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Focus: Managing Troubled Assets

ALLL: How to Know When You Have Enough

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It wasn't that long ago that if your Allowance for Loan and Lease Losses (ALLL) was at or close to 1.25% of gross loans, you were fine. Most banks' charge-offs had been negligible for years, the credit scourge had yet to hit, and examiners' attention was elsewhere.

That 1.25% is history. This reflects generalized credit pressures and the wide dispersion between banks' circumstances. As a result, ALLL coverage of non-performing assets (or some other indicator of credit quality) is now the more relevant measure. A variant of this is the Texas ratio, called so because of its correlation with the failure rate among Texas banks in the 1980s. It's measured as NPA plus OREO, divided by ALLL plus Common Equity. If over 100%, the likelihood of failure has been found to rise materially.

So, there we have one type of benchmark. But as anyone who tackles ALLL calculations knows, there's a lot more to it than that. Here are a few suggestions – not so much for ensuring compliance with the 2006 Interagency Guidance on ALLL (though that certainly ties in with it) as for gaining management and board comfort that you've reserved prudently against possible losses to come.

- It's not just levels of problem assets – it's trends. Look at your last few quarters of NPAs (= non-accruals plus over 90-day past dues) and where they're heading. Look at the trend in your delinquents (= anything over 30 days) as a leading indicator of NPAs. And look at migration analysis, which should include pass grades. For instance, evidence of downgrade trends from stronger to weaker pass grades is very relevant information, suggestive of potential future credit problems.
- Charge-offs: Keep in mind that these don't hit income directly, just the ALLL. If you've decided to recognize losses, then your ALLL will be depleted. Whether you need to replenish it depends on whether the charge-offs were a "clean-up" to get the house in order, or just a first crack at a bigger problem. Another scenario: Banks that find themselves capital constrained may try to delay full and immediate recognition of losses. If a bank is sitting on any pipeline of credit losses still to be put through, forget about loss factors and impairment testing; they should be provided for dollar-for-dollar in the ALLL.
- SFAS 114: There's good reason for the scrutiny examiners now pay to specific reserves. Given the preponderance of real estate loans in banks' problem loan portfolios, fair value of collateral becomes the key metric for impairment testing. With many markets still seeing month-over-month declines in real estate values, having even a six-month old appraisal can be dangerously misleading, especially if it shows a collateral cushion of only 5-10%. Conduct an in-house evaluation process to realistically mark down such appraisals. Integrate broker feedback, market data, and any other outside perspectives available. Remember that these are the loans that can really dent your reserves.
- Check your peers. Compare ALLL coverage ratios and credit quality measures against your UBPR (Uniform Bank Performance Reporting) peer group. But keep in mind that those groups are large and not homogeneous. It's also worth collecting data on a customized group of institutions you consider more directly comparable in terms of geography, asset size, lending focus, etc., especially if you have a more specialized niche. However, keep in mind that, depending on how you select

that group, you may end up comparing yourself against a sub-par group…and drawing conclusions accordingly.

- How much capital are you holding? From a theoretical viewpoint, loss reserves are held against expected losses, which represent long-run average loss experience. Capital is there to protect against unexpected losses, which reflect variability and co-variability in loss experience (i.e., the possibility of losses exceeding their long-run average in any given year…like a recession year). From a regulatory capital viewpoint, there's direct substitutability between them, with the ALLL counted (though not in full) in Tier 2 capital. Relatedly, from a more practical viewpoint, loss provisioning to (re)build ALLL is a direct hit to income, and therefore, to capital. The message: The higher your capital ratios, the less pressing the need for additional loss reserves.
- 2006 Interagency Guidance on the ALLL: Don't assume that regulatory guidance is only there to create more work for you. The biggest change in 2006 from previous statements are the nine Qualitative & Environmental Factors. They're not obviously or easily quantified for incorporation into your ALLL methodology. But they are questions you should be asking. Have you hired or lost staff with the work-out experience this environment requires? Have you made changes to your loan review program? And so on.

For management and governance purposes as much as for regulatory requirements, it's important to create a comprehensive package each quarter-end to support and substantiate the recommended ALLL amount. We see wide variability in the quality of those packages. Judging ALLL adequacy is certainly more art than science, but even an art has its disciplines.

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