevant documentation or reporting, internal or external, that was used in the calculation of the allowance. The more supporting documentation and defensible information an institution can provide in conjunction with the calculation, the higher the likelihood regulators will accept the number as "prudent, conservative but not excessive."

Even within an ALLL range defined by the board, banks may still face questions from auditors or regulators, or both. If they continue to pose questions, the burden then lies on the auditor and/or regulator to prove the calculation is not appropriate. The allowance is owned by the financial institution that prepares it, so the institution is likely prepared to answer their questions.

In fact, banks and credit unions should feel confident enough in their methodologies to tackle questions head-on. If an institution adheres to guidance and thoroughly supports its allowance calculation, it should not hesitate to dig in its heels when responding to criticism.

CONCLUSION

Institutions are torn between the sometimes conflicting interests of regulators and auditors. Regulators are charged with safety and soundness of the financial system while auditors represent the board of directors and shareholders. As a result, regulators typically want the allowance calculation to be on the higher end of what is permitted by guidance while auditors may fall on the opposite end of that spectrum.

But despite these differing opinions, banks and credit unions can accommodate both parties through a regimented and explainable allowance. The correct calculation is the one that is reasonably calculated, while properly documented. More often than not, this will satisfy both parties' interests and withstand their scrutiny.

ENDNOTES

[1] "Interagency Policy Statement on the Allowance for Loan and Lease Losses" *FDIC Law, Regulations, Related Acts.* 2006.

https://www.fdic.gov/news/news/financial/2006/fil06105a.pdf

[2] "About the OCC" *Office of the Comptroller of the Currency.* U.S. Department of the Treasury.

http://www.occ.gov/about/what-we-do/mission/index-about.html

[3] "Comptroller's Handbook" *Office of the Comptroller of the Currency.* U.S. Department of the Treasury.

http://www.occ.gov/publications/publications-by-type/comptrollers-handbook/index-comptrollers-handbook.html

[4] "Statements of Policy" *FDIC Law, Regulations, Related Acts.*

https://www.fdic.gov/regulations/laws/rules/5000-4700.html

ADDITIONAL **RESOURCES**

ALLL.com by Sageworks, *providing up-to-date recommendations, guidance and best practices for the ALLL.*

http://www.ALLL.com

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

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

ALLL Whitepapers & Articles, *Sageworks.*

https://www.sageworksanalyst.com/whitepapers-articles.aspx

ABOUT **SAGEWORKS & THE AUTHOR**

Sageworks
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. 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 an automated solution for calculating and documenting the allowance calculation. It helps bankers automate their ALLL process and add consistency to their methodology, making it defensible to auditors and examiners. To find out more, visit www.sageworksanalyst.com.

Robert Ashbaugh is a senior risk management consultant at Sageworks, where he is responsible for assisting financial institutions with their ALLL and stress testing programs. Rob has more than twenty years of capital markets and commercial banking experience as both a portfolio manager and risk manager, with a primary focus on mortgage-backed securities and commercial loans. Among his responsibilities were monthly ALLL calculations, institutional and concentration stress testing and risk analytics. He is a past holder of the Series 7, 52 and 63 licenses.

Rob received his bachelor's degree in both economics and international business from Temple University.