
**Office of the Comptroller of the Currency
Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of Thrift Supervision**

**Interagency Policy Statement on the
Allowance for Loan and Lease Losses¹**

Purpose

The Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Office of Thrift Supervision, jointly with the National Credit Union Administration, have revised the banking agencies' 1993 policy statement on the allowance for loan and lease losses (ALLL) to ensure consistency with generally accepted accounting principles (GAAP) and more recent supervisory guidance. The banking agencies originally issued the 1993 policy statement to describe the responsibilities of the boards of directors and management of banks and savings associations and of examiners regarding the ALLL. This revision replaces the 1993 policy statement and also makes it applicable to credit unions. In addition, the agencies are issuing the attached frequently asked questions (FAQs) to assist institutions in complying with GAAP and ALLL supervisory guidance.

Background

This policy statement reiterates key concepts and requirements included in GAAP and existing ALLL supervisory guidance.²

The principal sources of guidance on accounting for impairment in a loan portfolio under GAAP are Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), and Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114). In addition, the Financial Accounting Standards Board *Viewpoints* article that is included in Emerging Issues Task Force Topic D-80 (EITF D-80), *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio*, presents questions and answers that provide specific guidance on the interaction between these two FASB statements and may be helpful in applying them.

¹ This policy statement applies to all depository institutions (institutions), except U.S. branches and agencies of foreign banks, supervised by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of Thrift Supervision (the "banking agencies") and to institutions insured and supervised by the National Credit Union Administration (NCUA) (collectively, the "agencies"). U.S. branches and agencies of foreign banks continue to be subject to any separate guidance that has been issued by their primary supervisory agency.

² As discussed more fully in the "Nature and Purpose of the ALLL" section below, this policy statement and the ALLL generally do not address loans carried at fair value or loans held for sale. In addition, this policy statement provides only limited guidance on "purchased impaired loans."

In July 1999, the banking agencies and the Securities and Exchange Commission (SEC) issued a Joint Interagency Letter to Financial Institutions. The letter stated that the banking agencies and the SEC agreed on the following important aspects of loan loss allowance practices:

- Arriving at an appropriate allowance involves a high degree of management judgment and results in a range of estimated losses;
- Prudent, conservative, but not excessive, loan loss allowances that fall within an acceptable range of estimated losses are appropriate. In accordance with GAAP, an institution should record its best estimate within the range of credit losses, including when management's best estimate is at the high end of the range;
- Determining the allowance for loan losses is inevitably imprecise, and an appropriate allowance falls within a range of estimated losses;
- An "unallocated" loan loss allowance is appropriate when it reflects an estimate of probable losses, determined in accordance with GAAP, and is properly supported;
- Allowance estimates should be based on a comprehensive, well-documented, and consistently applied analysis of the loan portfolio; and
- The loan loss allowance should take into consideration all available information existing as of the financial statement date, including environmental factors such as industry, geographical, economic, and political factors.

In July 2001, the banking agencies issued a *Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions* (2001 Policy Statement). It is designed to assist institutions in establishing a sound process for determining an appropriate ALLL and documenting that process in accordance with GAAP.³ The guidance in the 2001 Policy Statement was substantially adopted by the NCUA through its Interpretative Ruling and Policy Statement 02-3, *Allowance for Loan and Lease Losses Methodologies and Documentation for Federally Insured Credit Unions* in May 2002 (NCUA's 2002 IRPS).

In March 2004, the agencies issued an *Update on Accounting for Loan and Lease Losses*. This guidance provided reminders of longstanding supervisory guidance as well as a listing of the existing allowance guidance that institutions should continue to apply.

