

FEDERAL FINANCIAL INSTITUTIONS EXAMINATION COUNCIL

Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions

AGENCY: Federal Financial Institutions Examination Council.

ACTION: Proposed Policy Statement; Request for comment.

SUMMARY: The Federal Financial Institutions Examination Council (FFIEC)¹ is requesting comments on a proposed Policy Statement on Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Banks and Savings Institutions (Policy Statement). This proposed Policy Statement is intended to provide guidance on the design and implementation of ALLL methodologies and supporting documentation practices.

DATES: Comments must be received by November 6, 2000.

ADDRESSES: Comments should be directed to Keith J. Todd, Executive Secretary, Federal Financial Institutions Examination Council, 2000 K Street, N.W., Suite 310, Washington, DC 20006, fax number: (202) 872-7501. Comments will be available for public inspection during regular business hours at the above address. Appointments to inspect comments are encouraged and can be arranged by calling the FFIEC at (202) 872-7500.

FOR FURTHER INFORMATION CONTACT:

FDIC: Carol L. Liquori, Examination Specialist, Division of Supervision, (202) 898-7289, or Doris L. Marsh, Examination Specialist, Division of Supervision, (202) 898-8905, FDIC, 550 17th Street, N.W., Washington, DC 20429.

FRB: Linda V. Griffith, Supervisory Financial Analyst, (202) 452-3506, or Arthur Lindo, Supervisory Financial Analyst, (202) 452-2695, Division of Banking Supervision and Regulation, Board of Governors of the Federal Reserve System, 20th Street and Constitution Avenue, N.W., Washington, DC 20551.

OCC: Richard Shack, Senior Accountant, Chief Accountant's Office, Core Policy Division, (202) 874-5411, or Louise A. Francis, National Bank Examiner, Chief

¹The FFIEC consists of representatives from the Board of Governors of the Federal Reserve System (FRB), the Federal Deposit Insurance Corporation (FDIC), the Office of the Comptroller of the Currency (OCC), the Office of Thrift Supervision (OTS) (referred to as the "banking agencies"), and the National Credit Union Administration. However, this guidance is not directed to credit unions.

Accountant's Office, Core Policy Division, (202) 874-1306, Office of the Comptroller of the Currency, 250 E Street, S.W., Washington, DC 20219.

OTS: William Magrini, Policy Analyst, Policy Division, (202) 906-5744, or Harrison E. Greene, Jr., Securities Accountant, Accounting Policy Division, (202) 906-7933, Office of Thrift Supervision, 1700 G Street, N.W., Washington, DC 20552.

SUPPLEMENTARY INFORMATION:

I. Background

On March 10, 1999, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission (together, the Agencies) issued a joint letter to financial institutions on the allowance for loan and lease losses (the Joint Letter). In the Joint Letter, the Agencies agreed to establish a Joint Working Group to study ALLL issues and to assist financial institutions by providing them with improved guidance on this topic. The Agencies agreed that the Joint Working Group would develop and issue parallel guidance for two key areas regarding the ALLL:

- Appropriate methodologies and supporting documentation, and
- Enhanced disclosures.

This proposed Policy Statement represents the banking agencies' guidance to banks and savings institutions relating to methodologies and supporting documentation for the ALLL. The Securities and Exchange Commission staff is planning to provide parallel guidance on this topic for public companies in a future Staff Accounting Bulletin.²

This Policy Statement clarifies the banking agencies' expectations regarding methodologies and documentation support for the ALLL from a generally accepted accounting principles (GAAP) perspective. For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP and supervisory guidance. GAAP requires that an institution maintain written documentation to support the amounts of the ALLL and the provision for loan and lease losses reported in the financial statements.

The proposal is not intended to change existing accounting guidance in, or modify the documentation requirements of, GAAP or guidance provided in the relevant joint interagency statements issued by the Agencies. It is intended to supplement, not replace, the guidance the banking agencies provided in their Interagency Policy Statement on the Allowance for Loan and Lease Losses, which was issued in December 1993. It is also

² The American Institute of Certified Public Accountants is developing more specific guidance on the accounting for loan losses and the techniques for measuring probable incurred loss in a loan portfolio. This guidance is expected to be released in final form in 2001.

intended to supplement guidance the banking agencies provided in their interagency guidelines establishing standards for safety and soundness that were issued in 1995 and 1996 pursuant to Section 39 of the Federal Deposit Insurance Act (FDI Act).³ Under the guidelines for asset quality, each institution should estimate and establish a sufficient ALLL supported by adequate documentation. The proposed Policy Statement does not address or change current guidance regarding loan charge-offs; therefore, institutions should continue to follow existing regulatory guidance that addresses the timing of charge-offs.

