

Allowance for Loan and Lease Losses: Beyond the Basics



Walter Yao

**Federal Reserve Bank of
San Francisco**

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“Call the Fed Audio-Conference”



Disclaimer

My comments do not necessarily reflect the views of the Federal Reserve Bank of San Francisco, the Board of Governors, or the Federal Reserve System



Overview

- Background and what's new with the Interagency Policy Statement (SR Letter 06-17)
- Key GAAP and supervisory guidances
- Observations from onsite loan loss allowance reviews
- Sound practices
- Useful resources

Background on SR 06-17

- On December 13, 2006, a new interagency policy statement (IPS) on the Allowance for Loan and Lease Losses (ALLL) and related supplemental FAQs were issued
- This new policy statement (SR 06-17) revises and replaces the 1993 policy statement (SR 93-70) on the ALLL



What's new with SR 06-17?

- Language specific to application of SFAS 114, *Accounting by Creditors for Impairment of a Loan*, which was not yet effective when the 1993 IPS was issued
- Elimination of the reference to the reasonableness test (i.e., 15% of substandard and 50% of doubtful)



Why eliminate the reference to the standard loss percentages?

- Ensure that the allowance is an institution-specific amount, and not based on a standard loss percentage
- Focus management attention on developing the best estimate of credit losses in the loan portfolio, including consideration of all known relevant internal and external factors that affect loan collectibility of that portfolio, as of the evaluation date



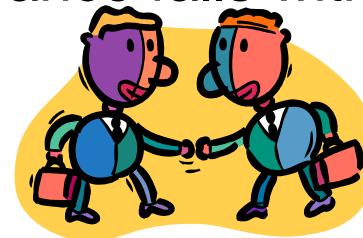


What's new with SR 06-17?

- Greater emphasis on support and documentation of the allowance
- Language to clarify the appropriate accounting treatment of allowances for off-balance-sheet instruments, which are not included in the ALLL
- Incorporation of the points of agreement between the SEC and the banking agencies since 1999

What are the points of agreement?

- Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses
- Prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses are appropriate
- Determining the loan loss allowance is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses



What are the points of agreement?

- An “unallocated” loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported
- Allowance estimate should be based on comprehensive, well-documented, and consistently applied analysis of the loan portfolio
- The ALLL should consider all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors



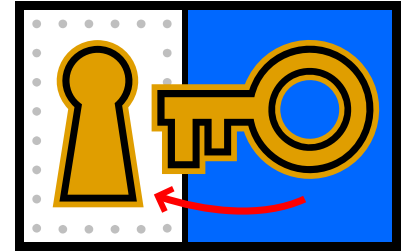
What are the key GAAP guidances for ALLL?



- FAS 114, *Accounting by Creditors for Impairment of a Loan*, May 1993
- Identify loans for individual loss evaluation
- Identify three impairment measurement standards
 - Fair value of collateral less costs to sell
 - Present value of expected cash flow, at the loan's effective interest rate
 - Observable market price of the loan

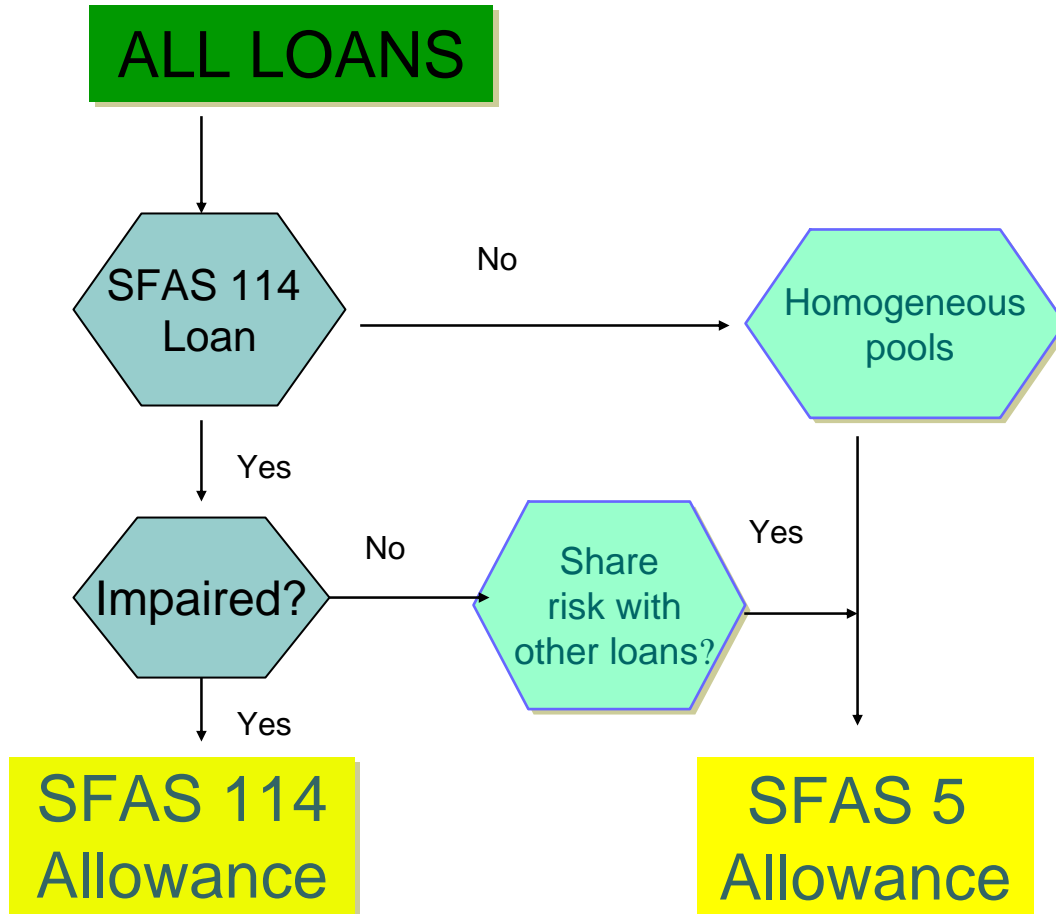
Mandatory if collateral dependent!