Nature and Purpose of the ALLL

The ALLL represents one of the most significant estimates in an institution's financial statements and regulatory reports. Because of its significance, each institution has a

³ The 2001 Policy Statement and the 2002 NCUA IRPS are available on the agencies' Web sites. In addition, the SEC staff issued parallel guidance in July 2001 in Staff Accounting Bulletin No. 102 – *Selected Loan Loss Allowance Methodology and Documentation Issues* (SAB 102), which has been codified as Topic 6.L. in the SEC's Codification of Staff Accounting Bulletins. Both SAB 102 and the Codification are available on the SEC's Web site.

responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL). To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP, the institution's stated policies and procedures, management's best judgment and relevant supervisory guidance.

As of the end of each quarter, or more frequently if warranted, each institution must analyze the collectibility of its loans and leases held for investment⁴ (hereafter referred to as "loans") and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. An appropriate ALLL covers estimated credit losses on individually evaluated loans that are determined to be impaired as well as estimated credit losses inherent in the remainder of the loan and lease portfolio. The ALLL does not apply, however, to loans carried at fair value, loans held for sale,⁵ off-balance sheet credit exposures⁶ (e.g. financial instruments such as off-balance sheet loan commitments, standby letters of credit, and guarantees), or general or unspecified business risks.

For purposes of this policy statement, the term "estimated credit losses" means an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances as of the evaluation date. Thus, estimated credit losses represent net charge-offs that are likely to be realized for a loan or group of loans. These estimated credit losses should meet the criteria for accrual of a loss contingency (i.e., through a provision to the ALLL) set forth in GAAP.⁷ When available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL.

⁴ Consistent with the American Institute of Certified Public Accountants' (AICPA) Statement of Position 01-6, *Accounting by Certain Entities (Including Entities With Trade Receivables) That Lend to or Finance the Activities of Others*, loans and leases held for investment are those loans and leases that the institution has the intent and ability to hold for the foreseeable future or until maturity or payoff.

⁵ Refer to the "Interagency Guidance on Certain Loans Held for Sale" (March 26, 2001) for the appropriate accounting and reporting treatment for certain loans that are sold directly from the loan portfolio or transferred to a held-for-sale account. Loans held for sale are reported at the lower of cost or fair value. Declines in value occurring after the transfer of a loan to the held-for-sale portfolio are accounted for as adjustments to a valuation allowance for held-for-sale loans and not as adjustments to the ALLL.

⁶ Credit losses on off-balance sheet credit exposures should be estimated in accordance with FAS 5. Any allowance for credit losses on off-balance sheet exposures should be reported on the balance sheet as an "Other Liability," not as part of the ALLL.

⁷ FAS 5 requires the accrual of a loss contingency when information available prior to the issuance of the financial statements indicates it is probable that an asset has been impaired at the date of the financial statements and the amount of loss can be reasonably estimated. These conditions may be considered in relation to individual loans or in relation to groups of similar types of loans. If the conditions are met, accrual should be made even though the particular loans that are uncollectible may not be identifiable. Under FAS 114, an individual loan is impaired when, based on current information and events, it is probable that a creditor will be unable to collect all amounts due according to the contractual terms of the loan agreement. It is implicit in these conditions that it must be probable that one or more future events will occur confirming the fact of the loss. Thus, under GAAP, the purpose of the ALLL is not to absorb all of the risk in the loan portfolio, but to cover probable credit losses that have already been incurred.

For “purchased impaired loans,”⁸ GAAP prohibits “carrying over” or creating an ALLL in the initial recording of these loans. However, if, upon evaluation subsequent to acquisition, it is probable that the institution will be unable to collect all cash flows expected at acquisition on a purchased impaired loan (an estimate that considers both timing and amount), the loan should be considered impaired for purposes of applying the measurement and other provisions of FAS 5 or, if applicable, FAS 114.

Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. For loans within the scope of FAS 114 that are individually evaluated and determined to be impaired,⁹ these estimates should reflect consideration of one of the standard’s three impairment measurement methods as of the evaluation date: (1) the present value of expected future cash flows discounted at the loan’s effective interest rate,¹⁰ (2) the loan’s observable market price, or (3) the fair value of the collateral if the loan is collateral dependent.

