WHITE PAPER

Reality v/s Myth: Revisiting the ALLL Calculation System

Allowance for Loans and Lease Losses (ALLL) is one of the most critical calculations for a bank and ALLL adequacy will continue to be an area of debate, inspection and elucidation.

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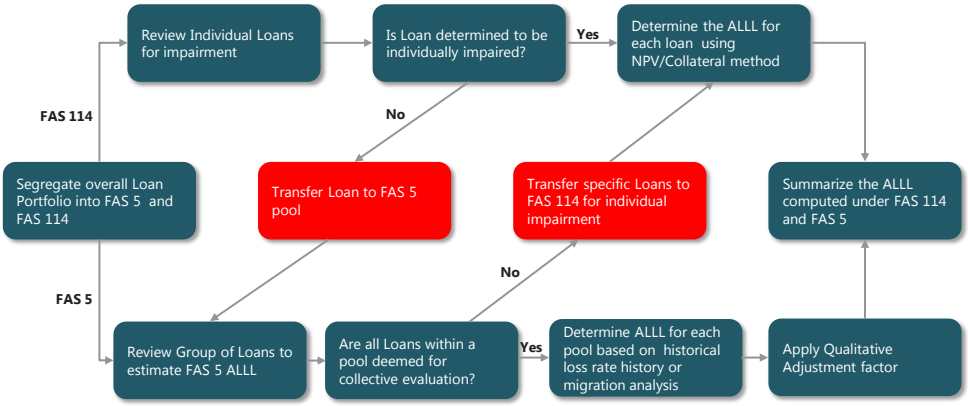
Mercurial changes in the economic environment have resulted in increased scrutiny of the ALLL methodology and numbers by regulators and auditors. Though the overall ALLL process seems simple with minimal steps (few accounting principles and specific calculation methodologies), banks have been struggling to overcome the ALLL challenge. Some of the major concerns in the overall ALLL calculation process could be around -

1) The calculation methodology:
   a. Historical Loss Rate v/s Migration Analysis
   b. NPV v/s Collateral
2) Identification of loans deemed potentially impaired
3) Appropriate segmentation criteria on similar risk characteristics for FAS 5 accounts



Overview of the general ALLL process prescribed by regulators

If the ALLL process is so straightforward, why has it become a distress factor for banks? And why have regulators become increasingly watchful? Over the years, banks have focussed primarily on the final numbers that are reported and presented to their boards, the regulators and auditors with considerable disregard to the foundational layer for ALLL. While this has worked favourably until now, the new regulatory focus on ALLL has forced banks to rethink their strategies and policies.

Subjectivity and multiple interpretations around FAS 5/ FAS 114 identification and the proposed calculation methodology has led banks to invest maximum resources for objectifying these aspects. Neglecting the basics has been one of the primary reasons for an unsuccessful ALLL story; also detrimental to migrating the bank's ALLL calculation ecosystem to a newer regulatory regime.

Let's analyse the three basics – *Data, Documentation and Process* - which need to be in place for a successful and forward-looking ALLL practice.

Data

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Let's take the example of a mid-sized bank that is primarily focussed on commercial & industrial loans (including commercial real estate). In this case ALLL, looks fairly straightforward, i.e. identify the sub-standard loans for individual impairment and create two pools of loans as mentioned in the call reports (the highlighted portions of RC-C seen below).

Dollar Amounts in Thousands	(Column A) To Be Completed by Banks with $300 Million or More in Total Assets[1] RCON	Bil	Mil	Thou	(Column B) To Be Completed by All Banks RCON	Bil	Mil	Thou	
1. Loans secured by real estate:									
a. Construction, land development, and other land loans:									
(1) 1–4 family residential construction loans					F158				1.a.(1)
(2) Other construction loans and all land development and other land loans					F159				1.a.(2)
b. Secured by farmland (including farm residential and other improvements)					1420				1.b.
c. Secured by 1–4 family residential properties:									
(1) Revolving, open-end loans secured by 1–4 family residential properties and extended under lines of credit					1797				1.c.(1)
(2) Closed-end loans secured by 1–4 family residential properties:									
(a) Secured by first liens					5367				1.c.(2)(a)
(b) Secured by junior liens					5368				1.c.(2)(b)
d. Secured by multifamily (5 or more) residential properties					1460				1.d.
e. Secured by nonfarm nonresidential properties:									
(1) Loans secured by owner-occupied nonfarm nonresidential properties					F160				1.e.(1)
(2) Loans secured by other nonfarm nonresidential properties					F161				1.e.(2)
2. Loans to depository institutions and acceptances of other banks					1288				2.
a. To commercial banks in the U.S.:									
(1) To U.S. branches and agencies of foreign banks	B532								2.a.(1)
(2) To other commercial banks in the U.S.	B533								2.a.(2)
b. To other depository institutions in the U.S.	B534								2.b.
c. To banks in foreign countries									
(1) To foreign branches of other U.S. banks	B536								2.c.(1)
(2) To other banks in foreign countries	B537								2.c.(2)
3. Loans to finance agricultural production and other loans to farmers					1590				3.
4. Commercial and industrial loans					1766				4.
a. To U.S. addressees (domicile)	1763								4.a.
b. To non-U.S. addressees (domicile)	1764								4.b.
5. Not applicable									
6. Loans to individuals for household, family, and other personal expenditures (i.e., consumer loans) (includes purchased paper):									
a. Credit cards					B538				6.a.
b. Other revolving credit plans					B539				6.b.
c. Automobile loans					K137				6.c.
d. Other consumer loans (includes single payment and installment, loans other than automobile loans, and all student loans)					K207				6.d.
7. Loans to foreign governments and official institutions (including foreign central banks)					2081				7.
8. Obligations (other than securities and leases) of states and political subdivisions in the U.S.					2107				8.

