



**NJ Bankers Association**  
**Financial Managers Society**  
**Accounting Seminar**  
**Renaissance Woodbridge Iselin,**  
**New Jersey**

**Regulatory Perspective on Loan  
Reserves and Charge-offs in  
Today's Environment**

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Office of Thrift Supervision

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**Allowance for Loan Losses - Outline:**

- GAAP Framework
- Regulatory Framework
- Regulatory/GAAP Position Today
- Best Practices
- Challenges
- Exam Issues
- Seven Deadly Sins



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## GAAP Framework:

- 1975 – SFAS No. 5, Accounting for Contingencies
  - Estimate loss for group of loans with similar credit characteristics
  - Generally, base loss rates on historic information (FASB ASC 450-20, Contingencies – Loss Contingencies)
- 1993 – SFAS No. 114, Accounting by Creditors for Impairment of a Loan
  - Impaired loans are measured based on PV of expected future cash flows discounted at loan's effective interest rate (or observable market price or FV of collateral) (FASB ASC 310-1—35-2 through 30, Receivables – Overall – Subsequent Measurement – Impairment)
- 1999 – EITF D-80, Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio" (FASB ASC 310-35-2 through 38)
  - Discusses interaction and measurement guidance of SFAS No. 5 and SFAS No. 114

ALLL = SFAS No. 5 for pools of loans and SFAS No. 114 for individually identified impaired loans <sup>3</sup>



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## GAAP Framework:

- Recent Developments
  - No Changes in GAAP (FAS 114, FAS 5, EITF D-80)
- Enhanced Disclosures required/proposed
  - SEC's "Dear CFO Letter"
  - FASB Exposure Draft

## SEC "Dear CFO" Letter

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- ALLL and PLLL "disclosure suggestions" regarding:
  - Higher-Risk Loans
  - Changes in ALLL practices
  - Declines in Collateral Value
  - Other
- A WARNING
- <http://www.sec.gov/divisions/corpfin/guidance/loanlossesltr0809.htm>

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## WARNING

- ~~■ Finally, although~~ determining your ALLL requires you to exercise judgment, it would be inconsistent with GAAP if you were to delay recognizing credit losses that you can estimate based on current information and events.
- Where we believe a financial institution's financial statements are inconsistent with GAAP, we will take appropriate action.

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## FASB ALLL Disclosure Framework

- ~~Responding to~~ criticism ALLL disclosures are inadequate and lack sufficient transparency
- Focus on five topics:
  1. ALLL and the corresponding financing receivable
  2. The fair value of loans
  3. Credit quality of the financing receivable
  4. Impaired financing receivables (loans, notes, A/R)
  5. Financing receivables that are on nonaccrual status
- Effective for first interim or annual reporting period ending after December 15, 2009

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### Allowance for Loan Losses - Interagency Guidance :

- Interagency Policy Statement on the ALLL, December 21, 1993
- Joint Press Release, November 24, 1998
- Joint Interagency Letter, March 11, 1999
- Joint Press Release, July 12, 1999
- Interagency Policy Statement on the ALLL, December 13, 2006

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## Allowance for Loan Losses – Better Practices:

- CEO Letter #304, “ALLL – Observed Thrift Practices Including Sound Practices”
- CEO Letter #325, Guidance on Prudent Commercial Real Estate Loan Workouts”

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## Allowance for Loan Losses:

Fundamental Principles: SEC, OTS, FDIC, FRB, OCC

- Prudent, conservative but not excessive ALLL
- Arriving at an appropriate ALLL involves a high degree of judgment and results in ranges of estimated losses
- May include a margin for imprecision inherent in most estimates

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## Allowance for Loan Losses:

Fundamental Principles: SEC, OTS, FDIC, FRB, OCC

- An unallocated loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP and is **properly supported**
- Management's judgment should be exercised in a disciplined way reflective of detailed analysis

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## Allowance for Loan Losses:

Fundamental Principles: SEC, OTS, FDIC, FRB, OCC

- Process must be based on a comprehensive, **reasonably documented**, and consistently applied analysis
- The ALLL should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic and political factors

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## SEC Comments & Analysis

- *“Please confirm that you follow the guidance in FASB 114 and FASB 118 in determining your specific allowance. If you don’t, please tell us how you applied FASB 114 and FASB 118 in determining the amount of your specific and your overall allowance for loan losses.”*
- Analyze ALLL Directional Consistency
- Analyze loan portfolio MD&A comments for consistency with ALLL analysis

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## Challenges

- Inaccurate risk-rating
- Directional inconsistencies
- Improper segmentation of portfolio analyzed under SFAS No. 5
- Stale appraisals
- Proper consideration of changes (generally declines) in collateral values when calculating loss rates for affected groups of loans when estimating loan losses under FAS 5
- Failure to timely charge off confirmed losses
- Lack of documentation/support for qualitative factors
- Inappropriate reporting lines

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### Exam Issues

- ALLL policy vague and/or actual practice differs from written policy
- Minimums set for loan grades, looking for bell curve
- Policy does not incorporate SFAS No. 114
- FAS 114 selection criteria not clearly defined, or in some instance, too narrow
- Under weighting significant factor in ALLL calculation

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### Exam Issues

- ALLL calculated properly, based on loan classifications, but loans initially misclassified
- Management failed to understand the difference between owner-occupied and non-occupied lending
- Inadequate Internal Loan Review

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## Exam Issues

- Loss estimates are determined using a range of loss estimates and the institution arbitrarily picked a number in the range rather than the best estimate within the range
- Definitional Misunderstandings – Includes “directionally consistent”, “probable”, etc.

