Bank: **Date of Exam:**

Charter #: **Prepared By:**

#2 – ALLOWANCE FOR LOAN AND LEASE LOSSES

(Risk Focused)

ASSIGNMENT OVERVIEW

The Allowance for Loan and Lease Losses (ALLL) should reflect potential losses inherent in a bank's loan portfolio and off-balance sheet lending activities. It is the responsibility of bank management and the board of directors to maintain an adequate and accurate level in the ALLL through at least quarterly evaluations of the methodology and the bank's credit risk. Significant understatement of the ALLL may represent a safety and soundness risk through overstatement of a bank's earnings and capital accounts. Significant overstatement of reserves is inappropriate from an accounting practice and could lead to complacent loan administration. Refer to the section titled "Loans" in the FDIC Examination Manual and the Interagency Policy Statement on the Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions dated June 29, 2001 for more information. The related Reference document for this procedure identifies useful regulations, guidance, and other issuances by various regulatory authorities.

INSTRUCTIONS

Examiners must follow the requirements in the Examiner Bulletin addressing Guidelines for Procedures and Work Paper Documentation for Commercial Examinations

All examiners performing these procedures must be listed above in the "Prepared By" section. All of the CORE ANALYSIS PHASE should be completed. Comments and findings for each step should be made in the comment box below each question. Reference to work paper documentation should also be included here. Documentation is to be sufficient to allow an audit trail of the examiner's thought process and all significant findings.

Information on the Summary of Findings page must tie back to the findings noted within the procedure. The SEIC/EIC will determine which information in the Summary of Findings will be included in the Report of Examination.

The EIC/AEIC should review this procedure when complete. Acknowledgement that this procedure has been reviewed by the EIC/AEIC will be noted on the SCOPE FORM.

EXAMINERS ARE RESPONSIBLE FOR EXERCISING SOUND JUDGMENT AND UTILIZING REASONABLE INVESTIGATIVE AND ANALYTICAL SKILLS TO ARRIVE AT AN ACCURATE ASSESSMENT OF THE RISK PROFILE OF THIS SEGMENT OF THE INSTITUTION'S OPERATIONS. PERFORMING ALTERNATE PROCEDURES NOT LISTED WITH THESE GUIDELINES MAY BE NECESSARY TO COMPLETE THIS RISK ANALYSIS.

CORE ANALYSIS PHASE

#2 – Allowance for Loan and Lease Losses

1. Prior Criticism

1. Determine whether deficiencies were noted in the last examination and most recent internal/external audit. If yes, determine if deficiencies have been addressed and/or corrected by management. Detail how deficiencies were corrected. *Include copy of audit exceptions and/or prior examination criticisms and management response in work papers or summarize exceptions/criticisms below or indicate the page number in the last examination report where deficiencies are noted, if applicable.*

Comment:

2. Account Balance and Activity

All entries to the ALLL account should flow through the appropriate income and expense accounts not through the capital accounts.

2a. Reconcile ALLL transcripts to call report Schedules RI-B and RC and financial statements. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance reported in the financial statements. *Include ALLL transcripts in 2-A of the work papers.*

Review for any unusual activity. Refer to **Appendix** for examples of unusual activity. If unusual activity is noted, perform a random sampling of charged-off loans and/or discuss current practices with employees in the loan department to document or detail unusual activity.

Explain and document any material differences or any unusual activity.

Comment:

2b. List any loans classified "Loss" which were not charged off at the last exam and document the reasons why.

Comment:

2c. Review the procedures for posting charge-offs and recoveries to the ALLL account. Comment on any inadequacy of these procedures, lack of segregation of duties, and/or board approval.

Comment:

3. Board and Management Oversight

#2 – Allowance for Loan and Lease Losses

3. Consider the effectiveness of board oversight. Determine if managerial reports provide sufficient information relative to the size and risk profile of the organization and if the reports provided to the board and executive management are accurate and timely. *Consult with the examiner performing the Loan Review procedure for input on the effectiveness of management in identifying, monitoring, and addressing asset quality problems and the impact on the ALLL.*

Comment:

4. Methodology & Adequacy of Reserves

4a. Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management's assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management's best estimate within the range. Determine whether the institution's historical loss experience and all significant qualitative or environmental factors that affect the collectability of the portfolio have been appropriately considered and that management has appropriately applied GAAP, including FAS 5 (ASC Topic 450-Contingencies) and FAS 114 (ASC Topic 310 – Receivables).

Comment specifically on compliance with FAS 5 (ASC Topic 450- Contingencies) and FAS 114 (ASC Topic 310 – Receivables).

