Allowance Documentation and Other Considerations

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Agenda

- Allowance Documentation – Best Practices
- Current Allowance Considerations
- Allowance and Asset Quality Trends
- Audit Considerations
- PPP

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Allowance Documentation – Authoritative Guidance

- U.S. Securities and Exchange Commission (SEC)
  - *Staff Accounting Bulletin 102*
  - *Staff Accounting Bulletin 119*

- Other Regulatory
  - *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions*
  - *Policy Statement on the Allowance for Loan and Lease Losses*
  - *Interagency Policy Statement on Allowances for Credit Losses*

Allowance Documentation Best Practices – ASC 450

- General allowance documentation
  - Rationale for loan pool groupings, those reviewed individually for impairment
  - How loss rates are determined and what factors are considered when establishing appropriate time frames over which to evaluate loss experience
  - Descriptions of qualitative factors
  - Copies of applicable supporting data
    - Economic charts
    - Concentration trend reports
    - Changes in staffing
    - Loan exceptions, etc.

Allowance Documentation Best Practices – ASC 450

- General allowance documentation
  - "For any adjustment of loss measurements for environmental factors, a registrant should maintain sufficient, objective evidence (a) to support the amount of the adjustment and (b) to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements."
    - Narrative discussion and supporting charts or other sources of data
    - Descriptions of any changes
    - Analysis of factor allocations over time
    - Analysis of how the current conditions compare to its previous loss experiences in similar circumstances

Allowance Documentation Best Practices – ASC 450

- Changes in/additions to qualitative factors
  - Process for determining the change
    - Minutes of meeting discussions
    - Change in the portfolio/supporting data which is related to the factor
  - Measurement of the new factor
    - Basis for the potential range of allocations to the factor
  - Disclosure, when significant

Allowance Documentation Best Practices – ASC 310

- Collateral-dependent loans
  - Documentation should ideally include:
    - Inputs to the calculation
      - Loan balance
      - Collateral value
      - Other discounts
    - How the fair value was determined
      - Appraisal
      - Assessment
      - Pricing quotes
      - Online resources (e.g., NADA)
    - Supporting rationale for
      - Adjustments to appraised values, if any
      - The determination of costs to sell, where applicable
        - » By property type
        - » Historical experience

Allowance Documentation Best Practices – ASC 310

- Collateral-dependent loans
  - Documentation should ideally also include assessments of the following:
    - Acceptability of the impairment method
    - Collateral value volatility
    - Reliability of the valuation, e.g., appraisal quality, and the expertise and independence of the appraiser
    - How recent a physical inspection of the property had been conducted
    - Assessment of the lien/security position
    - Historical losses on similar loans
    - Other factors as appropriate for the loan/collateral type

Allowance Documentation Best Practices – ASC 310

- Present value of expected future cash flows
  - Documentation should ideally include:
    - Balance
    - Amount and timing of cash flows
    - The effective interest rate used to discount the cash flows
    - The basis for the determination of cash flows
      - Current and past performance
      - Impact of the environment
    - Acceptability of the impairment method

Allowance Documentation Best Practices – Review

- Management review documentation
  - Agreement of loan balances to support
  - Agreement of loss history to support
  - Recalculation of historical loss factors
  - Assessment of qualitative factors, including changes
  - Individual review of inputs to/assessment of specific impairment calculations
  - Mathematical review
- Automated calculations should not discharge management of their responsibility to review the output and document their understanding of the Allowance calculation
  - Discuss approach
  - Availability of SOC report