An institution may choose the appropriate FAS 114 measurement method on a loan-by-loan basis for an individually impaired loan, except for an impaired collateral-dependent loan. The agencies require impairment of a collateral-dependent loan to be measured using the fair value of collateral method. As defined in FAS 114, a loan is collateral dependent if repayment of the loan is expected to be provided solely by the underlying collateral. In general, any portion of the recorded investment in a collateral-dependent loan (including any capitalized accrued interest, net deferred loan fees or costs, and unamortized premium or discount) in excess of the fair value of the collateral that can be identified as uncollectible, and is therefore deemed a confirmed loss, should be promptly charged off against the ALLL.¹¹

⁸ A “purchased impaired loan” is defined as a loan that an institution has purchased, including a loan acquired in a purchase business combination, that has evidence of deterioration of credit quality since its origination and for which it is probable, at the purchase date, that the institution will be unable to collect all contractually required payments. When reviewing the appropriateness of the reported ALLL of an institution with purchased impaired loans, examiners should consider the credit losses factored into the initial investment in these loans when determining whether further deterioration, e.g., decreases in cash flows expected to be collected, has occurred since the loans were purchased. The agencies’ regulatory reports and disclosures in financial statements may provide useful information for examiners in reviewing these loans. Refer to the AICPA’s Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*, for further guidance on the appropriate accounting.

⁹ FAS 114 does not specify how an institution should identify loans that are to be evaluated for collectibility nor does it specify how an institution should determine that a loan is impaired. An institution should apply its normal loan review procedures in making those judgments. Refer to the FAQs for further guidance.

¹⁰ The effective interest rate on a loan is the rate of return implicit in the loan (that is, the contractual interest rate adjusted for any net deferred loan fees or costs and any premium or discount existing at the origination or acquisition of the loan).

¹¹ For further information, banks and savings associations should refer to the Illustration in Appendix B of the 2001 Policy Statement. Credit unions should refer to the section heading “Application of GAAP” in the NCUA’s 2002 IRPS.

All other loans, including individually evaluated loans determined not to be impaired under FAS 114, should be included in a group of loans that is evaluated for impairment under FAS 5.¹² While an institution may segment its loan portfolio into groups of loans based on a variety of factors, the loans within each group should have similar risk characteristics. For example, a loan that is fully collateralized with risk-free assets should not be grouped with uncollateralized loans. When estimating credit losses on each group of loans with similar risk characteristics, an institution should consider its historical loss experience on the group, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans as of the evaluation date.

For analytical purposes, an institution should attribute portions of the ALLL to loans that it evaluates and determines to be impaired under FAS 114 and to groups of loans that it evaluates collectively under FAS 5. However, the ALLL is available to cover all charge-offs that arise from the loan portfolio.

Responsibilities of the Board of Directors and Management

Appropriate ALLL Level

Each institution's management is responsible for maintaining the ALLL at an appropriate level and for documenting its analysis according to the standards set forth in the 2001 Policy Statement or the NCUA's 2002 IRPS, as applicable. Thus, management should evaluate the ALLL reported on the balance sheet as of the end of each quarter (and for credit unions, prior to paying dividends), or more frequently if warranted, and charge or credit the PLLL to bring the ALLL to an appropriate level as of each evaluation date. The determination of the amounts of the ALLL and the PLLL should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the evaluation date. Management's evaluation is subject to review by examiners. An institution's failure to analyze the collectibility of the loan portfolio and maintain and support an appropriate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound practice.

In carrying out its responsibility for maintaining an appropriate ALLL, management is expected to adopt and adhere to written policies and procedures that are appropriate to the size of the institution and the nature, scope, and risk of its lending activities. At a minimum, these policies and procedures should ensure that:

- The institution's process for determining an appropriate level for the ALLL is based on a comprehensive, well-documented, and consistently applied analysis of its loan portfolio.¹³ The analysis should consider all significant factors that affect the

¹² An individually evaluated loan that is determined not to be impaired under FAS 114 should be evaluated under FAS 5 when specific characteristics of the loan indicate that it is probable there would be estimated credit losses in a group of loans with those characteristics. Refer to the FAQs for further guidance.