Document deficiencies noted and refer to Appendix for guidance. *Include copy of ALLL Policy/Methodology and internal ALLL calculation in work papers (items 2-C and 2-B, respectively).*

Comment:

4b. Describe the bank's process for determining impaired loans (ASC Topic 310). Determine what factors the bank uses to measure the impairment of a loan within the scope of FAS 114 (ASC Topic 310-Receivables) and whether supporting documentation is maintained for the assumptions and estimates used. Refer to Appendix for additional information.

Comment:

4c. Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances, this may include a quantitative analysis (using ratio analysis) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectability of loans at the institution and its current environment.

Examiner recommended reserves on individual credits reviewed during the examination should be included to determine the reasonableness of the ALLL.

Refer to the Interagency Policy Statement on the ALLL and FAQs issued December 13, 2006 for guidance.

#2 – Allowance for Loan and Lease Losses

policy_stmt_alll.pdf

FIL105-2006 ALLL FAQ.pdf

Optional: ALLL Worksheets are available in the Excel file below**.** The completion of the ALLL Worksheets is at the discretion of the EIC. *Indicate whether or not the worksheets are completed in the comment section.*

Examiner-Prepared ALLL Calculation.xlsx

Comment:

4d. Complete the **CECL Questionnaire** to determine the steps management has taken to implement CECL, whether the bank is on track to meet the target effective date, and if the steps taken have been performed adequately. (Review the CECL Questionnaire – Examiner Guide and Tips for Submission of CECL Questionnaire.) *Include CECL Questionnaire in workpapers.*

Refer to the following guidance on CECL**:**

- FASB's ASU 2016-13, *Financial Instruments - Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, commonly referred to as Current Expected Credit Losses (CECL)
- FASB's Credit Losses Educational Resources
- Federal Agencies' Frequently Asked Questions on the New Accounting Standard on Financial Instruments (April 3, 2019)
- Federal agencies' Joint Statement on New Accounting Standard on Financial Instrument – Credit Losses (June 17, 2016)
- Federal agencies' Frequently Asked Questions on the New Accounting Standard on Financial Instruments – Credit Losses (updated September 6, 2017)
- CSBS Readiness Checklist Tool

Completed Questionnaire and included in Workpapers?

5. Final Analysis

5a. Complete the **Summary of Findings** page.

5b. Prepare a comment for the report regarding the bank's preparedness and current actions being taken to implement CECL. Include with the ALLL comments in the report.

SUMMARY OF FINDINGS

#2-ALLOWANCE FOR LOAN AND LEASE LOSSES

Describe all strengths evident from the evaluation.
Describe all weaknesses evident from evaluation, including violations of law/regulation/rules; noncompliance with Departmental policies/guidelines; internal policy deficiencies/ noncompliance; internal control weaknesses; MIS problems; and deficiencies in management supervision.
Determine why weaknesses exist and comment on management's response and plan of action. Identify bank personnel making the response.
SUMMARY RATING ASSIGNED: Choose an item.

Provide copy of this page to EIC/AEIC. Receipt and review of this form by the EIC/AEIC will be evidenced by his/her initials in the appropriate column for this procedure on the SCOPE FORM.

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APPENDIX

Account Balance and Activity

The following are some examples of unusual activity which may require additional investigation:

- Large Items
- Reversal Entries
- Large charge-offs and/or recoveries in the 1st quarter of the year
- Specific types of loans with high charge-off rates
- Originating officers with high charge-off rates
- Charge-offs within 12 months of origination date
- Directors, officers, employees, or principal shareholders and related party (i.e. relative or business) with a charge-off
- Negative provisions to the ALLL account
- Accruals or credits not debited thru provision expense account
- Fast recoveries (within 30 days)
- Inappropriate expenses (i.e. ORE expenses, accrued interest, service charges)

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Methodology & Adequacy of Reserves

In determining the adequacy of the bank's methodology, consider the following:

1. Adequacy of policies and the Board's review/approval of the reserve account.
2. Compliance with the FFIEC's "Interagency Policy Statement on the ALLL" dated December 13, 2006 (FIL 105-2006) by considering:
    - Adequacy of specific reserve allocations
    - Adequacy of general reserve allocations (i.e. application of % reserves to both classified and non classified loans)
    - Exclusion of certain loans (i.e. CD secured or government guaranteed loans) from the general reserve
3. Compliance with FAS 5 - Accounting for Contingencies (FASB ASC Topic 450 –

Contingencies)

4. Compliance with FAS 114 – Accounting by Creditors for Impairment of a Loan (FASB ASC Topic 310 – Receivables)

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Loan Impairment

FDIC ALLL Decision Tree

alll decision tree.pdf

Call Report Glossary

"Loan Impairment" - The accounting standard for impaired loans is ASC Topic 310, Receivables (formerly FASB Statement No. 114, "Accounting by Creditors for Impairment of a Loan," as amended). For further information, refer to ASC Topic 310.

