Allowance for Loan and Lease Losses

(ALLL)*

The views and opinions expressed are those of the presenter and are not necessarily those of the Federal Reserve Bank of Atlanta or the Board of Governors of the Federal Reserve System.

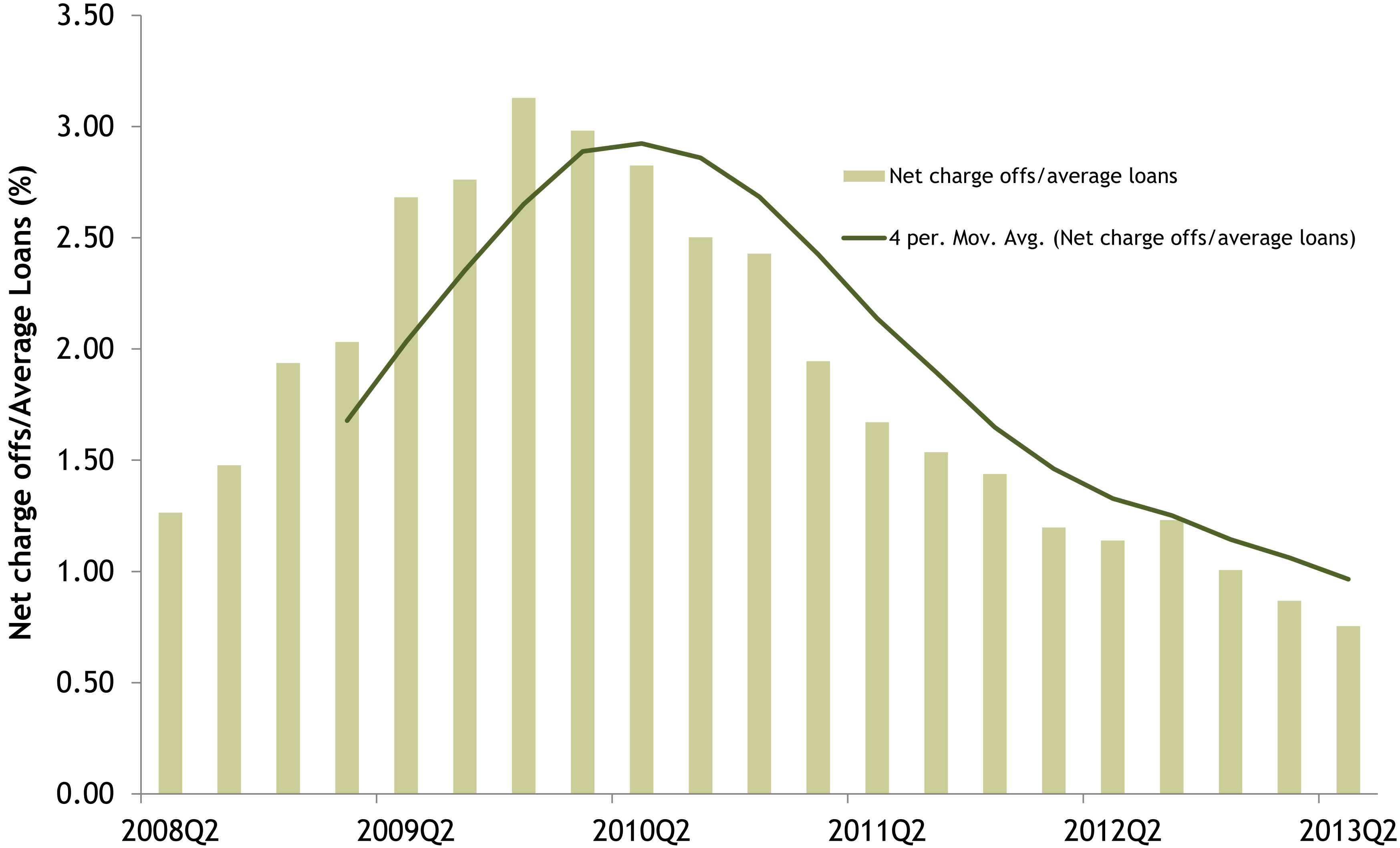
Agenda

- Key observations during the financial crisis
- What are the current conditions out in the field
- Key asset quality indicators
- Exam related issues
- Proposed changes to the ALLL

- Key Observations During the Financial Crisis
  - ALLL levels not commensurate with the overall risk in the portfolio
  - Charge offs over a short compressed timeframe
  - Provision requirements led to a significant erosion of capital and in some cases bank failures

- What are the Current Conditions Out in the Field?
  - Improving economic indicators leading to a reduction in past due and nonaccrual loans
  - Charge offs have reduced significantly
  - Minimal provision requirements and in some cases reverse provisions.