¹³ As noted in the 2001 Policy Statement and the NCUA's 2002 IRPS, an institution with less complex lending activities and products may find it more efficient to combine a number of procedures while continuing to ensure that the institution has a consistent and appropriate ALLL methodology. Thus, much of the supporting documentation

collectibility of the portfolio and should support the credit losses estimated by this process.

- The institution has an effective loan review system and controls (including an effective loan classification or credit grading system) that identify, monitor, and address asset quality problems in an accurate and timely manner.¹⁴ To be effective, the institution's loan review system and controls must be responsive to changes in internal and external factors affecting the level of credit risk in the portfolio.
- The institution has adequate data capture and reporting systems to supply the information necessary to support and document its estimate of an appropriate ALLL.
- The institution evaluates any loss estimation models before they are employed and modifies the models' assumptions, as needed, to ensure that the resulting loss estimates are consistent with GAAP. To demonstrate this consistency, the institution should document its evaluations and conclusions regarding the appropriateness of estimating credit losses with the models or other estimation tools. The institution should also document and support any adjustments made to the models or to the output of the models in determining the estimated credit losses.
- The institution promptly charges off loans, or portions of loans, that available information confirms to be uncollectible.
- The institution periodically validates the ALLL methodology. This validation process should include procedures for a review, by a party who is independent of the institution's credit approval and ALLL estimation processes, of the ALLL methodology and its application in order to confirm its effectiveness. A party who is independent of these processes could be the internal audit staff, a risk management unit of the institution, an external auditor (subject to applicable auditor independence standards), or another contracted third party from outside the institution. One party need not perform the entire analysis as the validation can be divided among various independent parties.

The board of directors is responsible for overseeing management's significant judgments and estimates pertaining to the determination of an appropriate ALLL. This oversight should include but is not limited to:

- Reviewing and approving the institution's written ALLL policies and procedures at least annually.

required for an institution with more complex products or portfolios may be combined into fewer supporting documents in an institution with less complex products or portfolios.

¹⁴ Loan review and loan classification or credit grading systems are discussed in Attachment 1. In addition, banks and savings associations should refer to the asset quality standards in the Interagency Guidelines Establishing Standards for Safety and Soundness adopted by their primary federal regulator, as follows: for national banks, Appendix A to Part 30; for state member banks, Appendix D-1 to Part 208; for state nonmember banks, Appendix A to Part 364; and for savings associations, Appendix A to Part 570.

- Reviewing management's assessment and justification that the loan review system is sound and appropriate for the size and complexity of the institution.
- Reviewing management's assessment and justification for the amounts estimated and reported each period for the PLLL and the ALLL.
- Requiring management to periodically validate and, when appropriate, revise the ALLL methodology.

For purposes of the Reports of Condition and Income (Call Report), the Thrift Financial Report (TFR), and the NCUA Call Report (5300) an appropriate ALLL (after deducting all loans and portions of loans confirmed loss) should consist only of the following components (as applicable),¹⁵ the amounts of which take into account *all relevant facts and circumstances as of the evaluation date*:

- For loans within the scope of FAS 114 that are individually evaluated and found to be impaired, the associated ALLL should be based upon one of the three impairment measurement methods specified in FAS 114.¹⁶
- For all other loans, including individually evaluated loans determined not to be impaired under FAS 114,¹⁷ the associated ALLL should be measured under FAS 5 and should provide for all estimated credit losses that have been incurred on groups of loans with similar risk characteristics.
- For estimated credit losses from transfer risk on cross-border loans, the impact to the ALLL should be evaluated individually for impaired loans under FAS 114 or evaluated on a group basis under FAS 5. See Attachment 2 for further guidance on considerations of transfer risk on cross-border loans.
- For estimated credit losses on accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution's balance sheet, the associated ALLL should be evaluated under FAS 114 or FAS 5 as appropriate, if not already included in one of the preceding components.