Each institution is responsible for maintaining an allowance for loan and lease losses (allowance) at a level that is appropriate to cover estimated credit losses in its entire portfolio of loans and leases held for investment, i.e., loans and leases that the bank has the intent and ability to hold for the foreseeable future or until maturity or payoff. ASC Topic 310 sets forth measurement methods for estimating the portion of the overall allowance for loan and lease losses attributable to individually impaired loans. For the remainder of the portfolio, an appropriate allowance must be maintained in accordance with ASC Subtopic 450-20, Contingencies – Loss Contingencies (formerly FASB Statement No. 5, "Accounting for Contingencies"). For comprehensive guidance on the maintenance of an appropriate allowance, banks should refer to the *Interagency Policy Statement on the Allowance for Loan and Lease Losses* dated December 13, 2006, and the Glossary entry for "allowance for loan and lease losses." National banks should also refer to the Office of the Comptroller of the Currency's Handbook for National Bank Examiners discussing the allowance for loan and lease losses.

In general, loans are impaired under ASC Topic 310 when, based on current information and events, it is probable that an institution will be unable to collect all amounts due (i.e., both principal and interest) according to the contractual terms of the original loan agreement. An institution should apply its normal loan review procedures when identifying loans to be individually evaluated for impairment under ASC Topic 310. When an individually evaluated loan is deemed impaired under ASC Topic 310 and is not collateral dependent, an institution must measure impairment using the present value of expected future cash flows discounted at the loan's effective interest rate (i.e., the contractual interest rate adjusted for any net deferred loan fees or costs, premium, or discount existing at the origination or acquisition of the loan), except that as a practical expedient, an institution may measure impairment based on a loan's observable market price. As discussed in the following paragraph, the agencies require the impairment of an impaired collateral dependent loan to be measured using the fair value of collateral method. A loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral and there are no other available and reliable sources of repayment. A creditor should consider estimated costs to sell, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the measure of an impaired loan is less than the recorded investment in the loan, an impairment should be recognized by creating an allowance for estimated credit losses for the impaired loan or by adjusting an existing allowance with a corresponding charge or credit to "Provision for loan and lease losses."

For purposes of the Reports of Condition and Income, the impairment of an impaired collateral dependent loan must be measured using the fair value of collateral method. In general, any portion of the recorded investment in an impaired collateral dependent loan (including recorded accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral (less estimated costs to sell, if applicable) that can be identified as uncollectible should be promptly charged off against the allowance for loan and lease losses. An institution should not provide an additional allowance for estimated credit losses on an individually impaired loan over and above what is specified by ASC Topic 310. The allowance established under ASC Topic 310 should take into consideration all available information existing as of the Call Report date that indicates that it is probable that a loan has been impaired. All available information would include existing environmental factors such as industry, geographical, economic, and political factors that affect collectability. ASC Topic 310 also addresses the accounting by creditors for all loans that are restructured in troubled debt restructurings involving a modification of terms, except loans that are measured at fair value or the lower of cost or fair value. According to ASC Topic 310, all loans restructured in troubled debt restructurings are impaired loans. For guidance on troubled debt restructurings, see the Glossary entry for "troubled debt restructurings."

As with all other loans, all impaired loans should be reported as past due or nonaccrual loans in Schedule RC-N in accordance with the schedule's instructions. A loan identified as impaired is one for which it is probable that the institution will be unable to collect all principal and interest amounts due according to the contractual terms of the original loan agreement. Therefore, a loan that is not already in nonaccrual status when it is first identified as impaired will normally meet the criteria for placement in nonaccrual status at that time. Exceptions may arise when a loan not previously in nonaccrual status is identified as impaired because its terms have been modified in a troubled debt restructuring, but the borrower's sustained historical repayment performance for a reasonable time prior to the restructuring is consistent with the modified terms of the loan and the loan is reasonably assured of repayment (of principal and interest) and of performance in accordance with its modified terms. This determination must be supported by a current, well documented credit evaluation of the borrower's financial condition and prospects for repayment under the revised terms. Exceptions may also arise for those purchased credit-impaired loans for which the criteria for accrual of income under the interest method are met as specified in ASC Subtopic 310-30, Receivables – Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, "Accounting for Certain Loans or Debt Securities Acquired in a Transfer"). Any cash payments received on impaired loans in nonaccrual status should be reported in accordance with the criteria for the cash basis recognition of income in the Glossary entry for "nonaccrual status." For further guidance, see the Glossary entries for "nonaccrual status" and "purchased credit-impaired loans and debt securities."

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