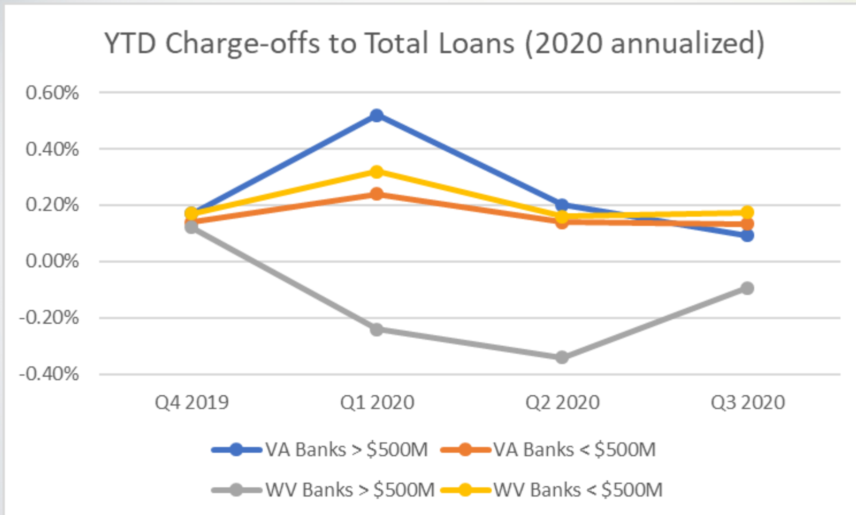
Current Allowance Considerations

- Significant uncertainty surrounding the impact of COVID-19 related to
  - The overall economy
  - Financial health of the institution's borrowers, particularly those in vulnerable industries
  - Impact on the value of collateral for collateral-dependent loans
- **Many community banking institutions are finding it difficult in an incurred loss model to account for the risk of probable losses inherent in the loan portfolio**, primarily resulting from the effects of short-term government intervention
  - PPP loans
  - CARES Act deferrals/modifications
  - Heightened unemployment benefits
  - Stimulus payments

Current Allowance Considerations

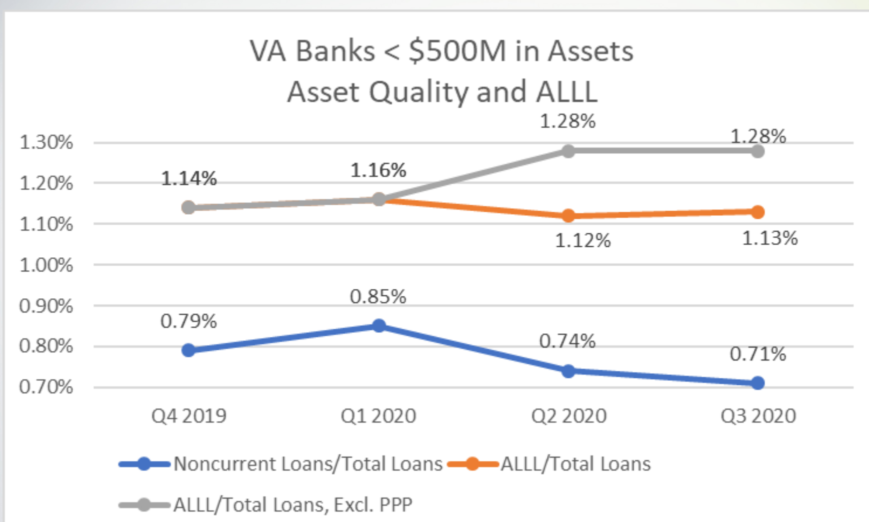
- Banks have several obstacles to accounting for the elevated risk of loss associated with the financial effects stemming from COVID-19
  - Lack of increases in negative credit quality indicators (e.g. past dues, charge-offs, TDRs, etc.)
  - Minimal historical losses currently captured by allowance model given recent credit cycle
  - Ranges of potential qualitative factor adjustments were last updated in an expanding economy
  - Too few levels employed in assessing the qualitative factors assigned (e.g. low, moderate, and high risk, when none, low, moderate, high, and very high risk might be more appropriate)
  - Already reached the top end of the range for certain qualitative factors in the current methodology (e.g. economic factors) with no room for adjustment if conditions deteriorate further

Allowance and Loss History (VA and WV Banks)



