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Allowance for Loan and Lease Losses Is Your ALLL Adequate?

When it comes to assessing the adequacy of their allowance for loan and lease losses (ALLL), many bankers feel like they're stuck between a rock and a hard place.

The problem is that not everyone is in agreement about exactly what determines "adequacy" and how to assess it. On one side are bank regulators, who have issued guidance on at least three occasions — most recently via the Interagency Policy Statement on the ALLL, or SR 06-17, in December 2006. Regulators have steadfastly maintained that banks' ALLL reserves should not be shrinking, especially during this time of credit market turmoil.

Banks' accountants, meanwhile, continue to use FAS 5 and FAS 114 as their rulebook for assessing ALLL adequacy. FAS 5 provides guidance on loss estimation for groups of smaller or homogeneous loans, while FAS 114 provides guidance on loan estimation and disclosure for individually reviewed loans that are considered impaired. In theory, SR 06-17 finally put everyone on the same page — but bankers can be forgiven if they feel otherwise.

In today's difficult credit and economic environment, the challenge can be



summed up as thus: How can you create an ALLL methodology that will satisfy both the regulators and your accountants — one that is well-defined and adequately supported by documentation? An enhanced ALLL methodology will also give you a better understanding of the credit risk within your loan portfolio.

Segmenting Your Portfolio

One of the best ways to achieve such a methodology is to segment your loan portfolio. This can be done in many different ways — by line of business, product type, geographic region, risk concentration or risk rating, to name a few. Ideally, a portfolio should be segmented by both loan type and asset quality rating (AQR).

AQR has long been used by banks to help manage their portfolio risk.

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How to Segment by AQR

As our lead article in this issue notes, one of the best ways to create a methodology for assessing the adequacy of your bank's allowance for loan and lease losses (ALLL) is to segment your loan portfolio by asset quality rating, or AQR. Most banks, especially community banks, have historically segmented their loan portfolios by line of business. While this is still adequate for smaller loans of \$150,000 or less, it is insufficient in today's credit environment for larger credits. There are two primary keys to successfully segmenting your portfolio by AQR:

1. There must be sufficient levels of granularity in your AQR framework.
2. You must preserve the integrity of your AQRs by ensuring that they are timely and accurately assigned.

Granularity in Your AQR Framework

"Granularity" simply refers to the number of categories in your AQR framework. Historically, many community banks simply used one broad "pass" category for minimal and acceptable risk loans, and the four standard regulatory categories of "special mention," "substandard," "doubtful" and "loss" for weak and potentially weak credits. However, such limited granularity does not help you differentiate between degrees of "good" – and thus distinguish between substantially risk-free loans and loans that are just marginally acceptable.

Adding granularity to the AQR framework typically involves breaking a single broad "pass" category into at least three (or as

many as 15 for larger banks) sub-categories of rankings. These rankings will usually be on a scale of 1 (signifying a substantially risk-free loan) to perhaps 6 (signifying the highest acceptable risk for a "pass" loan) for a community bank. In between would be categories of varying risk, such as "minimal," "modest" and "average" risk, each denoted by a number ranking of 2 to 5. Gauging the migration (or actual historical experience) of your AQR distribution – or how the distribution and risk level have changed over time – can help you determine the adequacy of your ALLL. For example, how many loans that started out as 3s became 4s, 5s or eventually defaulted? If your overall portfolio has shifted from lower to higher numbers, there may be the potential for significant problems if the portfolio is stressed.

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Wolf Banking Team Profiles

In the Spotlight



Kathy Dearborn

Our banking team includes three partners who lead professional staff with a variety of expertise and skills. They are experienced in providing audit and tax services, as well as other business advisory services, to banks. We would like you to get to know our team, so in select issues of our newsletter we will highlight one of our members.

Kathy Dearborn is a staff accountant in Audit and Accounting Services at Wolf & Company LLP. She received her Bachelor of Science in Accounting and Master of Business Administration degrees from Northern Illinois University. She is experienced in public accounting focusing on audits and reviews of annual financial statements. Some of her responsibilities include performing financial and compliance audit procedures and audit analysis. She has served clients in the banking, construction, manufacturing, governmental and not-for-profit industries.

Kathy is a proud Northern Illinois University athletics fan and a four-time varsity letter winner in softball at NIU. Some of her achievements include *Rookie of the Year* and *First Team All-Conference* awards.

The keys to using AQRs effectively are ensuring timely and accurate assignment of AQRs and sufficient levels of “granularity” within the AQR framework — or in other words, making sure there is an adequate number of categories in the framework. See page 2 for a detailed discussion of AQR granularity.

The next step is to incorporate environmental and qualitative factors into your methodology. What is the current economic environment in your local market? How might this impact your loan portfolio specifically? Do you have heavy concentrations of loans (and exposure) in specific industries that might pose unusually high risk right now (like residential and/or commercial real estate, for example)?

Determining Loss Rates

Determining actual historical loss rates is a critical part of any ALLL analysis. How these determinations are made can vary widely, from simply calculating averages to conducting loss migration analysis.

Both the regulators and accountants expect banks to use their own loss history in determining loss rates to be used as a basis for determining ALLL adequacy; however, this may not be possible if your bank or a loan product is new or if you have inadequate systems for determining losses accurately. In this case, it’s acceptable to use peer or industry data (e.g., RiskCalc), but you must demonstrate that the attributes and characteristics of your loans are similar to the proxy loan group.