Because deposit accounts that are overdrawn (i.e. overdrafts) must be reclassified as loans on the balance sheet, overdrawn accounts should be included in one of the first two components above, as appropriate, and evaluated for estimated credit losses.

¹⁵ A component of the ALLL that is labeled "unallocated" is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported and documented.

¹⁶ As previously noted, the use of the fair value of collateral method is required for an individually evaluated loan that is impaired if the loan is collateral dependent.

¹⁷ See footnote 12.

Determining the appropriate level for the ALLL is inevitably imprecise and requires a high degree of management judgment. Management's analysis should reflect a prudent, conservative, but not excessive ALLL that falls within an acceptable range of estimated credit losses. When a range of losses is determined, institutions should maintain appropriate documentation to support the identified range and the rationale used for determining the best estimate from within the range of loan losses.

As discussed more fully in Attachment 1, it is essential that institutions maintain effective loan review systems. An effective loan review system should work to ensure the accuracy of internal credit classification or grading systems and, thus, the quality of the information used to assess the appropriateness of the ALLL. The complexity and scope of an institution's ALLL evaluation process, loan review system, and other relevant controls should be appropriate for the size of the institution and the nature of its lending activities. The evaluation process should also provide for sufficient flexibility to respond to changes in the factors that affect the collectibility of the portfolio.

Credit losses that arise from the transfer risk associated with an institution's cross-border lending activities require special consideration. In particular, for banks with cross-border lending exposure, management should determine that the ALLL is appropriate to cover estimated losses from transfer risk associated with this exposure over and above any minimum amount that the Interagency Country Exposure Review Committee requires to be provided in the Allocated Transfer Risk Reserve (or charged off against the ALLL). These estimated losses should meet the criteria for accrual of a loss contingency set forth in GAAP. (See Attachment 2 for factors to consider.)

Factors to Consider in the Estimation of Credit Losses

Estimated credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date. Normally, an institution should determine the historical loss rate for each group of loans with similar risk characteristics in its portfolio based on its own loss experience for loans in that group. While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses, do not by themselves form a sufficient basis to determine the appropriate level for the ALLL. Management should also consider those qualitative or environmental factors that are likely to cause estimated credit losses associated with the institution's existing portfolio to differ from historical loss experience, including but not limited to:

- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices not considered elsewhere in estimating credit losses.

- Changes in international, national, regional, and local economic and business conditions and developments that affect the collectibility of the portfolio, including the condition of various market segments.¹⁸
- Changes in the nature and volume of the portfolio and in the terms of loans.
- Changes in the experience, ability, and depth of lending management and other relevant staff.
- Changes in the volume and severity of past due loans, the volume of nonaccrual loans, and the volume and severity of adversely classified or graded loans.¹⁹
- Changes in the quality of the institution's loan review system.
- Changes in the value of underlying collateral for collateral-dependent loans.
- The existence and effect of any concentrations of credit, and changes in the level of such concentrations.
- The effect of other external factors such as competition and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio.

In addition, changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, keeping in mind the characteristics of an institution's loan portfolio. For example, if declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the portfolio should generally increase, barring unusual charge-off activity. Similarly, if improving credit quality trends are evident, the ALLL level as a percentage of the portfolio should generally decrease.

Measurement of Estimated Credit Losses

FAS 5

When measuring estimated credit losses on groups of loans with similar risk characteristics in accordance with FAS 5, a widely used method is based on each group's historical net charge-off rate adjusted for the effects of the qualitative or environmental factors discussed previously. As

¹⁸ Credit loss and recovery experience may vary significantly depending upon the stage of the business cycle. For example, an over reliance on credit loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn.