National Charge-off Ratio

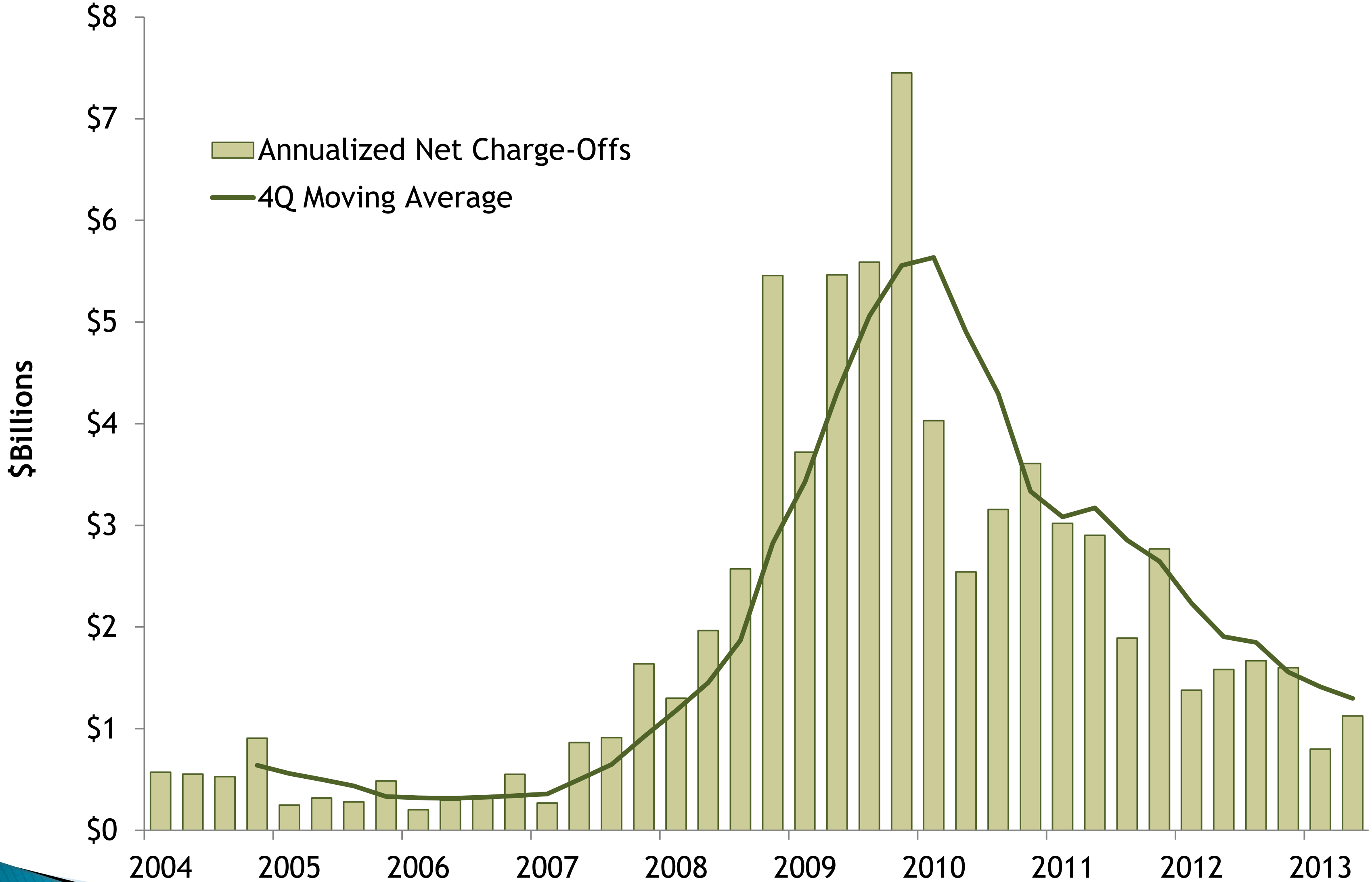


Source: Bank Call Reports

National Nonperforming Assets

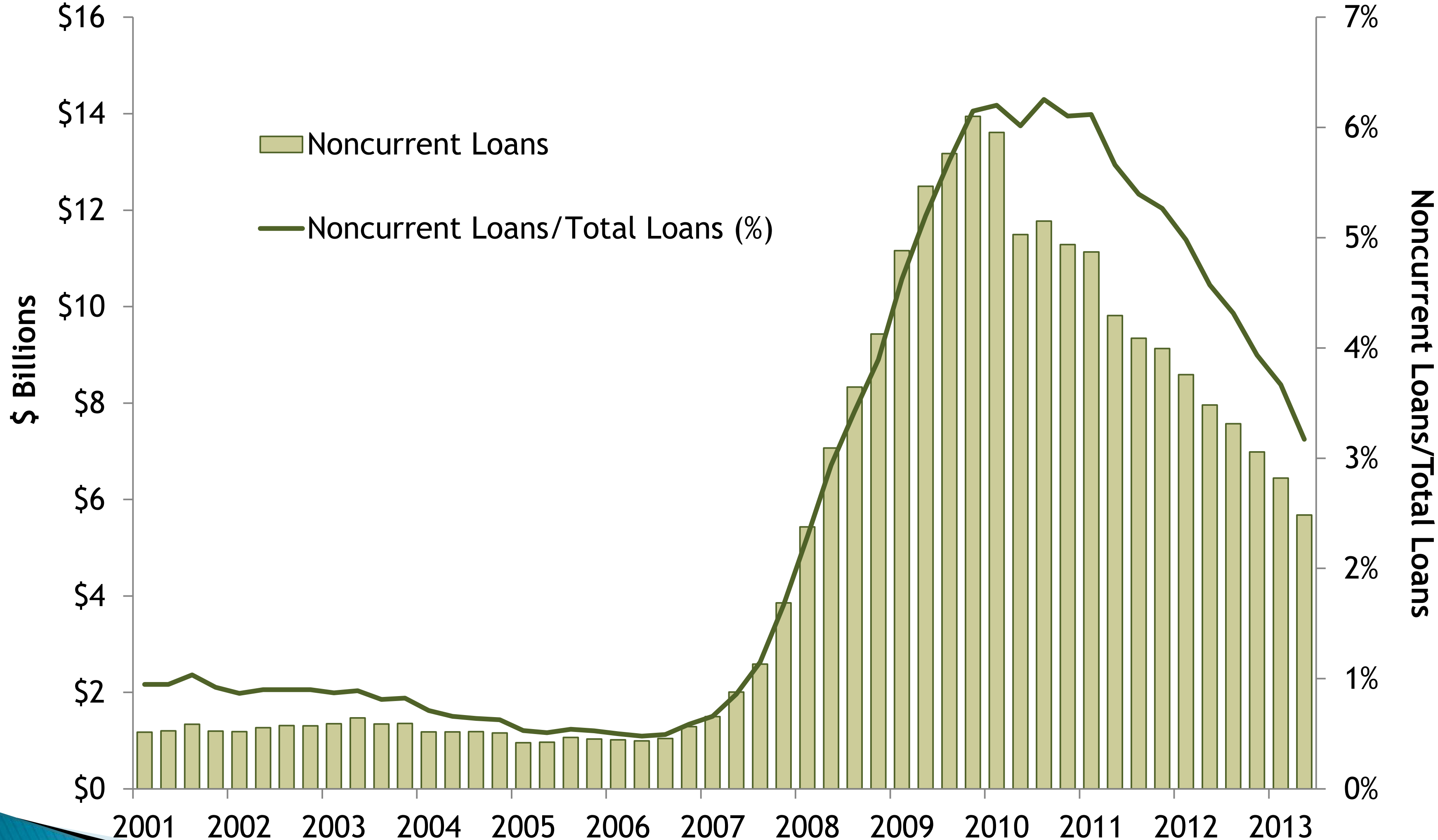
Source: Bank Call Reports

Sixth District Net Charge-Offs



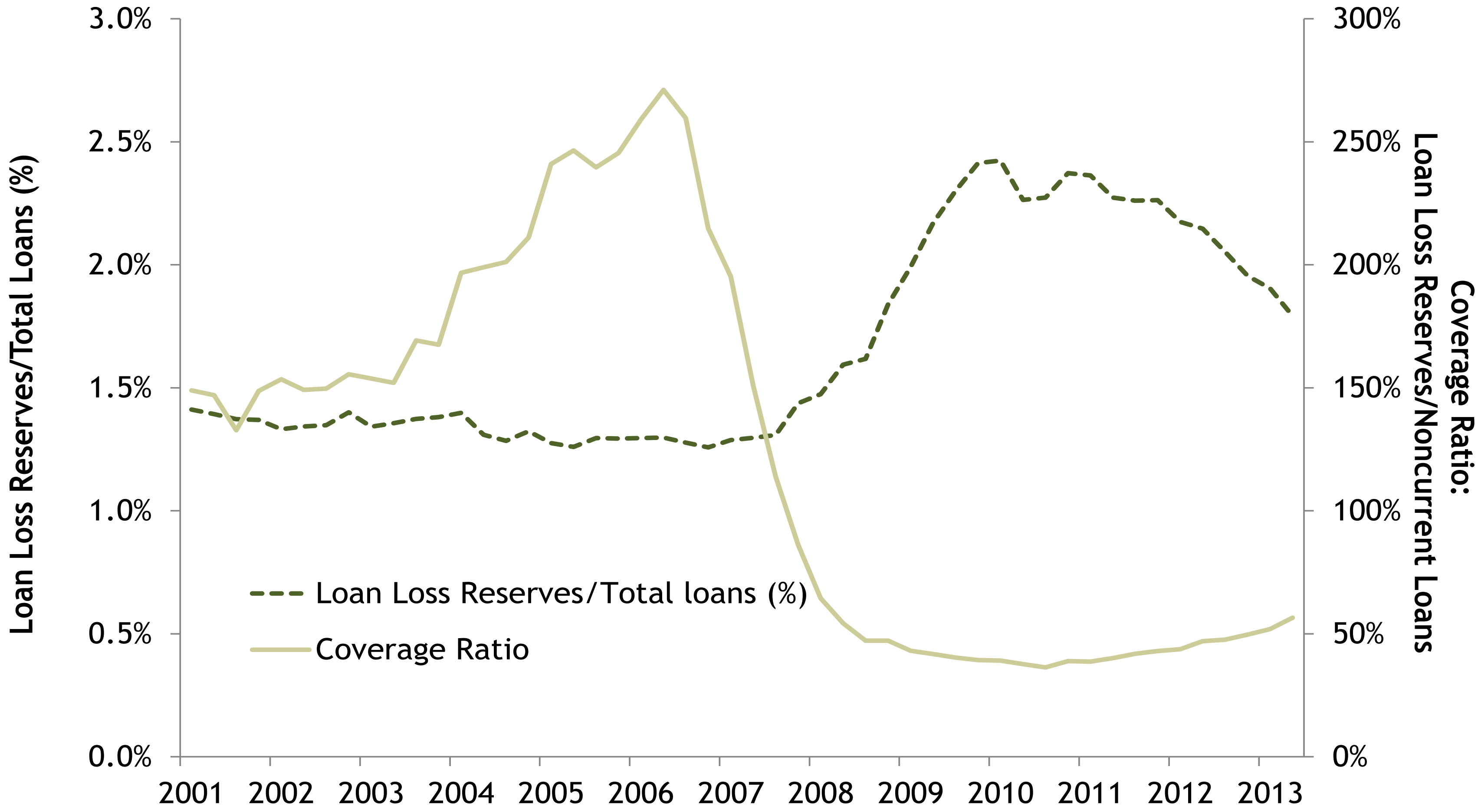
Source: Bank Call Reports

Sixth District Noncurrent Loans



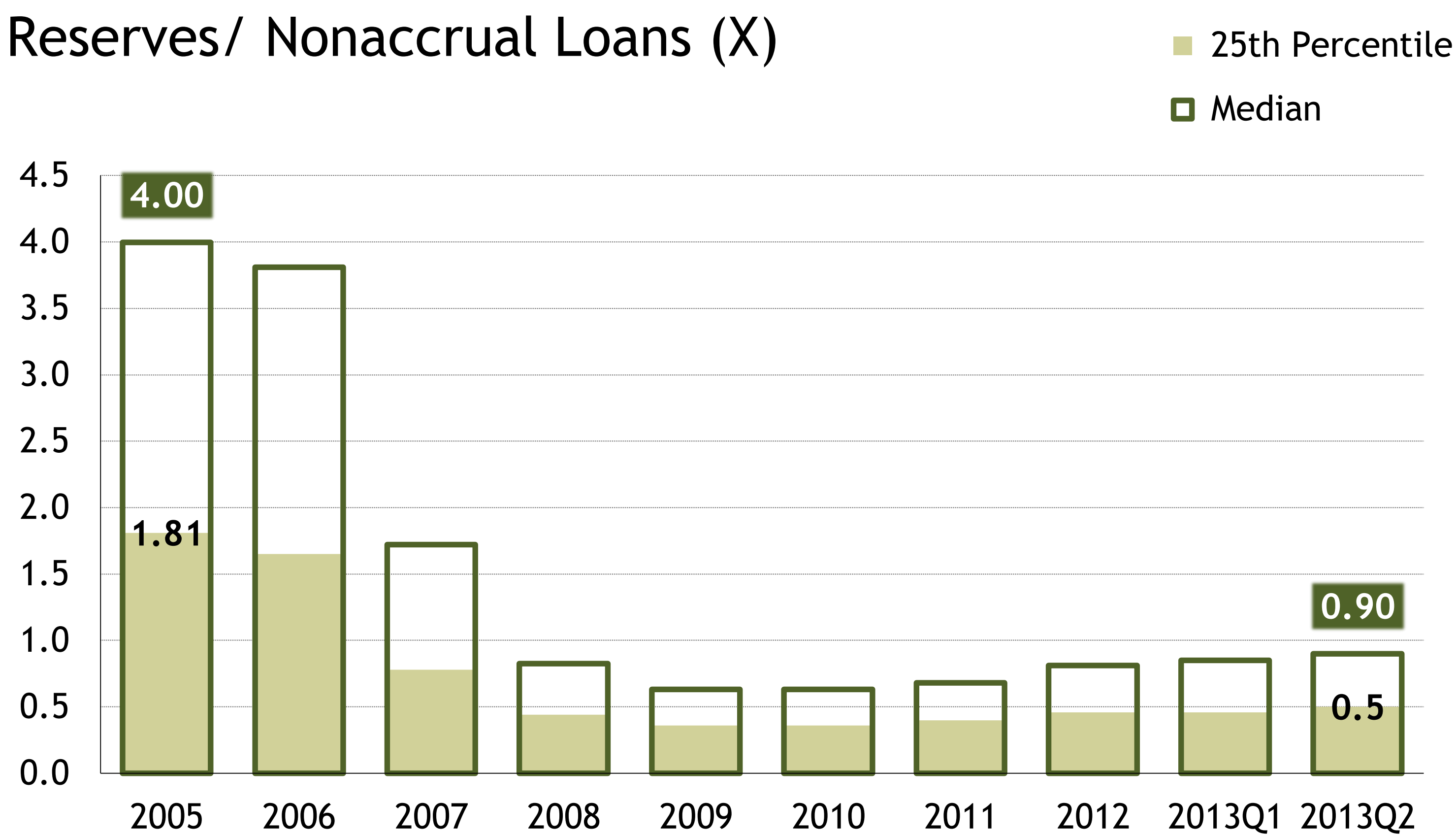
Source: Bank Call Reports

Sixth District Loan Loss Reserves



Source: Bank Call Reports