FFIEC 041 – Schedule RC – C – Loans and Lease Financing Receivables

Now let's bring in the baddie – "Credit Concentration". Since, the bank is focussed only on C&I loans, the overall portfolio would be classified into just two segments from the call report. Although, at a broad level risk characteristics of loans within a segment are the same, from a business perspective a further segmentation might be required based on risk ratings, industry category, customer vintage, geography, etc. Most mid-sized banks use FFIEC codes for segmentation, which might lead to high concentrations for certain segments leading to inappropriate ALLL.

Some of the issues can be easily resolved if a superior data ecosystem exists -

- Banks usually score well on internal risk classification/grading, but still fumble on creating a rich set of scenarios to identify FAS 114 loans for individual impairment
- Creating a universe of attributes to choose from, while creating sub-segments within FFIEC segments
- Re-segmentation; change in business focus might require the bank to pivot and redefine its segments. Most banks which change business focus knowingly or unknowingly, usually revisit and redefine their ALLL policies which is an unnecessary overhead

Documentation

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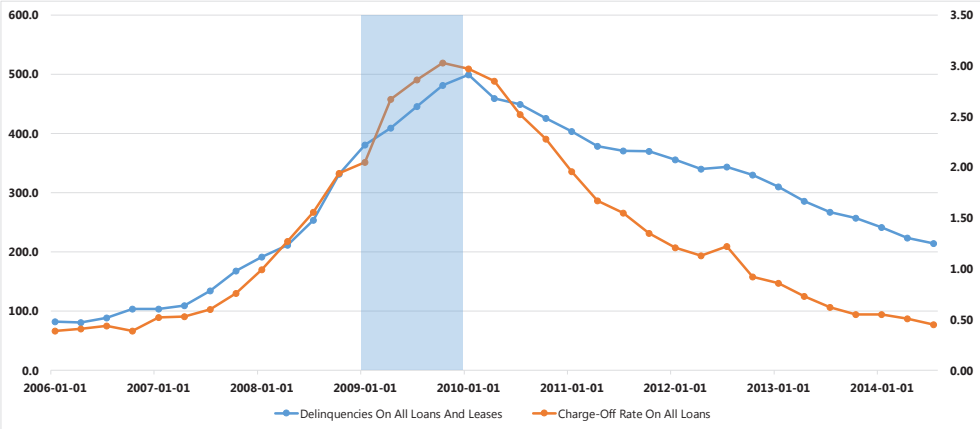
Documentation is key to an efficient ALLL process. But the big question is – Just what are the documents required? Let's take a classic example to understand the regulator's need for documentation before discussing how a bank can improve on the documentation front.

The depiction below on the delinquencies and charge-offs on loans has a highlighted area - the problem zone. There were two scenarios to consider; one - during this period and the other - post this period, which actually led to the current increased focus on ALLL.



Delinquencies and charge-off on all loans (Source: FRED)

Scenario 1: During the crisis, let's take 31 Dec 2009 ALLL reporting. Historical loss rates used to arrive at FAS 5 ALLL value were from the quarters of 2006 to 2008. Since charge-offs were substantially lower during this period, loss rates were low and hence the reported ALLL for 31 Dec 2009 was low. The regulator's expectation was to increase the ALLL using qualitative and environmental (Q&E) factors to reflect the prevalent economic/market conditions then. But most banks actually reserved low during the crisis period to show stable earnings.

Scenario 2: Post crisis, let's consider 31 Dec 2011 ALLL reporting. Historical loss rates used to arrive at FAS 5 ALLL value were from the quarters of 2009 and 2011. Since charge-offs had peaked during this period, the loss rates used for ALLL calculation were high which resulted in higher reported ALLL for 31 Dec 2011. What ideally should have happened was banks should have used the Q&E factors to reduce ALLL. But most banks reported high ALLL numbers and resorted to negative provisioning in the subsequent quarters primarily to show stable growth in earnings.