What are the key GAAP guidances for ALLL?



- *FAS 5, Accounting for Contingencies*, March 1975
 - Estimate loss for group of loans with similar credit characteristics
 - Generally, banks base loss rates on historic information, adjusted for current conditions
- *EITF D-80, Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio*, May 19-20, 1999
 - Discusses interaction and measurement guidance of FAS 5 and FAS 114

ALLL decision tree (simplified)



What are the other key supervisory guidances for ALLL?



- SR 01-17, *Policy Statement on ALLL Methodologies and Documentation for Banks and Savings Institutions*, July 2, 2001
 - ALLL level must conform to GAAP
 - Documentation expectations
 - Best practices and examples provided of how to support FAS 5 and FAS 114 loss estimation
- SR 99-22, *Joint Interagency Letter on the Loan Loss Allowance*, July 26, 1999

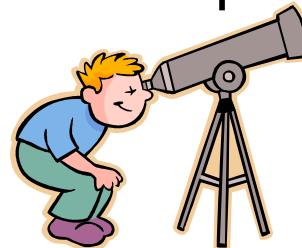
Observations from onsite ALLL reviews...

- Methodologies based on “reasonableness tests” without support
- FAS 114-related issues
 - Minima set for loan grades and as a result, “grossing up” of FAS 114 allowances
 - FAS 114 selection criteria not clearly articulated and in some cases, selection too narrow
 - Confusion about the interrelationship between FAS 5 and FAS 114, e.g., layering (double counting)



Observations from onsite ALLL reviews...

- Use of gross charge-off rate rather than net charge-off rate to estimate ALLL
- Documentation practices need enhancements
- Reporting reserves for off-balance-sheet items as part of ALLL instead of *other liabilities* and the misunderstanding that this represents a GAAP / RAP difference



Journal Entry: Reserves for OBS Items

- Correct:

- Dr: Other non-interest expense (RI item 7d)
- Cr: Other liabilities (RC-G item 3)



- Incorrect:

- Dr: Loan loss provisions (RI item 4)
- Cr: Loan loss allowance (RC item 4c)

This entry applies to establishing provisions for loan losses but not reserves for OBS items



Relevant Reference



“Management often considers credit losses associated with certain off-balance-sheet financial instruments (such as commitments to extend credit, guarantees, and letters of credits) at the same time it considers credit losses associated with the loan portfolio. Although it is generally practical to consider credit losses on loans and other financial instruments at the same time, allowances necessary for off-balance-sheet instruments should be reported separately as liabilities and not as part of the allowance for loan losses.”

AICPA Auditing and Accounting Guide for Depository and Lending Savings Institutions (Chapter 9, *Credit Losses*, §9.15)

What are some of the sound practices that we expect?

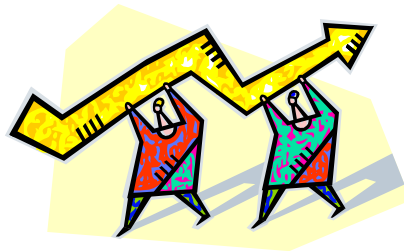


- Allowance amount based on management's sound judgment about the credit quality of the loan portfolio and on consideration of all known relevant internal and external factors
- Segmentation of loan portfolio based on the unique risk characteristics of different types of assets in the loan portfolio
- Use of reliable data to estimate loan losses

What are some of the sound practices that we expect?



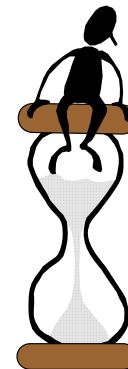
- Directional consistency
 - Changes in the level of the ALLL should be directionally consistent with changes in internal and external factors, taken as a whole



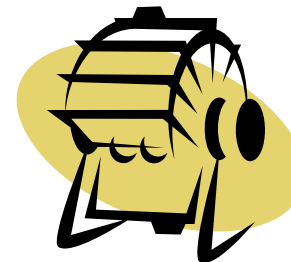
- The loan loss allowance amount is properly supported and documented

Useful Resources

- ALLL Job Aid
 - Summarizes GAAP and supervisory guidances
 - Outlines examination steps to take when evaluating the ALLL
 - Provides flowcharts to explain interaction between FAS 5 and FAS 114
 - Discusses inappropriate loan loss estimation practices
- Stay tuned...
 - Online ALLL Training
 - Interagency Best Practice Guidance



Contact Information



Walter Y. Yao, CFA, CPA

Senior Banking Analyst
Economic Capital, Accounting Policy & Practice
Banking Supervision and Regulation

FEDERAL RESERVE BANK OF SAN FRANCISCO

101 Market Street
San Francisco, California 94105

(415) 974-2936

Fax: (415) 974-3031

walter.yao@sf.frb.org

www.frbsf.org





A yellow rounded rectangle containing three stick figures holding up signs, a glowing question mark, and the text "It's QUESTION TIME!!". The stick figures are black and white, each holding a white sign. The glowing question mark is black with white radiating lines above it. The text is in bold black font.