The guidance in this Policy Statement recognizes that institutions should adopt methodologies and documentation practices that are appropriate for their size and complexity. For smaller institutions with fewer and less complex loan products, the amount of supporting documentation for the ALLL may be less exhaustive than for larger institutions.

Recognizing that a primary mission of the banking agencies is to support a safe and sound banking system, examiners will continue to evaluate the overall adequacy of the ALLL, including the adequacy of supporting documentation, to ensure that it is appropriate. While the proposed Policy Statement generally does not provide guidance to examiners in conducting safety and soundness examinations, examiners may criticize institutions that fail to document and maintain an adequate ALLL in accordance with this Policy Statement and other banking agency guidance. In such cases, institution management may be cited for engaging in unsafe and unsound banking practices and may be subject to further supervisory action.

II. Principal Elements of the Policy Statement

The proposed Policy Statement clarifies that the board of directors of each institution is responsible for ensuring that controls are in place to determine the appropriate level of the ALLL. It also emphasizes the banking agencies' long-standing position that institutions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, and applicable supervisory guidance.

The proposed Policy Statement provides guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, the proposal provides guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the institution and its loan portfolio. The proposed Policy Statement notes that it is critical for an institution's ALLL methodology to incorporate management's current judgments about the credit quality of the loan portfolio. The methodology must be a thorough, disciplined, and consistently applied process that is reviewed and approved by the institution's board of directors.

³ Institutions should refer to the guidelines adopted by their primary federal regulator as follows: For national banks, Appendix A to Part 30; for state member banks, Appendix D to Part 208; for state nonmember banks, Appendix A to Part 364; for savings associations, Appendix A to Part 570.

The proposal also discusses the methodology and documentation needed to support ALLL estimates prepared in accordance with GAAP, which requires loss estimates based upon reviews of individual loans and groups of loans. After determining the allowance on individually reviewed loans and groups of loans, the proposal states that management should consolidate these loss estimates and summarize the amount to be reported in the financial statements for the ALLL. To verify that the ALLL methodology is effective and conforms to GAAP and supervisory guidance, a review of the methodology and its application should be completed by external or internal auditors or some other party unrelated to the ALLL process, as appropriate for the size and complexity of the institution.

The proposal includes illustrations of implementation practices that institutions may find useful for enhancing their own ALLL practices, an appendix that provides examples of certain key aspects of ALLL guidance, a summary of applicable GAAP guidance, and a bibliographical list of relevant GAAP guidance, joint interagency statements, and other literature on ALLL issues.

III. Comments

Comment is requested on all aspects of the proposed Policy Statement.

IV. Paperwork Reduction Act

In accordance with the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 35), the banking agencies have reviewed the proposed Policy Statement and determined that it does not add any collections of information pursuant to the Act.

V. Proposed Policy Statement

The text of the proposed Policy Statement follows:

***POLICY STATEMENT ON ALLOWANCE FOR LOAN AND LEASE LOSSES
METHODOLOGIES AND DOCUMENTATION FOR BANKS AND SAVINGS
INSTITUTIONS***

Boards of directors of banks and savings institutions are responsible for ensuring that their institutions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the institutions' stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.¹ To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. By creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The ALLL methodology, the associated policies and procedures, and the amounts to be reported each period for the provision for loan and lease losses and ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the institution, the board of directors should have the methodology periodically validated and, if appropriate, revised. The board of directors' audit committee² should oversee and monitor the internal controls over the ALLL determination process.³

The banking agencies'⁴ have long-standing examination policies that call for examiners to review an institution's lending and loan review functions and recommend improvements, if needed. Additionally, in 1995 and 1996, the banking agencies adopted interagency guidelines establishing standards for safety and soundness, pursuant to

¹ A bibliography is attached that lists applicable ALLL GAAP guidance, interagency policy statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See Appendix B for additional information on applying GAAP to determine the ALLL.

