

Challenges in the Estimation of the Allowance for Loan and Lease Losses

By Mike Lubansky, Senior Analyst, Sageworks, Inc.

The estimation of the Allowance for Loan and Lease Losses has been a part of the financial institution's accounting processes for years, but it has taken on increased importance over the last several years. Between increased regulatory scrutiny and the challenges of documenting and defending the Allowance estimation to multiple constituencies including the regulators, external auditors, and the board, many financial institutions find themselves overwhelmed with the process of estimating and documenting the ALLL on a monthly or quarterly basis. The ALLL estimation is significant in that regulators are vigilant about ensuring that financial institutions have enough in their reserves, but the ALLL estimation is also significant in its impact on an institution's earnings and capital.

One of the defining regulatory statements on the ALLL, the 2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses states:

The ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports...each institution has a responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses.

Tom Ryan of Turner and Associates, Inc., a bank consulting firm serving clients in the Midwest, sees this in practice, noting: "Estimating the allowance for loan and lease loss is one of the most important challenges bankers face today, though often the least understood. Bankers can minimize the inherent imperfections of this estimate by adopting a supportable and consistently applied methodology and providing verifiable documentation of their findings."

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

1. 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 per month for several of the institution's finance, credit, and/ or lending staff. Some of the individuals involved in the estimation are high-level executives whose time is at a premium, so the greater amount of time directed towards the ALLL can be a burden. This process is labor intensive, manual, and often prone to error, through the usage of an assortment of Excel spreadsheets, which lend themselves to version control issues and formula errors, amongst other potential issues.
2. Keeping up with new accounting standards and regulatory demands that are being placed on the institution. The financial institution must stay current not only with the published regulatory guidance, but also with new accounting standards being issued from FASB, 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.
3. Additional reporting and disclosure requirements as well as increased scrutiny on the assumptions used to determine the ASC 450-20 (FAS 5) reserves. In recent years, FASB has continued to issue new requirements through its Accounting Standards Updates. While this often consists of simple reports and aggregation of data that is already being used, it can be time-consuming and places additional strain on limited resources.

4. Increased scrutiny on the assumptions used to determine the ASC 450-20 (FAS 5) reserves. This can include questions around the how to appropriately segment the ASC 450-20 (FAS 5) pools, assumptions used for the number of periods of historical data to include for establishment of the Historical Loss Reserve portion of the ASC 450-20 (FAS 5) reserves, and the judgment and defense of qualitative factor adjustments in the assessment of the ASC 450-20 reserves.

5. Increased scrutiny around the ASC 310-10-35 (FAS 114) reserves. This includes the appropriate determination of which loans need to be evaluated for impairment under ASC 310-10-35 (FAS 114), 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 FASB as pertains to Troubled Debt Restructure (TDR) loans that have been modified or restructured.

Nelson Reeves from Reeves Risk Management, a firm serving financial institutions in the Southeastern U.S., sums up these challenges by stating: “Overall, one of the most significant challenges is arriving at an amount in the allowance which both adheres to the accounting and regulatory requirements and satisfies the regulators as to its adequacy.”

Given the above list of conflicting demands pertaining to the ALLL that are being placed on financial institutions taken in context with increased regulatory demands in other areas of their operations, it is easy to see how many financial institutions are struggling to put together 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. Approaching such challenges requires a systematic approach in which the institution carefully 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.

About Mike Lubansky: Mike Lubansky is Senior Financial Analyst and Product Manager at [Sageworks](#) where he oversees product development, market research, and implementation in the financial institutions market. Mr. Lubansky has a background in both the financial and consumer industries. Before joining Sageworks in 2009, Mr. Lubansky served as Research Analyst for the Cherry Hills Fund and as Financial Analyst for Humana. Prior to that, Lubansky spent time as Specialty Account Manager for Pfizer and District Manager for consumer products marketing firm, Vector Marketing. Mr. Lubansky received his MBA with concentrations in Finance and Entrepreneurship from the University of North Carolina-Chapel Hill and his BA in American Studies from Yale University. He is also a CFA Level 2 candidate.

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