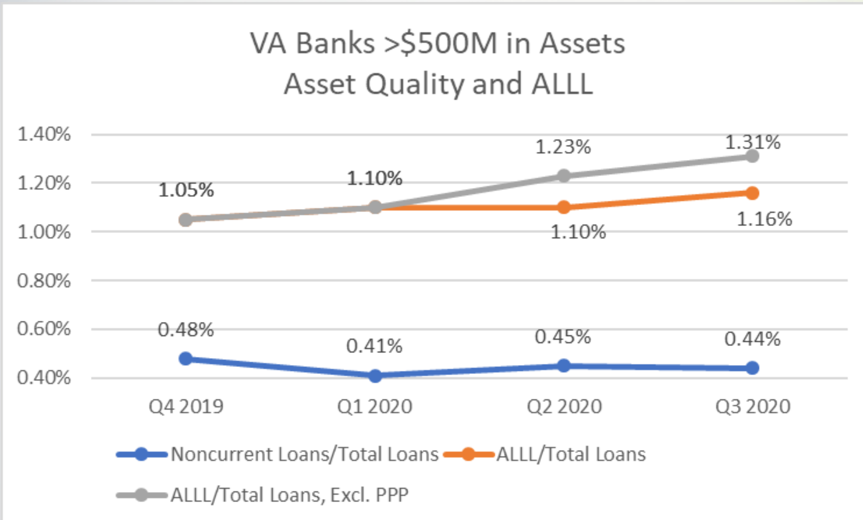
**Compiled based on FDIC data and excludes those subject to CECL.

Allowance and Credit Quality (VA Banks < $500 Million in Assets)



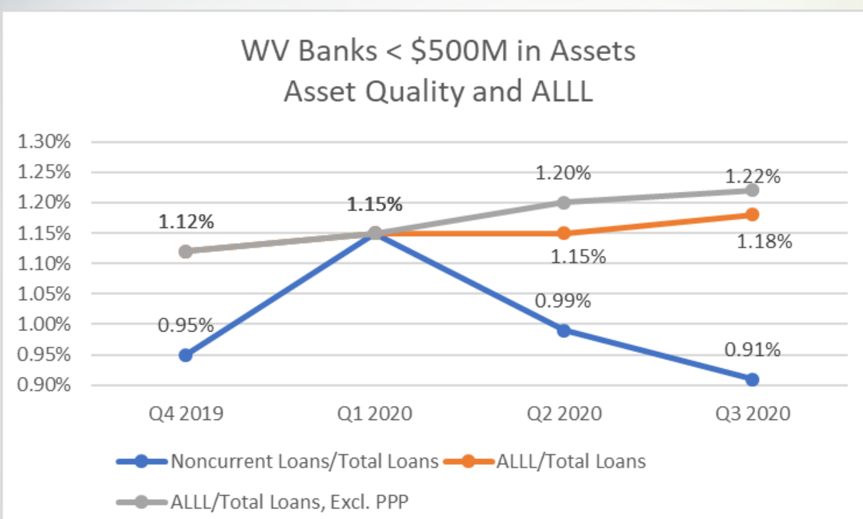
**Compiled based on FDIC data.

Allowance and Credit Quality (VA Banks > $500 Million in Assets)



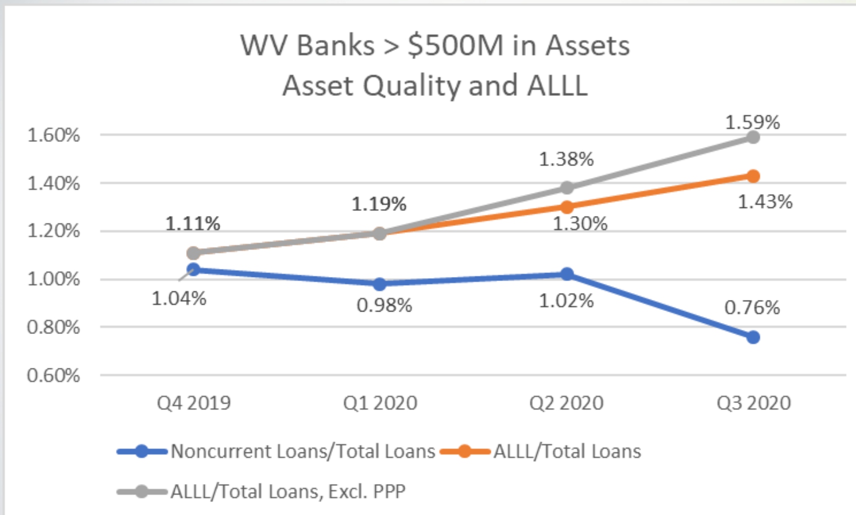
**Compiled based on FDIC data and excludes those subject to CECL.