In both scenarios, if a bank wanted to report an ALLL number which is higher/lower than the calculated figure (using historical loss rates), it could have used the Q&E factors to reflect changes in current economic/market environment compared to past. But, the only logical need is documentation to tie-up the numbers. A bank must be able to back-up the Q&E adjustment during audits, which they failed to do.

Some of the typical documentation requirements from an ALLL audit perspective are:

1) Policy documents on FAS 114 identifications and risk classifications
2) Heaps of documentation around qualitative factors (economic, environmental, peer data)
3) Credit Concentrations Reports to tie-up segmentation methodology
4) Trend analysis (Ageing Analysis, Delinquency Trends, Charge-Off Trends); Watch Lists, Special Mentions

Achieving excellence in ALLL documentation will require banks to have a superior data-ecosystem, a solid reporting tool and astute analysts who track the market on a regular basis. Banks must maintain a checklist of documents for each aspect of ALLL based on their size and complexity and applicability of the regulation.

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Process

There's no denying the fact that 'process' for ALLL is a new concept. A conclusion from several discussions with banks show that that the number of people responsible and involved in the ALLL calculation ranges anywhere between two and four and they are invariably from the CFO's office (including the accounting function). But, is this really sufficient?

Let's focus on the terms 'responsible' and 'involved'. Since ALLL is not just an accounting concept with numbers getting reflected in the financial statements, but also an overall estimation of the health of the loan book, the senior management (usually the CFO) has to be responsible for the calculated numbers, management reporting, board sign-offs, etc.

'Involvement' should mean evangelization amongst business owners within the bank. And why is it important? Let's take an ideal scenario. A bank has perfect data, has precisely identified the loans for individual impairment, has created perfect segments and has also calculated the related loss rates.

Do individuals 'responsible' for ALLL calculation actually go back and talk to the respective business owners to assess the economic impact on a particular segment? Or, check back with the credit appraisers/client relationship owners to assess the future expected cash-flows or any prior liens with other banks? Does the CFO's office have complete information on these aspects of FAS 5 segments and FAS 114 accounts?

Banks must define a process around overall ALLL calculation and involve more people for calculating ALLL. The 'responsible' ones should define policies, review calculations and report numbers. People who are truly in the know about the business or the clients should be the ones evaluating economic impacts and client behaviour. Besides reducing errors, a streamlined process makes the right people accountable.

Another common challenge banks have is in presenting the information to the auditors. A bank might be diligent enough to document every adjustment and number, but most banks struggle to present the right information during the audit, because of vital documentation lying somewhere in a 'shared folder'. From an audit perspective, it is essential that relevant documentation is linked with the appropriate ALLL calculation items.

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Just as banks frown upon incorrect/insufficient documentation to assess a client's financial health, regulators require documentation to accurately gauge the bank's health. Data lies at the heart of ALLL and helps banks migrate to new calculation regimes without impacting business as usual. For regulators, any number that is presented has to be backed with documentation, hence an inevitable and immediate must have. An overarching process that enrols the right people into the ALLL calculation brings in accountability into the overall process.

While ALLL in the current format has been around for a while, most banks are struggling to win the battle. The proverbial 'need of the hour' therefore is foresight. And with a CECL regime on the horizon, now is the right time to get the fundamentals right to prepare for a wave of new regulations.

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Sourav is a BFSI domain expert with seven years of experience spread across Investment Banking and IT Consulting for the BFSI Domain. A Finance graduate from the Indian School of Business and a Mechanical Engineer from the National Institute of Technology - Warangal, Sourav's interests span across Risk, Compliance and Banking Decision Sciences.

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(formerly iCreate)

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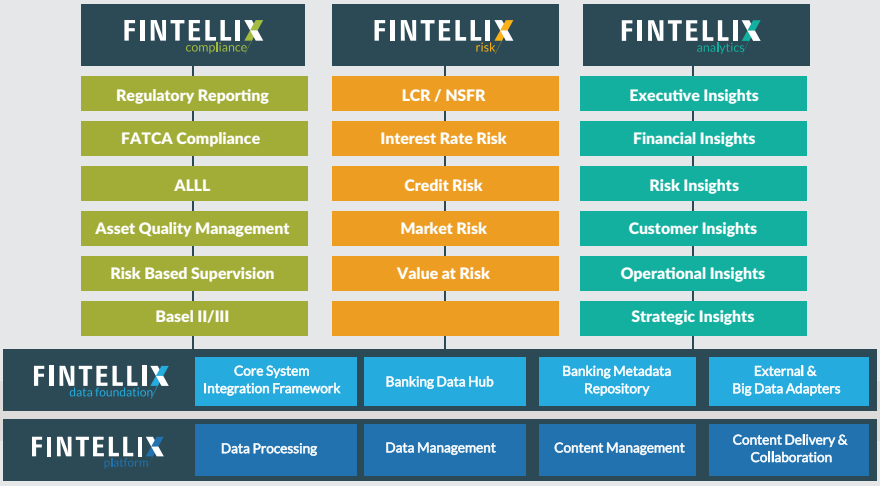

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