STATE OF ALABAMA
STATE BANKING DEPARTMENT

Bob Riley
Governor

John D. Harrison
Superintendent of Banks

MEMORANDUM

TO: **Chief Executive Officers of all Alabama, State-chartered Banks**

FROM: **John D. Harrison, Superintendent of Banks** John D. Harrison

SUBJECT: **Guidance on the Interagency Policy Statement on the Allowance for Loan and Lease Losses**

DATE: **April 22, 2008**

On December 13, 2006, the federal financial institution regulatory agencies issued a joint revised "Interagency Policy Statement on the Allowance for Loan and Lease Losses". This statement revised the 2001 Policy Statement on ALLL Methodologies and Documentation, and replaced the similarly named 1993 policy statement. The policy statement describes the responsibilities of the boards of directors, management, and bank examiners on the allowance for loan and lease losses (ALLL). The agencies also issued a supplemental document that answers 16 frequently asked questions (FAQs).

Over the past year, and especially the past several months, the State Banking Department has received numerous questions regarding the revised policy statement. The most frequently asked questions were regarding proper implementation of the policy statement, and how the Department would view the ALLL going forward. The Department is issuing this memo to further clarify the provisions and requirements of the statement, and the expectations of the Department for state-chartered banks. However, bank management should not rely on this memo in lieu of reading the policy statement and the supplemental FAQs, and consulting with the bank's accountants when developing its ALLL processes.

The State Banking Department expects all state-chartered banks to follow the provisions of the revised policy statement when determining the appropriateness of the ALLL. Although the revised statement became effective in December 2006, this Department recognized that state-chartered banks needed sufficient time to bring their ALLL processes and documentation into full compliance. Therefore, on examinations conducted prior to 2008, state examiners were instructed to only make recommendations to bank management regarding the bank's ALLL process. However, going forward, failure to comply with the revised policy statement will be handled in a manner consistent with all other violations and contraventions of laws, regulations, and statements of policy. Any areas of non-compliance will be detailed as a contravention of the policy statement on the "Violations of Laws and Regulations" page in the Report of Examination.

The revised Interagency Policy Statement on the Allowance for Loan and Lease Losses incorporates the requirements of GAAP into existing supervisory ALLL guidance. Annually the Board of Directors is required to review the ALLL Policy and methodology based on the bank's lending risk profile, and record their approval in the minutes. At least quarterly, bank management should analyze the collectibility of all loans included in the loan portfolio, and maintain an ALLL at an appropriate level in accordance with GAAP. The revised statement no longer includes benchmarks that were included in the previous statement, such as 15 percent of loans classified Substandard and 50 percent of loans classified Doubtful, as guidance in assessing the appropriateness of the ALLL. The revised statement requires financial institutions to comply with FAS 5, *Accounting for Contingencies*, and FAS 114, *Accounting by Creditors for Impairment of a Loan,* when determining the appropriateness of its ALLL.

It is important to note that all loans in the bank's portfolio must be evaluated for collectibility and an appropriate amount placed in the ALLL. However, some loans will be evaluated individually (using FAS 114), while the remaining loans in the portfolio will be segmented in groups, with each group of loans evaluated together (using FAS 5). The combined estimated credit losses on these loans make up the ALLL. To facilitate compliance with the policy statement, this memo attempts to explain the requirements and provisions of FAS 5 and 114 and breakdown the process into smaller, easier to digest steps.

1. The first step in the process is to determine which loans will be evaluated individually. Management should use criteria similar to those in its loan review procedures when identifying loans for individual evaluation. For instance, management may select loans based on size, classifications in regulatory reports of examination, internal "watch list" status, or delinquency. However, there is no set guidance on how management should determine what loans to choose other than using appropriate judgment and documenting the method and process used for identifying the loans. Any loans not selected would then be evaluated later using FAS 5 (see Step 5).

2. Once it has been determined which loans are to be evaluated individually, management should then determine which, if any, of the selected loans are "impaired" (FAS 114). A loan is considered impaired when it is ***probable*** that the bank will be unable to collect all amounts due according to terms of the loan agreement. It should be noted that the regulatory definition of Substandard is less harsh than the definition of impaired. The definition of Substandard states that there is the "***possibility*** [emphasis added] that the bank will sustain some loss" on a particular loan. Therefore, a loan may be classified by regulators or internally as Substandard and not be impaired. The distinction between "probable" and

"possible" is important. Using the above definition of impairment, management should individually evaluate each loan selected in Step 1 above to determine if it is impaired. Management should document the analysis that resulted in the impairment decision.

3. If a loan is individually evaluated and it is determined that it is <u>not</u> impaired in Step 2 above, that loan will then be evaluated later using FAS 5 (see Step 5), along with all other loans that were not selected to be individually evaluated in Step 1 above.