Allowance and Credit Quality (WV Banks < $500 Million in Assets)



**Compiled based on FDIC data.

Allowance and Credit Quality (WV Banks < $500 Million in Assets)



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Audit Considerations – Qualitative Factors

- Questions to ask concerning the allowance and COVID-19
  - Is the current level or range of potential basis points assigned to each qualitative factor reasonable based on prior experience and underlying data, specifically, in light of current circumstances?
  - Is there sufficient documentation available to support the rationale for the level of qualitative factors assessed?
  - Does the institution's methodology for assessing qualitative factors lend itself to a more subjective or objective/mathematical approach?
  - Could the institution benefit from a more grid-like approach employed through objectively defined ranges to determine qualitative allocations?
  - Can the institution's qualitative adjustments and the need for changes in those adjustments be sufficiently explained in press releases or regulatory filings, etc.?
  - Overall, are the institution's qualitative allocations appropriate?

Audit Considerations – Qualitative Factors

- Things to consider
  - Does historical data in similar economic cycles provide a basis for the level of qualitative factors assessed
  - Peer assessment
    - Similar banks with exposures to vulnerable industries – many others have disclosed
    - Similar loan portfolios
  - Subjectivity of the methods for allocating qualitative factors
    - Ranges
    - Scales
    - Grid-like approach

Audit Considerations – Qualitative Factors

- Things to consider
  - Analysis of the supporting narrative
    - Sufficiently detailed
      - Why the identified factors are appropriate to adjust historical losses
      - Why the allocation selected is appropriate
    - Focused on comparing Q factors across the appropriate periods
      - Current year end vs. prior year end
      - Not just current quarter vs. prior quarter

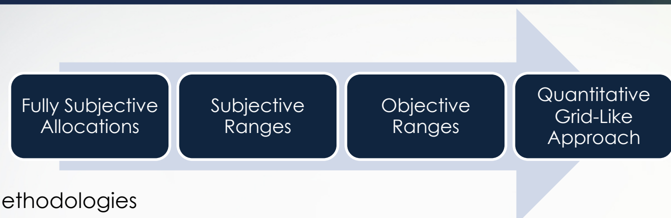
Audit Considerations – Qualitative Factors

- Things to consider
  - Changes in factors
    - Increases may be appropriate
      - » Concentrations (high risk industries)
      - » Economic factors
      - » Value of underlying collateral (possible commercial)
      - » Loans on deferral
      - » Personnel – experience in navigating a recessionary period
      - » Other
    - Changes in basis point ranges
      - » Based on qualitative ranges from recessionary periods
      - » Based on historical losses from recessionary periods
      - » Banks with no loss or limited loss history could consider peer data

Audit Considerations – Impact of COVID

- Things to watch out for
  - Accounting for COVID-19 uncertainty in a blanket COVID-19 qualitative factor that is not supported by underlying data
  - Factors added that are completely subjective and/or not easily adjusted based on underlying data
  - Significant unallocated balances

Audit Considerations – Qualitative Factors



- Qualitative factor methodologies
  - Fully-subjective allocations – Basis point allocations for qualitative factors assigned solely on the basis of management determination with no defined ranges for factors to be assessed.
  - Subjective ranges – Ranges for potential basis point adjustments have been established (e.g. 0-20 basis points); however, the range is not determined using objective data.
  - Objective ranges – Determined on the basis of underlying data (e.g. 0-15 basis points for each of the 9 qualitative factors). Total maximum of 135 basis points represents the institution's aggregate loss rate for the particular loan pool during the most recent downturn.
  - Quantitative grid-like approach – Range of factors assessed are first determined on the basis of underlying data and basis points assessed are assigned based on where the underlying metric falls along the scale (e.g. scale dictates 20 basis points for 5%-6% unemployment; 15 basis points for concentrations of credit that are between 75-100% of capital).
- Industry is migrating toward more quantitative grid-like models

