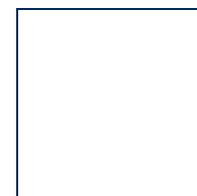


# Quest for a “Reasonable” Allowance for Loan and Lease Losses

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THE FEDERAL RESERVE BANK OF RICHMOND

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# What is a “reasonable” level for the Allowance for Loan and Lease Losses?

- The level is considered reasonable if it
  - is supported by an adequate and appropriate ALLL methodology that is compliant with ***applicable guidance***.
  - is sufficient based on estimated credit losses.
  - exhibits ***directional consistency*** in relation to movements of the institution’s ***asset quality indicators***.



# What guidance is available to help determine a “reasonable” Allowance for Loan and Lease Losses?

- ASC 310 – Analysis of Loan Impairment (FAS 114)
- ASC 450 – Analysis of Qualitative Factors (FAS 5)
- *Interagency Policy Statement on the Allowance for Loan and Lease Losses (SR06-17)*





# Interagency Policy Statement on the Allowance for Loan and Lease Losses (SR 06-17)

- Calls on bank's Board of Directors and Management to develop and maintain an ALLL methodology that is fully documented, auditable, and periodically validated by an independent party
- Requires analysis of the overall measurement of the ALLL
- Acknowledges that determining the appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment
- Encourages the utilization of *ratio analysis* as a supplemental tool for evaluating overall reasonableness of reserve levels



# Asset Quality Indicators

- **ALLL/Total Loans** – Direct comparison to portfolio size – disregards risk and collateral types
- **ALLL/Net Losses** – Backward looking on loss rates – may not be appropriate if expected losses are higher
- **Net Losses/Avg. Total Loans** – Backward looking on loss rates – may not be appropriate if expected losses are higher
- **ALLL/Nonaccrual Loans** – Coverage of nonaccruals
- **Noncurrent Loans/ALLL** – Coverage of noncurrent loans
- **Nonaccrual Loans/Gross Loans** – A measure of risk in the portfolio
- **Noncurrent Loans/Gross Loans** – A measure of risk in the portfolio
- **Past-due Loans+NA/Gross Loans** – A measure of risk in the portfolio
- **NonPerforming Assets + ORE** – A measure of risk in the portfolio
- **Recoveries to Prior Credit Loss** – A measure of collection efforts or delayed charge-offs



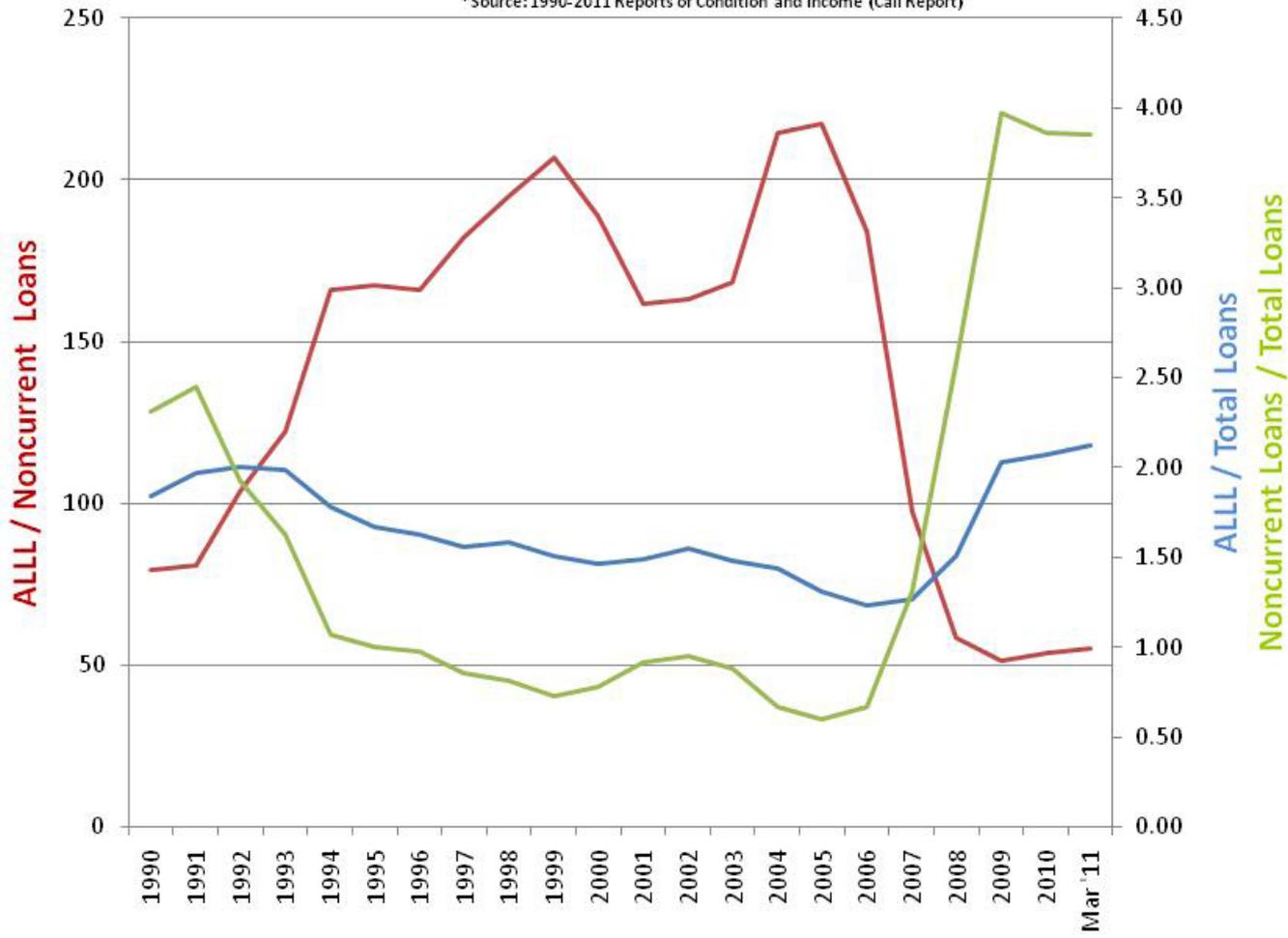
# Directional Consistency

- The Allowance for Loan and Lease Losses and credit quality indicators should move in the same direction.
- As credit quality declines and indicators increase accordingly, reserve levels should also increase and do so at a consistent rate of change



## Directional Inconsistency All Banks \$300 Million to \$1 Billion\*

\*Source: 1990-2011 Reports of Condition and Income (Call Report)





## What are examiners looking for?

- If the examiner review of the institution's procedures indicates that a meaningful and appropriate ALLL methodology is being utilized and the reserve levels appear adequate based on the overall credit/risk indicators, additional review is most likely not warranted
- If upon examination the ALLL methodology is determined to be inappropriate or unacceptable, and reserve levels are deemed inadequate, then examiners may alter the bank's methodology to produce an adjusted reserve using bank-specific information, which may result in required amendments to the bank's methodology.
- If this remedy is not adequate to produce a reliable reserve estimate, on rare occasions, examiners may use a short-term proxy.





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