² While all institutions are encouraged to establish audit committees, small institutions without audit committees should have the board of directors assume this responsibility.

³ Institutions and their auditors should refer to Statement on Auditing Standards No. 61, *Communication With Audit Committees* (as amended by Statement on Auditing Standards No. 90, *Audit Committee Communications*), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties, that have a significant impact on the accounting information included in the financial statements.

⁴ The banking agencies are the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, and the Office of Thrift Supervision.

Section 39 of the Federal Deposit Insurance Act (FDI Act).⁵ The interagency asset quality guidelines and the guidance in this paper assist an institution in estimating and establishing a sufficient ALLL supported by adequate documentation, as required under the FDI Act. Additionally, the guidelines require operational and managerial standards that are appropriate for an institution's size and the nature and scope of its activities.

For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale. This Policy Statement describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound banking practice.

This guidance applies equally to all institutions, regardless of the size. Because of their less complex lending activities and products, smaller institutions may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal approval processes) while continuing to ensure the institution has a consistent and appropriate methodology. Thus, much of the documentation that a larger institution might retain in support of the allowance may be combined into fewer supporting documents in a smaller institution. For example, simplified documentation can include spreadsheets, check lists, and other summary documents that many institutions currently use. Illustrations A and C provide specific examples of how smaller institutions may determine and document portions of their loan loss allowance.

Documentation Standards

Appropriate written supporting documentation facilitates review of the ALLL process and reported amounts, builds discipline into the ALLL determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. An institution should document the relationship between the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.⁶

At a minimum, institutions should maintain written supporting documentation for the following decisions, strategies, and processes:

⁵ Institutions should refer to the guidelines adopted by their primary federal regulator as follows: For national banks, Appendix A to Part 30; for state member banks, Appendix D to Part 208; for state nonmember banks, Appendix A to Part 364; for savings associations, Appendix A to Part 570.

⁶ This position is fully described for public companies in the Securities and Exchange Commission's (SEC) Financial Reporting Release No. 28 (FRR 28), in which the SEC indicates that the books and records of public companies engaged in lending activities should include documentation of the rationale supporting each period's determination that the ALLL and provision amounts reported were adequate.

- Policies and procedures:
 - Over the systems and controls that maintain an appropriate ALLL and
 - Over the ALLL methodology,
- Loan grading system or process,
- Summary or “roll-up” of the ALLL balance,
- Validation of the ALLL methodology, and
- Justification for periodic adjustments to the ALLL process.

The following sections of this Policy Statement provide guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, the paper provides guidance on:

- Policies and Procedures,
- Methodology,
- ALLL Under Financial Accounting Standards Board (FASB) Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114),
- ALLL Under FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5),
- Consolidating the Loss Estimates, and
- Validating the ALLL Methodology.

POLICIES AND PROCEDURES

Financial institutions utilize a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the institution and its loan portfolio.

An institution’s written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to:

- The roles and responsibilities of the institution’s departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine the ALLL to be reported in the financial statements;
- The institution’s accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;

- The description of the institution’s systematic methodology, which should be consistent with the institution’s accounting policies for determining its ALLL;⁷ and
- The system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal control system for the ALLL estimation process should:

- Include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;
- Ensure that the institution’s financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance;⁸ and
- Include a well-defined loan review process containing:
 - An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions;
 - Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and
 - Clear formal communication and coordination between an institution’s credit administration function, financial reporting group, management, board of directors, and others who are involved in the ALLL determination process (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

METHODOLOGY

An ALLL methodology is a system that an institution designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management’s current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

⁷ Further explanation is presented in the Methodology section that appears below.

⁸ In addition to the supporting documentation requirements for financial institutions, as described in interagency asset quality guidelines, public companies are required to comply with the books and records provisions of the Securities Exchange Act of 1934 (Exchange Act). Under Sections 13(b)(2)-(7) of the Exchange Act, registrants must make and keep books, records, and accounts, which, in reasonable detail, accurately and fairly reflect the transactions and dispositions of assets of the registrant. Registrants also must maintain internal accounting controls that are sufficient to provide reasonable assurances that, among other things, transactions are recorded as necessary to permit the preparation of financial statements in conformity with GAAP. See also SEC Staff Accounting Bulletin No. 99, *Materiality*.

