

Loan and Lease Loss Estimation Becomes a Heavier Burden for Banks

By Mike Lubansky, May 20, 2011

Estimating the allowance for loan and lease losses has been a part of a financial institution's accounting for years, but it has taken on heightened importance in the last several years.

Between increased regulatory scrutiny and the challenges of documenting and defending the estimation to multiple constituencies, including regulators, external auditors and the board, many companies find themselves overwhelmed by the process of estimating and documenting the ALLL every month or quarter.

The ALLL estimation is significant in that regulators are vigilant about ensuring that financial institutions have enough in their reserves, but it is also significant in its impact on a company's earnings and capital.

The overarching challenges that financial institutions face with regard to employing this type of comprehensive, systematic and consistently applied process to their ALLL estimation include:

- The manual, time-intensive nature of the process each month or quarter. For many financial institutions the process can take several days if not more for several finance, credit and/or lending staff. Some individuals are high-level executives whose time is at a premium, so the greater amount of time directed toward the ALLL can be a burden. This process is labor-intensive, manual and often prone to error, through the use of an assortment of Excel spreadsheets, which lend themselves to version control issues and formula errors, among other issues.
- Keeping up with new accounting standards and regulatory demands. The financial institution must stay current not only with the published regulatory guidance, but also with new accounting standards being issued from the Financial Accounting Standards Board, as well as the regulatory demands from the institution's specific regulators, which may or may not coincide precisely with the two aforementioned sets of standards.
- Additional reporting and disclosure requirements as well as increased scrutiny on the assumptions used to determine the general reserves. In recent years, the FASB has continued to issue new requirements through its Accounting Standards Updates. While these often consist of simple reports and aggregation of data that already in use, keeping up can be time-consuming and place an additional strain on limited resources.
- Increased scrutiny on the assumptions used to determine the general reserves. This can include questions about how to appropriately segment the pools, assumptions used for the number of periods of historical data to include for establishment of the historical loss reserve portion of the reserves, and the judgment and defense of qualitative factor adjustments in the assessment of the reserves.
- Increased scrutiny around the specific reserves for impaired loans. This includes the appropriate determination of which loans need to be evaluated for impairment,

determination of whether the loan should be considered "collateral-dependent" and evaluated under the "fair market value of collateral" method or under the "present value of future cash flows" method if the borrower is still expected to make repayments on the loan, the correct assumptions to employ in either method, as well as additional considerations that have been expanded upon by the FASB as pertains to troubled debt restructure loans that have been modified or restructured.

Given the conflicting demands on financial institutions as well as the increased regulatory demands in other areas of their operations, it is easy to see how many financial institutions struggle to establish a comprehensive, systematic and consistent estimation of their allowance for loan and lease losses and to meet the demands of the various constituencies that scrutinize this calculation.

Such challenges require a systematic approach in which the institution examines the impact of their loan policies and implements a structured approach to evaluating the losses inherent in their portfolio. Current spreadsheets and policies may or may not be adequate to meet these demands.

Any efforts to streamline the process and better document the financial institution's assumptions are beneficial in defending the estimation of the allowance in a comprehensive manner.

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