¹⁹ For banks and savings associations, adversely classified or graded loans are loans rated "Substandard" (or its equivalent) or worse under the institution's loan classification system. For credit unions, adversely graded loans are loans included in the more severely graded categories under the institution's credit grading system, i.e., those loans that tend to be included in the credit union's "watch lists."

the first step in applying this method, management generally bases the historical net charge-off rates on the “annualized” historical gross loan charge-offs, less recoveries, recorded by the institution on loans in each group.

Methodologies for determining the historical net charge-off rate on a group of loans with similar risk characteristics under FAS 5 can range from the simple average of, or a determination of the range of, an institution’s annual net charge-off experience to more complex techniques, such as migration analysis and models that estimate credit losses.²⁰ Generally, institutions should use at least an “annualized” or 12-month average net charge-off rate that will be applied to the groups of loans when estimating credit losses. However, this rate could vary. For example, loans with effective lives longer than 12 months often have workout periods over an extended period of time, which may indicate that the estimated credit losses should be greater than that calculated based solely on the annualized net charge-off rate for such loans. These groups may include certain commercial loans as well as groups of adversely classified loans. Other groups of loans may have effective lives shorter than 12 months, which may indicate that the estimated credit losses should be less than that calculated based on the annualized net charge-off rate.

Regardless of the method used, institutions should maintain supporting documentation for the techniques used to develop the historical loss rate for each group of loans. If a range of historical loss rates is developed instead for a group of loans, institutions should maintain documentation to support the identified range and the rationale for determining which rate is the best estimate within the range of loss rates. The rationale should be based on management’s assessment of which rate is most reflective of the estimated credit losses in the current loan portfolio.

After determining the appropriate historical loss rate for each group of loans with similar risk characteristics, management should consider those current qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group’s historical loss experience. Institutions typically reflect the overall effect of these factors on a loan group as an adjustment that, as appropriate, increases or decreases the historical loss rate applied to the loan group. Alternatively, the effect of these factors may be reflected through separate standalone adjustments within the FAS 5 component of the ALLL.²¹ Both methods are consistent with GAAP provided the adjustments for qualitative or environmental factors are

²⁰ Annual charge-off rates are calculated over a specified time period (e.g., three years or five years), which can vary based on a number of factors including the relevance of past periods’ experience to the current period or point in the credit cycle. Also, some institutions remove loans that become adversely classified or graded from a group of nonclassified or nongraded loans with similar risk characteristics in order to evaluate the removed loans individually under FAS 114 (if deemed impaired) or collectively in a group of adversely classified or graded loans with similar risk characteristics under FAS 5. In this situation, the net charge-off experience on the adversely classified or graded loans that have been removed from the group of nonclassified or nongraded loans should be included in the historical loss rates for that group of loans. Even though the net charge-off experience on adversely classified or graded loans is included in the estimation of the historical loss rates that will be applied to the group of nonclassified or nongraded loans, the adversely classified or graded loans themselves are no longer included in that group for purposes of estimating credit losses on the group.

²¹ An overall adjustment to a portion of the ALLL that is not attributed to specific segments of the loan portfolio is often labeled “unallocated.” Regardless of what a component of the ALLL is labeled, it is appropriate when it reflects estimated credit losses determined in accordance with GAAP and is properly supported.

reasonably and consistently determined, are adequately documented, and represent estimated credit losses. For each group of loans, an institution should apply its adjusted historical loss rate, or its historical loss rate and separate standalone adjustments, to the recorded investment in the group when determining its estimated credit losses.