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## ALLL – Seven Deadly Sins

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- 1.) Impaired loans identified for evaluation under SFAS No. 114 have not been segregated from the rest of the portfolio in the ALLL methodology.
- 2.) Certain impaired loans are “double-counted” in the ALLL calculations (i.e. using both SFAS No. 114 and SFAS No. 5 measurements for the same loan).
- 3.) Unfunded commitments are included in the ALLL calculation

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### ALLL – Seven Deadly Sins - continued

- 4.) The recorded ALLL is materially less or materially exceeds the amount supported by the ALLL methodology and related documentation by significant amounts.
- 5.) Monthly increases are provided to the ALLL based on budgeted amounts, as opposed to analyzing the loan portfolio.
- 6.) Traditional percentages for loans characterized as Special Mention, Substandard, and Doubtful are being used without substantiation.

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### ALLL – Seven Deadly Sins – continued

- 7.) The ALLL is determined based on target and/or peer statistics (e.g., ALLL to total loans) without adequate justification or evaluation of the institution's own experience.

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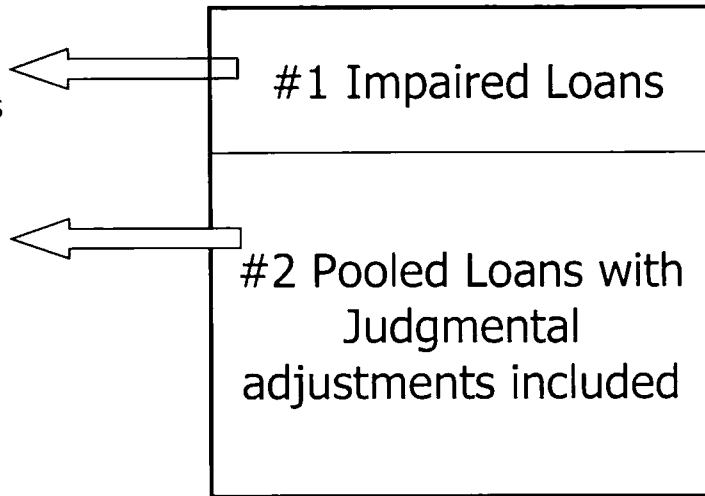


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## ALLL Components

FAS 114: Individual Loan Analysis (Carrying Value less one of three methods)

FAS 5: Pools of Loans x historical loss rates + Pools of loans x judgmental adjustments



**ALLL = 1+2**

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ALLL – Loss Measurement Factors:

- Delinquency Trends
- Charge off Experience
- Economic Conditions
- Portfolio Trends
- Effects of Changes in Underwriting, Policies & Procedures
- Concentration
- Experience, Ability & Depth of Lending Staff
- Management Insight/Judgment

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# Q1: Is an incurred loss an expected loss?

~~No, an incurred loss~~ is based on the facts and circumstances that exist as of the balance sheet date. An expected loss takes into consideration facts and circumstances that may arise after the balance sheet date.

SFAS 5, ¶ 8(a) "Information available prior to issuance of the financial statements indicates that it is probable that an asset had been impaired or a liability incurred at the balance sheet date...one or more future events will occur confirming the fact of the loss"

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## FAS 5 - LOSS EMERGENCE/CONFIRMATION HORIZON



<b><u>LOSS EVENT</u></b> (Loss Event or Series of Events)	<b><u>DISCOVERY OF LOSS EVENT</u></b>	<b><u>CONFIRMATION AND LOSS REALIZATION</u></b>
<ul style="list-style-type: none"> <li>■ Loss of Job</li> <li>■ Catastrophe</li> <li>■ Increase in interest rates leading to unaffordable payment resets</li> <li>■ Loss of major customer</li> <li>■ Material decline in borrower's primary line of business</li> </ul>	<ul style="list-style-type: none"> <li>■ First missed payment</li> <li>■ Credit score refresh</li> <li>■ Receipt of Financial Statements</li> <li>■ Bankruptcy</li> <li>■ News Report</li> <li>■ Overdraft</li> <li>■ Credit review and downgrade</li> </ul>	<ul style="list-style-type: none"> <li>■ Charge-off of confirmed amount</li> <li>■ 180 days (retail credit)</li> </ul>

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## Q2: Should ALLL contain 12 mos of net charge-offs?

~~No, generally, institutions~~ should use at least an "annualized" of 12-month average net charge-off rate that will be applied to groups of loans when estimating credit losses. However, this rate could vary. For example, loans with effective lives longer than 12 months ...which indicate that the estimated credit losses should be greater than that calculated based solely on the annualized net charge-off rate for such loans. These groups may include certain commercial loans....." 2006 ALLL IPS

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## Q3: Is a Substandard loan automatically an impaired loan?

No, given the definition, a "Substandard" loan that is individually evaluated for impairment under FAS 114 ~~would not automatically~~ meet the definition of impaired.

However, if a "Substandard" loan is significantly past due or is in nonaccrual status, the borrower's performance and condition provide evidence that the loan is impaired, i.e. that it is probable that the institution will be unable to collect all amounts due according to the contractual terms of the loan agreement, such a loan would be impaired in accordance with FAS 114. If not, there may be probable incurred losses associated with a group of "Substandard" loans under FAS 5. REF: 2006 Q&A, Q11

NOTE: An impaired loan is always at least substandard

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Substandard, maybe, Doubtful,  
loss, definitely impaired

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**DOUBTFUL**

**LOSS**

**IMPAIRED**