An institution's ALLL methodology is influenced by institution-specific factors, such as an institution's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. However, there are certain common elements an institution should incorporate in its ALLL methodology. A summary of common elements is provided in Appendix B.⁹

Documentation of ALLL Methodology in Written Policies and Procedures

An institution's formal policies and procedures should describe the primary elements of the institution's ALLL methodology. Such elements would include portfolio segmentation, impairment measurement, and loss rate determination. Specifically, written policies and procedures should describe the methodology:

- For segmenting the portfolio:
 - How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
 - When a loan grading system is used to segment the portfolio:
 - ◆ The definitions of each loan grade,
 - ◆ A reconciliation of the internal loan grades to supervisory loan grades, and
 - ◆ The delineation of responsibilities for the loan grading system.
- For determining and measuring impairment under FAS 114:
 - The methods used to identify loans to be analyzed individually;
 - For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:
 - ◆ Procedures describing the impairment measurement techniques available and
 - ◆ Steps performed to determine which technique is most appropriate in a given situation.
 - The methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.

⁹ Also, refer to paragraph 7.05 of the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Banks and Savings Institutions*, 1999 edition (AICPA Audit Guide).

- For determining and measuring impairment by applying loss rates to loan balances under FAS 5:
 - How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
 - How historical loss rates are determined and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and
 - Descriptions of qualitative factors (e.g., changes in economic conditions) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in an institution's credit files, loan review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

ALL UNDER FAS 114

An institution's ALLL methodology related to FAS 114 loans begins with the use of its normal loan review procedures to identify whether a loan is impaired as defined by the accounting standard. Institutions should document:

- The method and process for identifying loans to be evaluated under FAS 114 and
- The analysis that resulted in an impairment decision for each loan and the determination of the impairment measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once an institution has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- When using the present value of expected future cash flows method:
 - The amount and timing of cash flows,
 - The effective interest rate used to discount the cash flows, and
 - The basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- When using the fair value of collateral method:
 - How fair value was determined, including the use of appraisals, valuation assumptions, and calculations,

- The supporting rationale for adjustments to appraised values, if any,
 - The determination of costs to sell, if applicable, and
 - Appraisal quality and expertise of the appraiser.
- When using the observable market price of a loan method:
 - The amount, source, and date of the observable market price.

Illustration A describes a practice used by a small financial institution to document its FAS 114 measurement of impairment using a comprehensive worksheet.¹⁰ Q&A #1 and #2 in Appendix A provide examples of applying and documenting impairment measurement methods under FAS 114.

ILLUSTRATION A
DOCUMENTING AN ALLL UNDER FAS 114

Comprehensive worksheet for the impairment measurement process

A small institution utilizes a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Q&A #3 in Appendix A presents an example of an institution whose loan portfolio includes fully collateralized loans and describes the documentation maintained to support the conclusion that no ALLL was needed for those loans.

¹⁰ The referenced “gray box” illustrations are presented to assist institutions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all institutions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of ALLL Questions and Answers (Q&As) are included in Appendix A of this paper.

ALL UNDER FAS 5

Segmenting the Portfolio

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Institutions decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller institutions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate in only the smallest of institutions offering a narrow range of loan products. Larger institutions typically offer a more diverse and complex mix of loan products. Such institutions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment. Regardless of the method used, documentation should be maintained to support that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, institutions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration B presents an example in which an institution refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

ILLUSTRATION B DOCUMENTING SEGMENTING PRACTICES

Documenting a refinement in a segmentation method

An institution with a significant portfolio of consumer loans performed a review of its ALLL methodology. The institution had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the institution decided to evaluate loss rates on an individual product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

Institutions use a variety of documents to support the segmentation of their portfolios. Some of these documents include:

- Loan trial balances by categories and types of loans,
- Management reports about the mix of loans in the portfolio,
- Delinquency and nonaccrual reports, and
- A summary presentation of the results of an internal or external loan grading review.

Reports generated to assess the profitability of a loan product line may be useful in identifying areas in which to further segment the portfolio.