4. If a loan is determined to be impaired under Step 2 above, management must then measure the impairment using one of three methods:

    - Present value of expected future cash flows
    - Observable market price of the loan
    - Fair value of the collateral less costs to sell

    Management may choose an impairment measurement method on a loan-by-loan basis. However, for a collateral-dependent loan, the fair value of the collateral method must be used. A loan is considered collateral-dependent if repayment of the loan is expected to be provided solely by the underlying collateral. After measuring the impairment of an individual loan, the amount of the impairment should be included in the total ALLL. Each loan determined to be impaired should be measured and the impairment amount added to the ALLL.

    Note: In most cases, a loan that is determined to be impaired will have an impairment amount to be added to the ALLL. However, in some rare cases, it is possible for a loan to be considered impaired, but the impairment amount is measured to be "0" (zero). An example would be a loan that has already been written down to the value of the collateral. The loan is impaired because the bank will probably not collect all amounts due under the terms of the original loan agreement, as evidenced by the partial charge-off. However, since the loan is already written down to the collateral value, no additional amount is necessary for the ALLL. Unlike the loans in Step 3 above that were <u>not</u> impaired, a loan that is determined to be impaired, but the impairment is measured to be "0", does <u>not</u> get evaluated again under FAS 5. The impairment is "0" and no additional amounts are added to the ALLL level.

5. Now that each loan selected for individual evaluation has been evaluated, the next step is to evaluate all other loans. All loans not selected for individual evaluation in Step 1, and all loans individually evaluated and determined to be not impaired in Step 3, will now be evaluated using FAS 5.

    All loans that will be evaluated under FAS 5 should be divided into several smaller groups of loans, with each separate group of loans evaluated together. There are no specific instructions on how the loans should be segmented, except that all loans in a given group should have similar risk characteristics. For example, first mortgage residential loans should not be grouped with speculative home construction loans. Management may segment its loan portfolio based on a variety of factors, such as loan type: commercial loans, acquisition and development, commercial real estate, asset-based lending, unsecured loans, farm loans, first mortgage residential, etc. Management may also choose to further segment the portfolio by segregating loans that are adversely classified internally or by examiners. For example, management may group commercial real estate loans that have been rated Substandard in a separate group from all other commercial real estate loans.

6. Once the loans are segregated into separate groups of similar loans, management will then measure estimated credit losses on each group of loans. While the policy statement does not specify what method should be used, it does state that "a widely used method is based on each group's historical net charge-off rate…" Management may choose a methodology to use when determining the historical net charge-off rate; however, the bank should maintain supporting documentation for the technique used. While there is no fixed period of time that banks should use to determine historical loss experience, the period used should be long enough to capture sufficient data. It should be noted that if a bank is offering a new loan product, or if the bank is a de novo institution, it may not have its own historical loss experience to base its estimates of credit loss. In such cases, management may use the experience of other institutions on a short-term basis until the bank has developed its own loss experience.

7. After determining historical loss rates for each group of loans, management should now decide whether rates should be adjusted for factors that are likely to cause credit losses to differ from historical rates. Such factors may include changes in the experience of the lending staff, changes in the volume and severity of past due loans or adverse classifications, or economic changes – either locally or nationally. If rates are adjusted for any group of loans, management should maintain documentation to support what factors affected the analysis. The policy statement lists several examples of supporting evidence, such as "relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers."