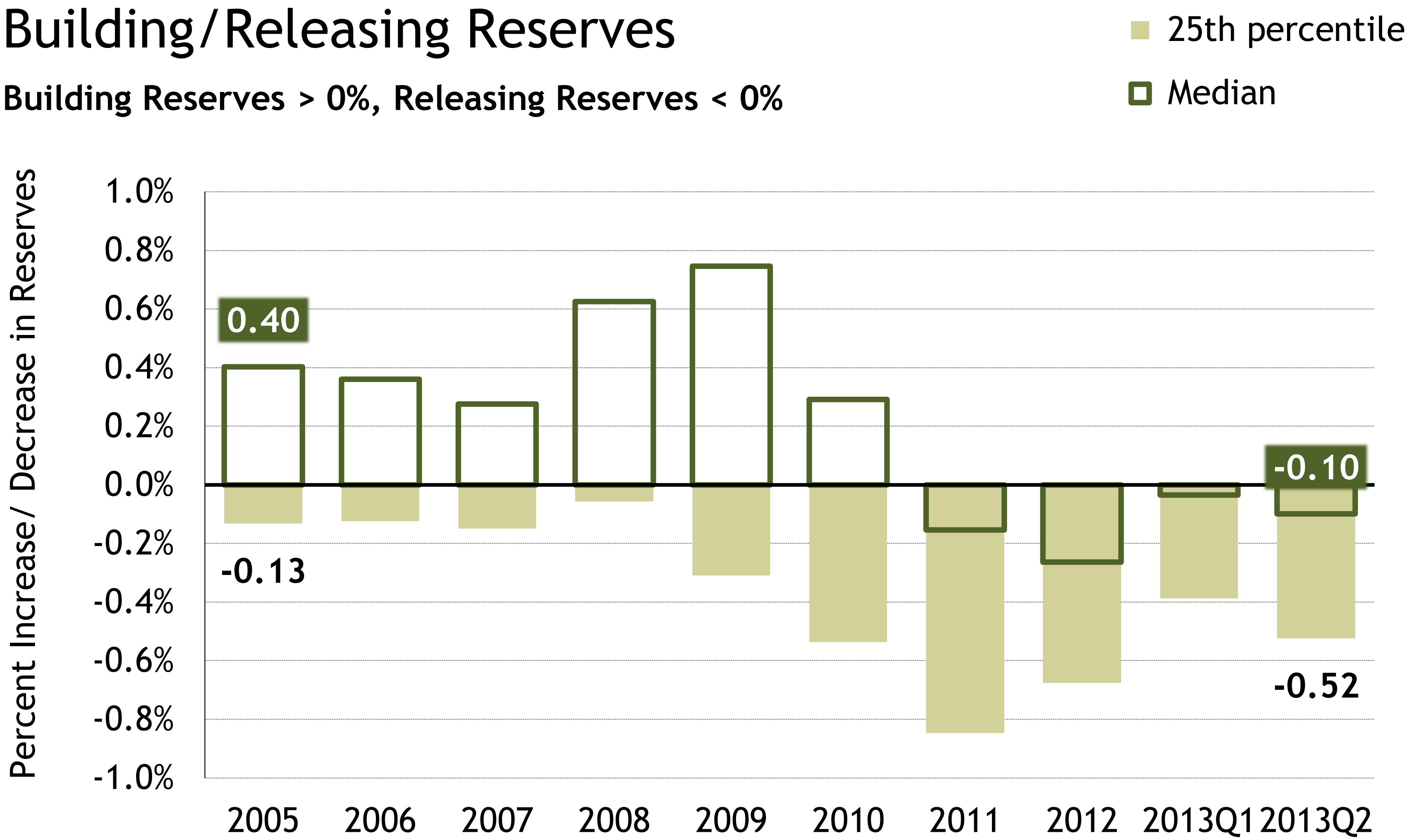
Sixth District Reserve Adequacy



Source: Bank Call Reports

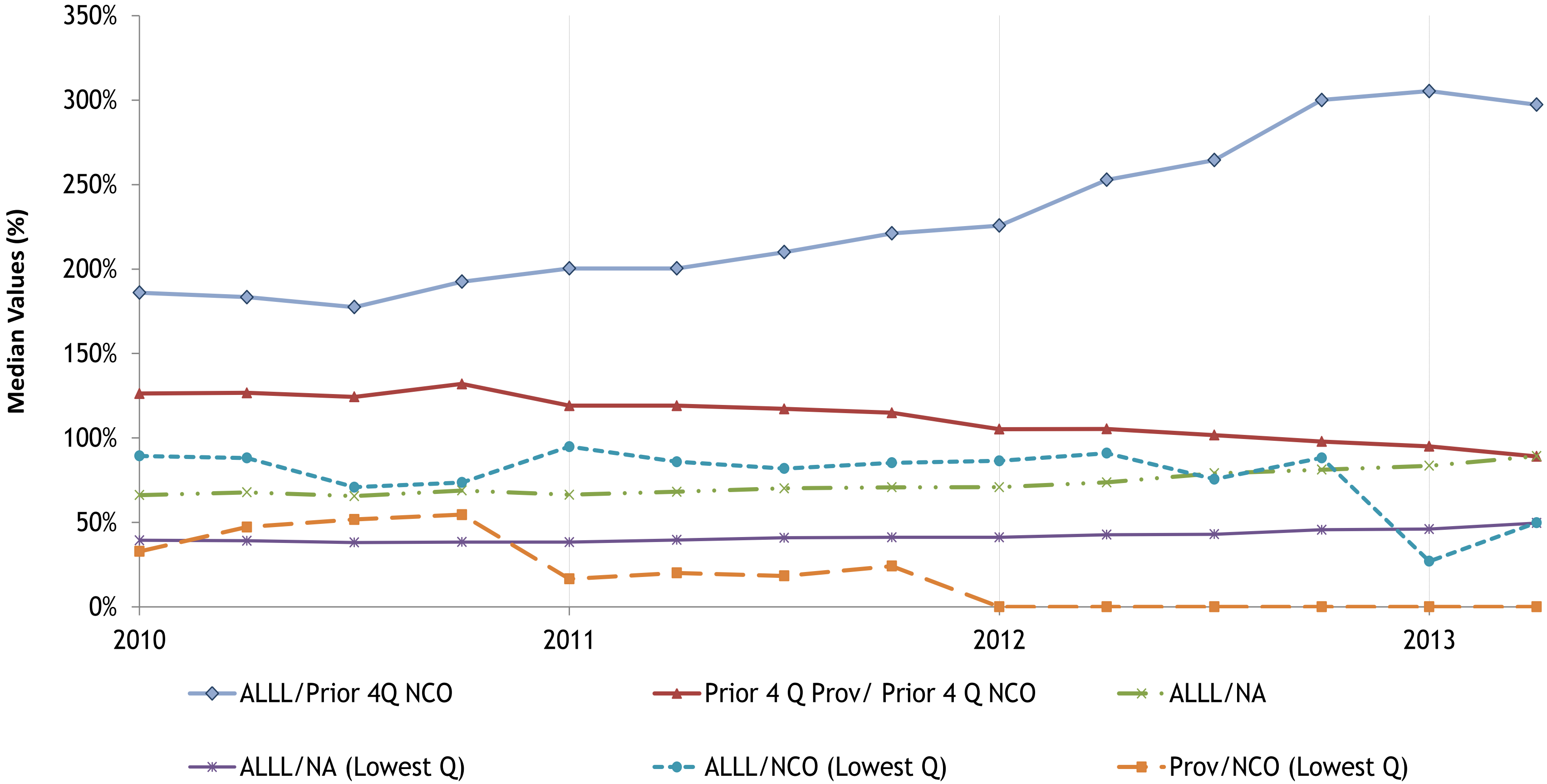
Building/Releasing Reserves

Building Reserves > 0%, Releasing Reserves < 0%



Source: Bank Call Reports

Sixth District CBG Median ALLL Coverage Trends



Source: Bank Call Reports

- Exam Related Issues
  - Loss periods need to transition back to normal time periods
  - Support Unallocated portfolio
  - Documentation
  - Validation

