

COMPLYING WITH ALLL GUIDANCE

Help Us Help You

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ALLL TEST

Risk Grade	Description	Total Loans	Canned Program ALLL	
1	Negligible Risk	\$ 48,914	0.00%	\$ -
2	Reasonable Risk	131,930	0.05%	66
3	Acceptable Risk	158,039	0.50%	790
4	Watch	86,768	1.53%	1,328
5	Special Mention	47,291	2.55%	1,206
6	Substandard - Accruing	4,367	15.00%	655
7	Substandard-Non-Accrual	5,453	20.00%	1,091
8	Doubtful	3,303	50.00%	1,652
9	Loss	0	100.00%	0
	Total	\$ 486,065		\$ 6,787

ALLL TEST

Ratio Analysis - ALLL to:	12/31/05	Peer
Total Loans	1.4%	1.50%
Past Due & Nonaccrual Loans	31.6%	30.7%
Performing Loans	1.5%	1.2%
Gross Charge-offs	151.2%	146.9%
Net Charge-offs	175.4%	170.4%
Additional Ratio:		
Avg Net C/Os to Avg Loans	0.679%	0.728%

ALLL TEST

**IS THE ALLL OVER OR UNDER
FUNDED????**

**THE ANSWER IS
IT DEPENDS.....**

Watch Lists

Loan Review & Grading Process

Documentation

Validation

FAS 5

Homogeneous Groups

FIN 14

EITF D-80

Policies & Procedures

FAS 114

Loss factors

ALL PROCESS INVOLVES

- Loan Review & Grading Process (slide 2)
- Watch Lists (slides 11 – 12)
- Consistently Applied Charge Off Policies
- Segmentation of Homogeneous Groups
- Accurate Calculation of Historical Loss Factors

ALL PROCESS INVOLVES

- Documented Qualitative & Economic Factors That Adjust Historical Rates
- An Understanding of FAS 5, FAS 114, & FIN 14
- Creating an ALL Methodology
- Describing the Methodology in a Written ALL Policy

ALLL PROCESS INVOLVES

- Assigning Responsibilities for Each ALLL Piece
- Auditing for Adherence to all Policies that Factor into the ALLL Process
- Validating the Methodology and Accuracy of the ALLL
- Communication with the Board of Directors (Responsible Parties)

Loan Review & Grading Process

(required by 2001 and 2006 Interagency Policy Statements)

- Must be written & assign responsibilities for independent loan review and grading
- Should promptly identify potential credit weaknesses
- Identify adverse trends affecting the portfolio
- Should use to evaluate lending personnel activities and compliance with policies & laws

Loan Review & Grading Process

(required by 2001 and 2006 Interagency Policy Statements)

- Provide Sr management & BOD objective & timely assessment of loan quality
- Provide input for informative “Watch Lists”
- Should summarize loans into groupings that can be translated into the regulatory classifications of “pass,” “special mention,” “substandard,” “doubtful,” and “loss” (slide 2)
- Feeds into the ALLL calculation

Watch List Content Example

AAA Bank	
Watch List as of 12/31/06	
Call Code #	1415
Borrower	ABC
Loan #	123
Risk Grade	4
Principal Balance	1,595
Officer Initials	AE

Watch List Content Example

(continued)

AAA Bank	
Watch List as of 12/31/06 (continued)	
Comments	Experiencing operating losses
Type of Collateral	land & equipment
Collateral Value	1,700
Estimated Costs to sell	(425)
Net Collateral Value	1,275
Net Collateral Cushion or (Shortfall)	(320)

CHARGE OFF POLICIES

(Required by the 2001 & 2006 Interagency Policy Statements)

- Institutions must promptly charge off loans
- Additional guidance is found in the 6/6/2000 Uniform Retail Classification Interagency Policy Statement (IPS)
- FFIEC 1/8/2003 Joint Account Management & Loss Allowance Guidance for Credit Cards
- Call Report requirements for Collateral Dependent Loans