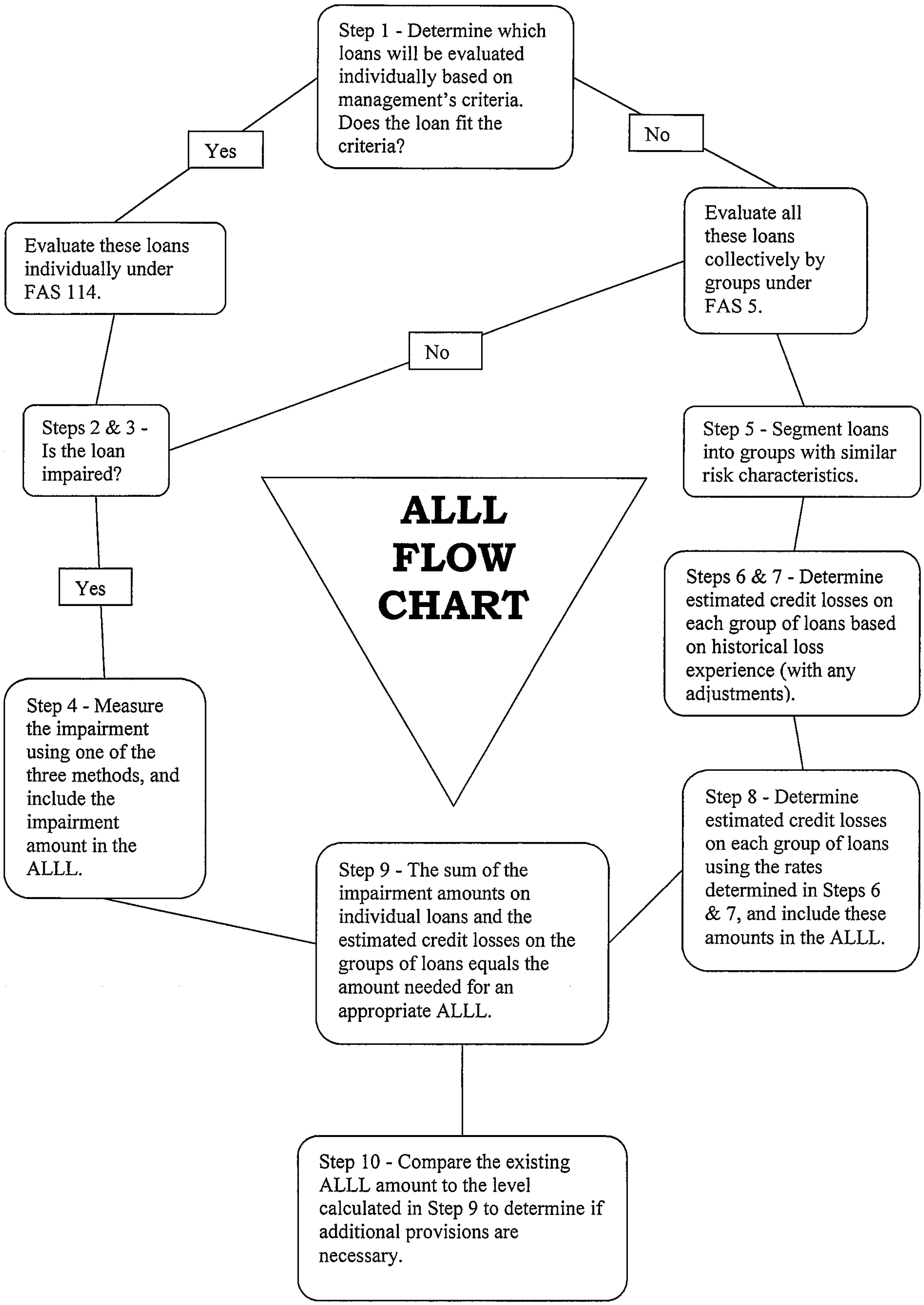
8. An estimate of credit losses on each group of loans should now be determined by applying the historical loss rate determined in Step 7 above. The aggregate estimate of credit losses should be included in the total ALLL.

9. Now that the amount of impairment on loans evaluated under FAS 114 and the amount of estimated credit losses on loans evaluated under FAS 5 have been calculated, the amounts should be summed to arrive at the amount needed for an appropriate ALLL.

10. The amount calculated in Step 9 above should be compared to the existing ALLL amount to determine if additional provisions are necessary.

The following page contains a flow chart demonstrating the above ten steps. The ten steps and flow chart are provided to aid management in complying with the revised policy statement. However, as noted above, bank management should not rely on this memo in lieu of reading the policy statement and the supplemental FAQs, and consulting with the bank's accountants when developing its ALLL processes. This memo only attempts to cover the basics, while the actual statement and FAQs contain valuable information, and in much greater detail, that management will need in complying with the policy statement.

The two overriding themes throughout the policy statement are management's judgment, and supporting documentation. When determining the appropriateness of the ALLL, bank management will need to exercise prudent judgment, and make sure that each decision has adequate supporting documentation. The bank's methodology and processes, and adequate documentation of such, will be key factors when examiners are determining not only compliance with the policy statement, but the appropriateness of the ALLL.


Step 1 - Determine which loans will be evaluated individually based on management's criteria. Does the loan fit the criteria?
Yes
No
Evaluate these loans individually under FAS 114.
Evaluate all these loans collectively by groups under FAS 5.
No
Steps 2 & 3 - Is the loan impaired?
Step 5 - Segment loans into groups with similar risk characteristics.
ALLL FLOW CHART
Yes
Steps 6 & 7 - Determine estimated credit losses on each group of loans based on historical loss experience (with any adjustments).
Step 4 - Measure the impairment using one of the three methods, and include the impairment amount in the ALLL.
Step 8 - Determine estimated credit losses on each group of loans using the rates determined in Steps 6 & 7, and include these amounts in the ALLL.
Step 9 - The sum of the impairment amounts on individual loans and the estimated credit losses on the groups of loans equals the amount needed for an appropriate ALLL.
Step 10 - Compare the existing ALLL amount to the level calculated in Step 9 to determine if additional provisions are necessary.