Audit Considerations – Specific Impairment

- Collateral-Dependent Loans
  - Volumes remain relatively low
  - Not many changes in composition over the last several quarters
- Things to consider
  - Recency of underlying appraisals, particularly for commercial properties
  - Knowledge of recent appraisal values (for other properties)
  - Further inquiries to determine
    - Extent of any changes in lease status for non-owner occupied properties
    - Rent concessions which may call into question appraisal conclusions

Audit Considerations – Specific Impairment

- Loans measured using the present value of expected future cash flows
  - Most are performing troubled debt restructurings (TDRs)
  - Again, not a lot of new TDRs or loans measured using this method over the last several quarters
- Things to watch for
  - Calculations with no commentary as to appropriateness of the method (i.e. why cash flows is more appropriate than collateral)
  - Recency of financial information
  - Other items which may indicate changes in the borrower's ability to perform
    - Declining deposit account balances
    - Complete or partial shutdown of business
  - Modifications to loan structures

Audit Considerations – Validation

- Regulatory guidance prescribes at a minimum, periodic validation of allowance models[1]
  - Generally conducted annually
    - Internal audit
    - External audit (subject to applicable independence standards)
- Should be performed by parties unrelated to the process
  - Not responsible for development
  - Do not have an interest in whether the model proves to be valid
- Additional processes which contribute to the allowance should be included in the testing

[1]Interagency Policy Statement on the Allowance for Loan and Lease Losses; Interagency Policy Statement on Allowances for Credit Losses

Audit Considerations – Validation

- Primary areas of focus for allowance model validations
  - Accuracy and appropriateness of
    - Loan segmentation
    - Historical look-back period
    - Underlying charge-off data
  - Qualitative factors
    - Selection of qualitative factors
    - Documentation for allocation ranges, current allocations, and changes from the prior period
  - Impairment methodology
  - Impairment testing
    - Accuracy of inputs/calculations
    - Valuations

Audit Considerations – Validation

- Primary areas of focus for allowance model validations
  - Other model mechanics
    - Migration analysis
    - Probability of default, loss given default
    - Loss emergence period
    - Other
  - Management and Board review
    - Depth of review documentation
      - Checklists, memorandums
    - Formal policies for the allowance
    - If an outsourced model, service auditor report review
  - Access to the calculation and personnel charged with preparation/review

Audit Considerations – Validation

- Other processes that should be considered for inclusion
  - Approval of loan charge-offs
  - Completeness of nonaccrual loans
  - Accuracy of loan risk ratings
    - Problem loan identification meetings/mechanisms
    - Loan review
      - Loans with recommended rating changes
      - Sufficiency of loans sampled
      - Timing
    - Examinations
      - Loans with recommended rating changes

Audit Considerations – Validation

- Other processes that should be considered for inclusion
  - Proper accounting for TDRs
    - COVID related modification process
  - Interaction of the allowance with acquired loans
    - Acquired impaired
    - Acquired performing

PPP Loans and the Allowance

- PPP loans
  - No allowance in most cases, unless a reason to believe the SBA guarantee is in jeopardy
  - Account for the risk of loss for errors and omissions only
    - Has the bank reviewed its PPP origination process?
  - An allowance would be necessary in any case where the lender incurs losses (e.g. for violations of SBA required practices)

- Regulatory guidance on PPP loans and the allowance
  - FDIC FAQ https://www.fdic.gov/coronavirus/smallbusiness/faq-sb.pdf
  - FRB FAQ https://www.federalreserve.gov/covid-19-supervisory-regulatory-faqs.htm