

Allowance for Loan and Lease Losses

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Allowance for Loan and Lease Losses

- One of most significant accounting estimates for banks
- Maintain allowance for loan and lease losses (ALLL) at a level that is appropriate and determined in accordance with
 - GAAP (www.fasb.org)
 - FAS 114, Accounting by Creditors for Impairment of a Loan
 - FAS 5, Accounting for Contingencies
 - Bank's stated policies and procedures
 - Management's best judgment

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- Relevant supervisory guidance
 - (<http://www.fdic.gov/regulations/laws/rules/5000-100.html>;
 - <http://www.federalreserve.gov/boarddocs/srletters/>)
 - 2006 Interagency Policy Statement on the ALLL
 - 2001 Interagency Policy Statement on ALLL Methodologies and Documentation
- Determination of appropriate level for the ALLL should be based on management's current judgments about loan credit quality, including consideration of all significant qualitative factors that affect collectibility

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- Evaluate individual loans for impairment under FAS 114
 - Apply normal loan review procedures to identify loans for evaluation
 - Impairment represents a judgment about collectibility in accordance with loan terms, i.e., performance, not collateral
 - A real estate loan is not impaired solely because the fair value of the collateral is less than the loan's recorded investment

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- An impaired real estate loan is not collateral dependent solely because the fair value of the collateral is less than loan's recorded investment
- An impaired loan is collateral dependent if repayment is expected to be provided solely by the underlying collateral
 - If there are other available and reliable sources of repayment besides the collateral, the loan is not collateral dependent
- Measure impairment on an individually impaired loan that is not collateral dependent based on present value of expected future cash flows discounted at loan's effective interest rate

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- Agencies' policies require impairment of an individually impaired collateral dependent loan to be measured based on fair value of collateral (less costs to sell, if appropriate), even if foreclosure is not probable
 - Factors to consider when estimating fair value include, but are not limited to
 - Timing and reliability of appraisal or other valuation
 - Timing of most recent inspection of collateral
 - Historical losses on similar loans
 - Bank's estimate of fair value (less costs to sell) is subject to examiner review

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- For all loans, other than individually evaluated and impaired loans, provide for estimated credit losses on groups of loans with similar risk characteristics by measuring the associated ALLL under FAS 5
 - Determine appropriate historical loss rate for each loan group
 - During periods of significant economic expansion or contraction, relevance of data that are several years old may be limited
 - Period used should be long enough to capture sufficient loss data

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- Consider current qualitative factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience
- Banks typically reflect overall effect of relevant qualitative factors on a loan group as an adjustment to the group's historical loss rate

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- Changes in an institution's ALLL level should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, considering characteristics of portfolio
 - If declining credit quality trends relevant to an institution's portfolio are evident, the ALLL level as a percentage of loans should generally increase
 - If improving credit quality trends are evident, the ALLL level as a percentage of loans should generally decrease

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Questions