Collateral Dependent Loan Example

Call Report Code	5367
Borrower	RST
Loan #	485
Risk Grade	7
Principal Balance	1,706
Officer Initials	MW
Comments	foreclosure pending

Collateral Dependent Loan Example

(Continued)

Call Report Code	5367
Is loan impaired?	Y
Loan balance	1,706
Is loan collateral dependent?	Y
Collateral Value	1,500
Est Costs to sell	(295)
Net Collateral Value	1,205
Net Required Charge-off	(501)

SEGMENTING PORTFOLIOS

(required by 2001 and 2006 Interagency Policy Statements)

- Must segment portfolios for Call Report and ALLL calculations
- Segments should represent “homogeneous” groups of loans with similar characteristics
- Systems must be able to aggregate net historical losses by segment
- Historical losses must be accurate & comply with charge-off policies

Loan Segmenting Example

Loan Segments (If you use Call Report as a Guide)	Call Report Code
RE Secured Construction	1415
RE Sec'd Farmland Lns	1420
RE Open-End LOC (1-4 fam sec'd)	1797
RE Closed-End Lns Sec'd (1st Liens on 1-4 fam)	5367
RE Closed-End Lns Sec'd (Jr liens on 1-4 fam)	5368
RE Lns Sec'd by Multi-Family Residential	1460

Loan Segmenting Example

Loan Segments (continued)	Call Report Code
RE Lns Sec'd Non-Farm Non-Residential Prop	1480
Commercial & Industrial Lns to US addresses	1766
Credit cards	B538
Other Consumer Lns (Single Pmt, Install & Student)	2011
All Other Lns (Exclude Consumer Lns)	1563
Total	

QUALITATIVE FACTORS

(are discussed in the 2001 and 2006 Interagency Policy Statements)

- Historical losses do not form a sufficient basis in determining the appropriate ALLL level
- Should also consider changes in lending policies
- Economic conditions
- Volume of portfolio

QUALITATIVE FACTORS

(are discussed in the 2001 and 2006 Interagency Policy Statements)

- Experience & depth in lending management
- Changes in volumes of past due loans
- Changes in quality of loan review system
- Concentrations of credit
- Other external factors
- These factors adjust charge-off rates

Qualitative Factors

▲ ▼ Portfolio Composition %'s

▲ ▼ Tier 1 Capital Concentrations

▲ ▼ Past-Dues & Non-Accruals

▲ ▼ Avg Business Bankruptcies

▲ ▼ Avg Individual Bankruptcies

▲ ▼ Avg Mortgage Interest rates

▲ ▼ Avg Vacancy Rates

▲ ▼ Avg Unemployment Rates

▲ ▼ Ln Officer Avg Yr Experience

▲ ▼ Loan Policy Deficiencies

FAS 5

- Accounting guidance for estimating contingency losses in portfolio
- Requires ALL accruals when information that exists **prior to or on the F/S date** indicates it is probable an asset has been impaired and the amount can be reasonably estimated

FAS 5

- Is used in determining the ALLL accrual for loans that are not individually evaluated for impairment. FAS 5 is used for homogeneous loan segments
- You use historical loss factors, adjusted for qualitative factors, in determining the amount of ALLL needed in a FAS 5 calculation, the “FAS5 ALLL Component.”