Estimating Loss on Groups of Loans

Based on the segmentation of the portfolio, an institution estimates the loan and lease losses to determine the appropriate level of the FAS 5 portion of the ALLL.¹¹ For those segments that require an ALLL, the institution estimates the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance. The institution should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation. Regardless of the method used to determine loss rates, an institution should demonstrate and document that the loss rates used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.¹²

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If an institution does not have loss experience of its own, it may be appropriate to reference the loss experience of other institutions, provided that the institution demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the institution providing the loss experience.¹³ Institutions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. Institutions that determine losses based upon a range of loss should maintain documentation to support the identified range of loss and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of how a small institution performs a comprehensive historical loss analysis is provided as the first item in Illustration C.

¹¹ An example of a loan segment that does not generally require an ALLL includes loans that are fully secured by deposits maintained at the lending institution.

¹² Refer to paragraph 8(b) of FAS 5. Also, the AICPA is currently developing a Statement of Position that will provide more specific guidance on accounting for loan losses.

¹³ Refer to paragraph 23 of FAS 5.

ILLUSTRATION C

DOCUMENTING SETTING LOSS RATES

Comprehensive historical loss analysis in a small institution

A small institution determines its historical loss rates based on annual loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The institution also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The institution maintains supporting documentation for its loss factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of historical rates for changes in local economic conditions

An institution develops a factor to adjust historical loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on commercial real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The institution generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The institution maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Before employing a loss estimation model, an institution should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. Institutions that use loss estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the support for adjustments to the model or its results.

To adjust historical loss rates for current conditions, institutions should consider environmental factors and then document which factors were used in the analysis. Factors that should be considered in adjusting historical loss rates include the following:¹⁴

- Levels of and trends in delinquencies and impaired loans;
- Levels of and trends in charge-offs and recoveries;
- Trends in volume and terms of loans;
- Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- Experience, ability, and depth of lending management and other relevant staff;

¹⁴ Refer to paragraph 7.13 in the AICPA Audit Guide.

- National and local economic trends and conditions, and industry conditions; and
- Effects of changes in credit concentrations.

For any adjustment of historical loss rates, the institution should document that the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss rates. The second item in Illustration C provides an example of how an institution adjusts its commercial real estate historical loss rates for changes in local economic conditions. Q&A #4 in Appendix A provides an example of maintaining supporting documentation for adjustments to portfolio segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Q&A #5 in Appendix A describes one institution's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

CONSOLIDATING THE LOSS ESTIMATES

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include:

- An estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- The aggregate probable loss estimated using the institution's methodology;
- A summary of the current ALLL balance;
- The amount, if any, by which the ALLL is to be adjusted;¹⁵ and
- Depending on the level of detail that supports the ALLL analysis, detailed subschedules of loss estimates that reconcile to the summary schedule.

Illustration D describes how institutions may document their estimated ALLL by adding comprehensive explanations to their summary schedules.

¹⁵ Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

ILLUSTRATION D

CONSOLIDATING ESTIMATES

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, some institutions include detailed supporting information on their summary schedules. For example, in the summary schedule that presents FAS 114 allowances, some institutions describe their policy for selecting loans for evaluation under FAS 114. Institutions identify which FAS 114 impairment measurement method was used for each individually reviewed impaired loan. Other items include brief descriptions of loss factors for particular segments of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period.

Generally, an institution's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Q&A #6 in Appendix A addresses the documentation of the final amount of the ALLL.

VALIDATING THE ALLL METHODOLOGY

To verify that the ALLL methodology is effective and conforms to GAAP and supervisory guidance, an institution's directors should establish internal control procedures, appropriate for the size and complexity of the institution. These procedures should include an independent review of the methodology and its application.

In practice, financial institutions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

- A review of trends in loan volume, delinquencies, restructurings, and concentrations.

- A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- A review by an independent party, such as an independent loan review committee, external auditors, or internal audit staff. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.
- An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the review of the ALLL function. Additional documentation often includes the summary findings of the independent third party reviewer. The institution's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

APPENDIX A – ALLL QUESTIONS AND ANSWERS

Q&A #1 - ALLL Under FAS 114 – Measuring and Documenting Impairment

Facts: Approximately one-third of Institution A's commercial loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Institution A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Institution A determines that certain of the loans are impaired as defined by FAS 114.