It’s important to note that in today’s credit environment, considering recent historical performance only will likely result in very low loss rates that may not accurately represent the true credit risk. Environmental factors should play a significant role if an appropriate

ALLL level is to be determined. Credit risk may be increasing today for a number of different reasons: lowered underwriting standards, heavy concentrations in some loan products (e.g., commercial real estate) and the current credit market turmoil in general, to name a few. So in addition to examining historical loss rates, you must determine if the risk in your current portfolio will result in losses consistent with, or perhaps higher than, your historical losses. This may happen due to:

- Levels and trends in delinquencies, impaired loans, charge-offs and recoveries.
- Trends in loan volume and terms.
- Effects of changes in risk selection, underwriting practices and credit concentrations.
- Bank management’s lending ability and experience.
- Economic and industry trends and conditions, both national and local.

Environmental factors will be a key to determining how estimated losses may differ from historical ones (see sidebar).

An Inexact Estimate

By its very nature, the ALLL will be an inexact estimate (hence, the term “allowance” for loan and lease losses), which makes a high degree of judgment by lenders critical. Both regulatory guidelines and GAAP require banks to record their best estimate within a range of estimated losses.

In an article in the February 2007 issue of *The RMA Journal*, bank examiner Doreen Ledbetter notes that many banks are

“moving toward more precision by using models and quantifying the environmental factors that result in one final number without considering a range of possible loss estimates.”

While this approach makes it easier to determine the ALLL for financial reporting purposes, it doesn’t account for the fact that actual losses may be different from estimated losses, resulting in the need for further analysis. “Furthermore, it limits the use of management’s judgment, which is an important part of analyzing the ALLL. The use of a range of loss allows a bank to use

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Guidance on Environmental Factors

The Interagency Policy Statement on ALLL Methodologies and Documentation for Banks and Savings Institutions (SR 01-17) from July 2, 2001, offers guidelines for using the environmental factors that should be considered as part of your ALLL methodology analysis. It offers documentation guidance on:

- Policies and procedures
- Methodology
- ALLL under FAS 114 and FAS 5
- Consolidation of ALLL balance
- Validation of the methodology

In addition, the statement provides a number of technical Q&As and guidelines for application of GAAP, including a description of applicable GAAP, interaction with FAS 114 and loans with a split classification, and inappropriate layering of losses.



BANKING BRIEFS

Adding Value: Mature and Aging Businesses

In the last two issues of Community Banking, we have discussed the role of the lender in the various life stages of a business. In this final article in the series, we take a close look at appropriate product and service recommendations for mature and aging businesses.

The most important factor for owners of mature and aging businesses is to begin planning for ownership and management succession. This is not a product or service offering per se; however, it's critical for bankers to be involved in this process by building relationships with successor owners and managers. Otherwise, you could find yourself on the outside looking in when the successors take over.

You can offer financing options to help owners facilitate succession. These may include LBOs, ESOPs, commercial paper, alternative pricing (e.g., LIBOR, Treasuries), and acquisition financing, as well

as key-person insurance to help facilitate the structure of buy-sell agreements. Other product and service recommendations that may be appropriate for mature and aging businesses:

- Wealth management and private banking – These fee-based services targeted to high-net-worth customers can provide a big boost to your bank's revenue and earnings. Affluent customers, including business owners, will often pay a premium for personalized, high-touch service from their bank.
- Estate planning and investment services – Business owners and high-net-worth customers are prime candidates for sophisticated (and profitable) services like various kinds of trusts (revocable, irrevocable, charitable remainder, Directed Dynasty), asset management accounts, buy-sell agreements and alternative investments.

- Retirement plans – Qualified retirement plans, like 401(k)s and SIMPLE plans, are a win-win: They enable employers to offer a valuable benefit while helping employees save for their financial future. Both employers and employees may receive deductions for their contributions to qualified plans as well. ■

Allowance for Loan and Lease Losses

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management's judgment in determining the best estimate within the range," Ledbetter concludes.

Finally, when using a range of loss, management must provide adequate documentation to support allowance estimates, demonstrating that the estimates are based on an analysis that is comprehensive, well-documented and consistently applied.

Regulatory guidance allows the level of documentation to match

each bank's size and complexity; however, Ledbetter notes that it's not necessarily the volume of documentation that's important, but rather the linking of comments directly to the analysis. Or in other words, "It's the quality, not the quantity, of the documentation that counts," she says. ■

If you have questions or would like more information, please contact Tim Johnson at 630-545-4594.

How to Segment by AQR

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Timely and Accurate Assignment

The responsibility for accurately assigning, monitoring and, when necessary, changing AQRs often rests with the lender. This makes it critical to build a culture that will encourage lenders to make timely and accurate AQR assignments. The fact is, lenders may be tempted to misgrade loans on the high or low side. For example, a lender might be tempted to call a 5-rated loan a 3 (thus understating the risk) to improve the chances of loan approval or lower the interest rate. Or conversely, the lender might be tempted to play it safe by calling a 3-rated loan a 5 (thus overstating the risk) to protect himself or herself should the loan go bad.

Lenders, in short, must be the gatekeepers responsible for making sure the right data is gathered and used for AQR assignments in the most effective manner possible. Therefore, you must provide adequate training and impose discipline on lenders to enforce accurate grading, perhaps penalizing lenders for exceeding a certain percentage of misgrades. ■



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