

Examiners Taking Hard Look at ALLL Methodologies and Assumptions

Expect tough questions from your examiner about the quality of your loan portfolio and whether you relied on the right assumptions when setting aside your allowance for loan and lease losses (ALLL). If you primarily relied on historical loan loss rates to predict future losses, you could be in trouble.

"Models that rely on lagging data are inadequate in changing loss rate environments," cautions Timothy T. Ward, OTS director of examinations, supervision and consumer protection in a [May 22 CEO Memo](#), noting that historical charge-offs "may not be predictive in periods of rapidly changing loss rates."

Brian Velligan, CEO and managing member of Velligan-Blaxall Consultants, LLC in Bryn Mawr, Pa., says the OTS memo is a sign that examiners are not happy with what they've been finding. "Are banks setting aside enough money? Examiners are getting concerned," he says. "The reality is delinquencies are through the roof. If banks are using historical loss rates to predict future losses, that's no good. Banks need to have a more proactive method."

Banks have significantly increased loan loss provisions in the past year, according to the 2009 Q1 FDIC Quarterly Banking Profile, which notes that two out of every three institutions increased their loss provisions. "Insured institutions set aside \$60.9 billion in loan loss provisions in the first quarter, an increase of \$23.7 billion (63.6 percent) from the first quarter of 2008," the report states. The ratio of reserves to total loans rose during the quarter from 2.2% to 2.5%, "an all-time high," the FDIC noted.

"Facts and circumstances dictate" how much money each institution should reserve, says George Mark, partner and Financial Institutions Industry leader for Grant Thornton in New York. He says most institutions have at least 1% ALLL coverage.

Regulator Scrutiny of ALLL is "the new life"

OTS isn't the only regulator focusing on ALLL methodologies. "Whether it's OCC, FDIC or OTS, financial institutions that have gone through exams in the last two years have had their assumptions and loan loss reserve methodology challenged," Mark says. "This is the new life. Banks undergoing exams right now are being put to this test."

Banks that perform well, he says, had good documentation and a robust methodology to estimate the ALLL. "It's all about documenting your conclusions," he notes. "This is one of the many tests that will never be publicly acknowledged. They start with management's ability, in this case, to recognize and understand the quality of their loan portfolio. Once they understand that, they look to see whether there is a quality of earnings issue and whether management understands that."

OTS says it found some institutions that were not validating their ALLL methodology, which is required under [the December 2006 Interagency Police Statement](#). A third-party can validate the methodology or the institution can back-test the model by comparing actual losses to model estimates, or by comparing results of the ALLL estimate using more than one methodology.

"We're in an environment we have not seen before," notes Donna Fisher, the American Bankers Association senior vice president of tax and accounting. "It's a logical thing for the banking regulators to take a hard look at the reserving process, just as the banks themselves are."

Macke B. Mauldin, president of Bank Independent in Sheffield, Ala., says his \$896 million bank doesn't have substantial loan losses. "So it's hard for us to justify on the accounting side more loan loss provisions." He thinks the loan loss reserves should be a tax-deductible expense. "When we have a crisis like we have today, banks wouldn't have to be putting in millions in loan loss provisions when we can't afford it."

Velligan says banks need to realize that even with depressed earnings, the set-asides for loan losses are crucial. "I do believe that banks are more concerned about this than in the past. It's definitely a focus. I'm not sure it's enough of a focus yet," he says. "Institutions have to balance that fine line of hitting earnings projections, yet there is increased regulatory pressure to more aggressively reverse uncollected accrued interest income."

New Focus Related to Stress Tests

The increased focus on ALLL has its roots in the adverse scenarios that were part of the stress tests given to the nation's largest banks and which will be applied to community banks in the future, Velligan says. "That's what's really driving this. If the economy continues to sour and more loans in these banks fail, is there enough set aside to compensate for the failure? If not, then banks would take a hit to their capital, which jeopardizes the safety and soundness of the bank."

Indeed, the [Federal Reserve's April 2009 Senior Loan Officer Opinion Survey](#) on Bank Lending Practices found that 82.6% of loan officers believed their commercial and industrial loans would deteriorate this year and 86.6% felt their commercial real estate loans would weaken.

While experts agree there is no single best method to estimate losses, sound practices outlined in the OTS memo suggest you should:

- **Use a migration analysis to track loans from their current status to delinquent status.** Migration analysis segregates loans into delinquency buckets in order to determine the amount that will eventually progress to charge-off. Look at 30- and 60-day delinquencies, Velligan suggests. Factor that into your loss equation.
- **Stress test loss rates and delinquency rates to make sure your bank's methodology is working.** You need to be able to inform management of the risk of miscalculation if the credit environment changes.
- **Capture the features and risks intrinsic to each loan.** Look at a change in a borrower's FICO score, date of interest rate resets, changes in housing market prices and borrower's payment habits.
- **Review ALLL monthly to spot trends more quickly.** Banks must document the ALLL estimate quarterly.
- **Make sure that management has the right players making the right judgment calls** when predicting loan losses. "Factors such as experience, ability of the lending staff, and the quality of the institution's loan review system remain key when estimating an appropriate ALLL," the OTS memo says.

OTS examiners also found a number of practices that they considered "weak" and not in accordance with accounting rules or supervisory guidance.

- **Do not charge-off losses only at foreclosure or when deemed uncollectible.** Assess the current value of the collateral and selling costs when a loan is no more than 180 days past due. Any loan balance in excess of that assessment should be classified a loss.

- **Make sure you categorize your troubled debt restructurings (TDRs) appropriately.** OTS found some institutions were giving concessions to borrowers by modifying interest rates but not counting those loans as troubled. "If the borrower cannot obtain a loan at a similar rate and with similar terms with another lender, the modification is likely a TDR," OTS says. Velligan says many "banks would consider that a current loan, but in reality that loan is at risk. That type of loan should be on a watch list."
- **Require under your nonaccrual policy that loans be placed on nonaccrual status in a timely manner,** generally when 90 days delinquent, and that accrued but uncollected interest should be reversed through current earnings.
- **Do not increase interest reserves on construction loans** and continue to accrue interest income when the borrower cannot make out-of-pocket payments.
- **Make sure you have a reasonable look-back period,** giving appropriate weighting to loss rates within those periods. The IPS states that a look-back period will depend up on the relevance of the past periods' loss experience to the current period or a point in the credit cycle.

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