Question: For the commercial loans reviewed under FAS 114 that are individually impaired, how should Institution A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

Interpretive Response: For those loans that are reviewed individually under FAS 114 and considered individually impaired, Institution A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Institution A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its commercial loans for the past five years.

Institution A should maintain written documentation to support its measurement of loan impairment under FAS 114. If it uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions. When using the fair value of collateral to measure impairment, Institution A should document how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable. Similarly, Institution A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Q&A #2 – ALLL Under FAS 114 – Measuring Impairment for a Collateral Dependent Loan

Facts: Institution B has a \$10 million loan outstanding to Company X that is secured by real estate, which Institution B individually evaluates under FAS 114 due to the loan's size. Company X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Institution B determines that its loan to Company X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Institution B measures impairment of the loan based on the fair value of the collateral. Institution B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Institution B believes that many of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Institution B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral. After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell, is \$8 million. Given that the recorded investment in the loan is \$10 million, Institution B concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

Question: What type of documentation should Institution B maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Company X?

Interpretive Response: Institution B should document that it measured impairment of the loan to Company X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million. This documentation should include the institution's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Institution B arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.¹

¹ In accordance with the FFIEC's Federal Register Notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 FR 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

Q&A #3 – ALLL Under FAS 114 – Fully Collateralized Loans

Facts: Institution C has \$10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Institution C's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Institution C perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Institution C's credit administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Institution C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Institution C has historically not incurred any material losses on these loans. Institution C believes these loans are fully-collateralized and therefore does not maintain any ALLL balance for these loans.

Question: What documentation does Institution C maintain to adequately support its determination that no allowance is needed for this group of loans?

Interpretive Response: Institution C's management summary of the ALLL includes documentation indicating that, in accordance with the institution's ALLL policy, the collateral protection on these loans has been verified by the institution, no probable loss has been incurred, and no ALLL is necessary. Documentation in Institution C's loan files includes the two independent market quotes obtained each quarter for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Institution C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. The policy requires the following factors, at a minimum, to be considered and the institution's findings concerning these factors to be fully documented:

- Volatility of the market value of the collateral
- Recency and reliability of the appraisal or other valuation
- Recency of the bank or other third party inspection of the collateral
- Historical losses on similar loans
- Confidence in the bank's lien or security position including appropriate:
 - Type of security perfection (e.g., physical possession of collateral or secured filing)
 - Filing of security perfection (i.e., correct documents and with the appropriate officials), and
 - Relationship to other liens.

Q&A #4 – ALLL Under FAS 5 – Adjusting Loss Rates

Facts: Institution D's lending area includes a metropolitan area that is financially dependent upon the profitability of a number of manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Institution D has yet to confirm an increase in its loss experience as a result of these events, management knows that the institution lends to a significant number of businesses and individuals whose repayment ability depends upon the long-term viability of the manufacturing businesses. Institution D's management has identified particular segments of its commercial and consumer customer bases that include borrowers highly dependent upon sales or salary from the manufacturing businesses. Institution D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL.

Question: How should Institution D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

Interpretive Response: Institution D should document its identification of the particular segments of its commercial and consumer loan portfolio for which it is probable that the manufacturing business' financial downturn has resulted in loan losses. In addition, Institution D should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Institution D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, and economic data.

Because Institution D has had similar situations in the past, its supporting documentation also includes an analysis of how the current situation compares to the institution's previous loss experiences in similar circumstances. A summary of the amount and rationale for the adjustment factor is presented to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Q&A #5 – ALLL Under FAS 5 – Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts: Institution E has outstanding loans of \$2 million to Company Y and \$1 million to Company Z, both of which are paying as agreed upon in the loan documents. The institution's ALLL policy specifies that all loans greater than \$750,000 must be individually reviewed for impairment under FAS 114. Company Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Company Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the institution's loan grading system. Despite its concern, management believes Company Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Institution E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2. The loan to Company Y has risk characteristics similar to the loans included in Segment 1 and the loan to Company Z has risk characteristics similar to the loans included in Segment 2.²

Question: How does Institution E adequately support and document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: In its determination of the ALLL under FAS 5, Institution E includes its loans to Company Y and Company Z in the groups of loans with similar characteristics (i.e., Segment 1 for Company Y's loan and Segment 2 for Company Z's loan). Management's analyses of Segment 1 and Segment 2 indicates that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors, such as current local economic conditions, provides a reasonable estimate of the institution's probable loan losses in these segments.