- Proposed Changes to Accounting for Credit Losses
  - Reasons for change in accounting for credit losses
  - Summary of proposed changes
  - Improvements over existing model

Reasons for Changes to Accounting for Credit Losses

- Crisis led to calls for improvement in accounting for credit losses
  - In April 2009, G20 requested that standard setters "strengthen accounting recognition of loan-loss provisions..."
- Weaknesses in current credit loss accounting model:
  - Delayed recognition of credit losses until losses <u>are probable.</u>
  - Inability to factor in expectations of future conditions

Summary of Proposed Changes

- What are the main provisions of the FASB model?
  - Requires an estimate of losses expected over the remaining life of a financial asset
    - Lifetime loss estimate now only used in FAS 114 and SOP 03-3
  - Incorporate information about past events, current conditions, and reasonable and supportable <u>forecasts of the future</u>.

Proposal: Improvements over Existing Model

- Will lead to early recognition of credit losses
  - By recognizing credit losses expected over the life rather than just losses that have been incurred as of the balance sheet date.
- Will incorporate "reasonable and supportable" forecasts of the future.
- Simple in concept but possibly not in application.

Challenge Community Banks Face:
Estimation of Expected Credit Losses

- The proposal does not require the use of any specific method
- The proposal will require data on historical lifetime loss experience that most banks may not have
  - Will require banks to track new data
  - May require new systems to track lifetime loss experience

Regulatory Views

- Regulators have pushed for long transition period
- Regulators have pushed for practical expedients to be allowed
- Regulatory guidance will be robust
- Regulators understand the challenge this will present to community banks.