FIN 14

- FASB Interpretation No. 14: Reasonable Estimation of the Amount of a Loss (FIN 14) provides additional guidance on FAS 5
- FIN 14 states that when a reasonably estimated loss (under FAS5) is a range and one amount in a range appears to be a better estimate than any other amount in the range, that amount shall be accrued

FAS 5 Example

FAS 5 Calculation for Commercial RE Loan Segment		
1	Call Report Loan Code	1480
2	Total Loans for this Segment	215,558
3	Less FAS 114 Loans (this segment)	(10,356)
4	FAS 5 Loans (2) - (3)	205,202
5	Times FAS 5 Ratios (10)	0.4743%
6	FAS 5 ALLL Component (4) x (5)	973
7	Calculation of FAS 5 Ratio for this segment	
8	4 Yr Avg Net Charge-Off Ratio	0.2146%
9	+ Qualitative Factors Adjustment	0.2597%
10	FAS 5 Ratio for this Segment (8) + (9)	0.4743%

Qualitative Factors that contributed to an increase in the historical charge off ratios for Commercial RE Loans

These indicators changed	Avg	2005
▲ Portfolio Composition %'s	41%	44%
▲ Tier 1 Capital Concentrations	391%	472%
▲ Past-Dues & Non-Accruals	2.09%	3.42%
▲ Avg # Business Bankruptcies	628	718
▲ Avg Unemployment Rate	6.28%	7.20%

Qualitative Factors that contributed to an increase in the historical charge off ratios for Commercial RE Loans

These indicators changed, resulting in the following adjustments to the historical C/O ratio for RE Secured Commercial Loans

▲ Portfolio Composition %'s	0.02%
▲ Tier 1 Capital Concentrations	0.04%
▲ Past-Dues & Non-Accruals	0.14%
▲ Avg # Business Bankruptcies	0.03%
▲ Avg Unemployment Rate	0.03%
Total	0.26%

Qualitative Factors that contributed to an increase in the historical charge off ratios for Commercial RE Loans

(1) Calculation for adjusted historical loss rate for RE Secured Commercial loans: If average net charge offs (average historical loss rate) for RE Secured Commercial loans = 0.21% when average past dues & non-accruals for this segment is 2.09%, what would the adjusted net charge off rate ("x") be if the past due and non-accruals for this segment rose to 3.42%?

"x" divided by 3.42% = 0.21% divided by 2.09%

"x" = (0.21% times 3.42%) divided by 2.09%

"x" = 0.35%

Qualitative Factors that contributed to an increase in the historical charge off ratios for Commercial RE Loans

(2) Calculation of additional basis points for RE Secured Commercial loans: the additional basis point adjustment ("y"), if it results in a higher average historical loss, is the Adjusted net charge off rate less the average net charge off rate. If this calculation results in a negative adjustment, a "n/a" is shown.

$$\text{"y"} = 0.35\% - 0.21\%$$

$$\text{"y"} = 0.14\%$$

FAS 114

- Is used in determining the ALLL accrual for loans that are individually evaluated for impairment.
- A loan is impaired when it is probable a creditor will be unable to collect all of the contractual interest and principal payments as they become due.

FAS 114

- You can measure impairment in one of three ways: estimating the present value of expected future cash flows discounted at the loan's effective interest rate, a loan's observable market price, or the fair value of collateral less estimated costs to sell, if the loan is collateral dependent
- This becomes the "FAS 114 ALLL component"

FAS 114 Example

Call Report Code	5367
Borrower	RST
Loan #	485
Risk Grade	7
Principal Balance	1,706
Officer Initials	MW
Comments	90 days past due, sporadic pmts

FAS 114 Example

Call Report Code	5367
Is loan impaired?	Y
Loan balance	1,706
Is loan collateral dependent?	N
Collateral Value	1,500
Est Costs to sell	(295)
Net Collateral Value	1,205
ALLL Provision Needed for this Loan (if you use collateral as a basis for the impairment)	(501)

ALL METHODOLOGY

(Involves the following)

- Determining which loans need to be charged off according to policies and procedures & charge them off
- Identifying and listing all loans that need to be on the watch list, pursuant to policies and procedures, including what will be captured on the watch list
- Identifying which loans will be segregated and reviewed on a “homogeneous” group basis (FAS 5 Loans)
- Calculating accurate historical net charge-offs by segment

ALL METHODOLOGY

(Involves the following)