Institution E documents its decision to include its loans to Company Y and Company Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Institution E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The institution also maintains copies of the economic and other reports that provided source data.

² These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

Q&A #6 - Consolidating the Loss Estimates – Documenting the Reported ALLL

Facts: Institution F determines its ALLL using an established systematic process. The accounting department prepares supporting schedules that include the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management and the Credit Committee. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes to be made to certain of the ALLL estimates. As a result of the adjustments made by management, the total amount of the ALLL changes. The supporting schedules are not updated to reflect the adjustments made by senior management and the Credit Committee. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL supporting schedules that were reviewed by management and the Credit Committee, as well as a verbal explanation of the changes made by management and the Credit Committee when they met to discuss the loan loss allowance.

Question: Are Institution F's documentation practices related to the balance of its loan loss allowance appropriate?

Interpretive Response: No. An institution must maintain supporting documentation for the loan loss allowance amount reported in its financial statements. An institution should document not only the determination of the ALLL using its methodology, but also any subsequent adjustments to the amount of the ALLL and the rationale for those adjustments, such as adjustments made by management or board committees as in the circumstances described above.

APPENDIX B--APPLICATION OF GAAP

An ALLL recorded pursuant to GAAP is an institution's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.¹ A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, an institution may determine that the amount of loss falls within a range. An institution should record its best estimate within the range of loan losses.²

Under GAAP, Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.³ Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, an institution should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. The following Illustration provides an example of an institution estimating a loan's impairment when the loan has been partially charged-off.

¹ This Appendix provides guidance on the ALLL and does not address allowances for credit losses for off-balance sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Institutions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Banks and Savings Institutions* (AICPA Audit Guide). Additionally, this Appendix does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 125, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities* (FAS 125).

² Refer to FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and Emerging Issues Task Force Topic No. D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF Topic D-80).

³ EITF Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other. The AICPA is currently developing a Statement of Position (SOP) that will provide more specific guidance on accounting for loan losses.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are *not* included in the scope of FAS 114.⁴ Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer

ILLUSTRATION

INTERACTION OF FAS 114 WITH AN ADVERSELY CLASSIFIED LOAN, PARTIAL CHARGE-OFF, AND THE OVERALL ALLL

An institution determined that a collateral dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the institution established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the institution classified a portion of the recorded investment as “Loss” and the remaining recorded investment as “Substandard.” For this loan, the amount classified “Loss,” which was deemed to be the confirmed loss, was less than the impairment amount (as determined under FAS 114). The institution charged off the “Loss” portion of the loan. After the charge-off, the portion of the ALLL related to this “Substandard” loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the institution’s overall ALLL.

installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis and loans that are individually evaluated but are not individually considered impaired.

Institutions should ensure that they do not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when an institution includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.⁵

There are certain common elements an institution should incorporate in its loan loss allowance methodology. Generally, an institution’s methodology should:⁶

⁴ In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

⁵ According to the Federal Financial Institutions Examination Council’s Federal Register Notice, *Implementation Issues Arising from FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*, published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

⁶ Refer to paragraph 7.05 of the AICPA Audit Guide.

- Include a detailed analysis of the loan portfolio, performed on a regular basis;
- Consider all loans (whether on an individual or group basis);
- Identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;
- Consider all known relevant internal and external factors that may affect loan collectibility;
- Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
- Consider the particular risks inherent in different kinds of lending;
- Consider collateral values (less costs to sell), where applicable;
- Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
- Be based on current and reliable data;
- Be well documented with clear explanations of the supporting analyses and rationale; and
- Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

A systematic methodology that is properly designed and implemented should result in an institution's best estimate of the ALLL. Accordingly, institutions should adjust their ALLL balance, either upward or downward, in each period for material differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.⁷

⁷ Institutions should refer to the guidance on materiality in SEC Staff Accounting Bulletin No. 99, *Materiality*.

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