GRAPPLING WITH RESERVES

by Steve Brown

Ninja's often use grappling hooks to climb tall walls and sneak into places. In December 2006, the banking regulators threw grappling hooks over the walls of community banks and released a revised joint policy statement on the allowance for loan and lease losses ("ALLL"). ALLL, as we all know, is an accounting estimate of probable (but unconfirmed) asset impairment that has occurred in the loan portfolio as of a given financial statement date. A loss is considered confirmed when information available before the financial statement date indicates a loan (or portion of a loan) will become uncollectible.

The change in regulatory guidance was significant in many ways, but not the least of which was the elimination of the reference to the reasonableness test. Recall that in the old days, bankers used to test ALLL for reasonableness along the lines of 15% for substandard and 50% for doubtful. The change was made to ensure bankers used institution specific amounts and moved away from standardized loss percentages.

It is clear that this change and others incorporated within the new policy statement pointed to a shift in the regulatory landscape. Gone were the days of standardized ALLL thresholds, replaced by a concerted regulatory effort to get bank management to focus attention on developing a better estimate of credit losses in the loan portfolio that is consistent with GAAP. Regulators want community banks to take both internal and external factors into consideration that could affect loan collectability, as well as the impact on the overall portfolio. Risk management is "in" and standardization is "out."

In simple terms, regulators want banks to do a better job of documenting how they came up with the allowance. As bankers know, determining ALLL is imprecise by nature and involves setting more of a range of estimated losses than deriving a single number. That said, regulators want to know what factors went into the calculation and where those factors came from. Judgment still remains, but statistical analysis is emphasized.

The goal of the new policy statement is to give community banks reinforcement that the appropriate way to calculate ALLL is by basing it on relevant, comprehensive and well-documented analysis consistent with GAAP rules. The entire loan portfolio should be incorporated into the analysis and the metrics must be consistently applied. Analysis should include pertinent and relevant information regarding portfolio performance and the lending environment; including economic expectations, industry, sector, geographic and other trends. The key is to convert historical bank experience into a view that reflects both current economic and loan performance conditions. In so doing, bankers will create a more robust framework of analysis, while considering relevant factors that could impact potential losses.

Regulators are clear that they want banks to follow GAAP. While everyone knows conflicts can occur from time to time, properly documented ALLL is critical. As documentation is increased, methodologies must also remain reasonable and they must include support as required. In short, segmentation of the portfolio based on risk characteristics is a good starting point, but bankers should understand that merely "sorting" by type isn't enough and further analysis is required.

To ensure your bank is adhering to the new policy statement, we suggest improved documentation and estimation of credit losses on both individually impaired loans; as well as within groups that have similar risk characteristics. In addition, banks should adjust ALLL for relevant qualitative and environmental factors that could impact credit quality. Finally, banks should develop, maintain and document a comprehensive, systematic and consistently applied process to ALLL. Prompt charge-offs, effective loan reviews and directionally-correct reserve changes will be expected.

No matter what you think of the new ALLL policy statement, grappling with it sooner rather than later and ramping up the documentation process cannot hurt.

BANK NEWS

Mobile Promotion

US Bank, MasterCard and Nokia have teamed up and introduced a mobile payment program to be piloted in Spokane, WA. Customers of US Bank will receive free Nokia cell phones equipped with mobile banking software and MasterCard's "Paypass."

ATMs

JPMorgan Chase is promoting "ATM Quick Choice." The feature allows customers to set their screen and amount preferences online. The customized and personalized ATM screen is designed to speed up transactions.

Subprime Probe

The FBI is probing 14 companies (all unidentified) for accounting fraud, securitization pricing and insider trading related to subprime mortgage origination.