- Calculating and documenting the qualitative factors used to adjust historical net charge-offs
- Calculating adjusted historical loss rates and apply these to the FAS 5 loans
- Determine the FAS 5 ALLL Component
- Identifying which loans will be reviewed on an individual basis and review these loans for impairment (FAS 114 Loans)

ALLL METHODOLOGY

(Involves the following)

- Calculate and accumulate the FAS 114 ALLL Component
- Aggregate the FAS 5 and FAS 114 ALLL components in arriving at management's estimate of ALLL
- Determine if this estimate falls in a range and choose the best estimate within the range pursuant to FIN 14
- Compare the computed ALLL to reported ALLL and adjust

ALLL Methodology Example

Loan Segments	Call Rep Codes	Total Loans	FAS 5 Part	FAS 114 Part	Total ALLL
RE Sec Const	1415	\$19,607	23	26	48
RE Sec Farmland	1420	709	30	0	30
RE Open End LOC	1797	6,665	96	17	113
RE 1st Mort 1-4	5367	90,280	461	619	1,080
RE Jr Mort 1-4 Res	5368	7,700	224	46	269
RE Multil Fam Res	1460	16,032	25	375	399

ALLL Methodology Example

(Continued)

Loan Segments	Call Rep Codes	Total Loans	FAS 5 Part	FAS 114 Part	Total ALLL
RE Sec Commercial	1480	215,558	973	1,686	2,659
Commercial Loans	1766	86,543	1,361	13	1,374
Credit Cards	B538	1,407	72	0	72
Other Consumer Lns	2011	33,515	1,645	0	1,645
All Other Loans	1563	8,049	0	1,726	1,726
Total		486,065	4,909	4,507	9,416

ALLL POLICY

(required by 2001 and 2006 Interagency Policy Statements)

- After you test the ALLL methodology to get all of the bugs out, you should create a written ALLL policy that complies with the 2001 and 2006 Interagency Policy Statements
- Include in the policy the roles & responsibilities of departments and personnel

ALLL POLICY

(required by 2001 and 2006 Interagency Policy Statements)

- Include the accounting policies for loans and loan losses, charge-offs and recoveries, and methodology for estimating the fair value of collateral
- Include a description of the ALLL methodology
- Include a description of the internal controls used to ensure that the ALLL process is maintained in accordance with GAAP

ALLL POLICY EXAMPLE

**See The Sample Policy Statement in
Packet**

VALIDATING THE PROCESS

- Validating requires institutions to test the underlying data (including historical charge-off ratios) to make sure it is reliable and accurate
- The internal audit department should audit the process to determine compliance with the ALLL policy as well as other policies that feed into the estimation process

BOARD & MANAGEMENT RESPONSIBILITIES

- The BOD is responsible for overseeing management's significant judgments and estimates pertaining to the determination of an appropriate ALLL
- Management is responsible for maintaining the ALLL at an appropriate level and for documenting its analysis according to the standards set forth in the 2001 IPS

BOARD & MANAGEMENT RESPONSIBILITIES

- Management should evaluate the ALLL at the end of each quarter and bring the ALLL to an appropriate level as of each evaluation date.
- An institution's failure to analyze the collectability of the loan portfolio and maintain and support an appropriate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound practice

ALLL TEST

**IS THE ALLL OVER OR UNDER
FUNDED????**

**THE ANSWER IS
UNDERFUNDED BY \$2,627,000**

ALLL TEST

Ratio Analysis: ALLL to	Per Bank		Per GAAP
Total Loans	1.4%		1.7%
Past Due & Nonaccrual Loans	31.6%		40.6%
Performing Loans	1.5%		1.8%
Gross Charge-offs	151.2%		147.2%
Net Charge-offs	175.4%		165.4%
Gross Dollar Differences			
GROSS ALLL	\$ 6,788		\$ 9,416

ALL TEST

- **ANY QUESTIONS?**
- **If not, then this is the end.....**