Management must exercise significant judgment when evaluating the effect of qualitative factors on the amount of the ALLL because data may not be reasonably available or directly applicable for management to determine the precise impact of a factor on the collectibility of the institution's loan portfolio as of the evaluation date. Accordingly, institutions should support adjustments to historical loss rates and explain how the adjustments reflect current information, events, circumstances, and conditions in the loss measurements. Management should maintain reasonable documentation to support which factors affected the analysis and the impact of those factors on the loss measurement. Support and documentation includes descriptions of each factor, management's analysis of how each factor has changed over time, which loan groups' loss rates have been adjusted, the amount by which loss estimates have been adjusted for changes in conditions, an explanation of how management estimated the impact, and other available data that supports the reasonableness of the adjustments. Examples of underlying supporting evidence could include, but are not limited to, relevant articles from newspapers and other publications that describe economic events affecting a particular geographic area, economic reports and data, and notes from discussions with borrowers.

There may be times when an institution does not have its own historical loss experience upon which to base its estimate of the credit losses in a group of loans with similar risk characteristics. This may occur when an institution offers a new loan product or in the case of a newly established (i.e., de novo) institution. If an institution has no experience of its own for a loan group, reference to the experience of other enterprises in the same lending business may be appropriate, provided the institution demonstrates that the attributes of the group of loans in its portfolio are similar to those of the loan group in the portfolio providing the loss experience. An institution should only use another enterprise's experience on a short-term basis until it has developed its own loss experience for a particular group of loans.

FAS 114

When determining the FAS 114 component of the ALLL for an individually impaired loan,²² an institution should consider estimated costs to sell the loan's collateral, if any, on a discounted basis, in the measurement of impairment if those costs are expected to reduce the cash flows available to repay or otherwise satisfy the loan. If the institution bases its measure of loan impairment on the present value of expected future cash flows discounted at the loan's effective interest rate, the estimates of these cash flows should be the institution's best estimate based on reasonable and supportable assumptions and projections. All available evidence should be considered in developing the estimate of expected future cash flows. The weight given to the

²² As noted in FAS 114, some individually impaired loans have risk characteristics that are unique to an individual borrower and the institution will apply the measurement methods on a loan-by-loan basis. However, some impaired loans may have risk characteristics in common with other impaired loans. An institution may aggregate those loans and may use historical statistics, such as average recovery period and average amount recovered, along with a composite effective interest rate as a means of measuring impairment of those loans.

evidence should be commensurate with the extent to which the evidence can be verified objectively. The likelihood of the possible outcomes should be considered in determining the best estimate of expected future cash flows.

Analyzing the Overall Measurement of the ALLL

Institutions are also encouraged to use ratio analysis as a supplemental tool for evaluating the overall reasonableness of the ALLL. Ratio analysis can be useful in identifying divergent trends (compared with an institution's peer group and its own historical experience) in the relationship of the ALLL to adversely classified or graded loans, past due and nonaccrual loans, total loans, and historical gross and net charge-offs. Based on such analysis, an institution may identify additional issues or factors that previously had not been considered in the ALLL estimation process, which may warrant adjustments to estimated credit losses. Such adjustments should be appropriately supported and documented.

While ratio analysis, when used prudently, can be helpful as a supplemental check on the reasonableness of management's assumptions and analyses, it is not a sufficient basis for determining the appropriate amount for the ALLL. In particular, because an appropriate ALLL is an institution-specific amount, such comparisons do not obviate the need for a comprehensive analysis of the loan portfolio and the factors affecting its collectibility. Furthermore, it is inappropriate for the board of directors or management to make adjustments to the ALLL when it has been properly computed and supported under the institution's methodology for the sole purpose of reporting an ALLL that corresponds to the peer group median, a target ratio, or a budgeted amount. Institutions that have high levels of risk in the loan portfolio or are uncertain about the effect of possible future events on the collectibility of the portfolio should address these concerns by maintaining higher equity capital and not by arbitrarily increasing the ALLL in excess of amounts supported under GAAP.²³

Estimated Credit Losses in Credit Related Accounts

Typically, institutions evaluate and estimate credit losses for off-balance sheet credit exposures at the same time that they estimate credit losses for loans. While a similar process should be followed to support loss estimates related to off-balance sheet exposures, these estimated credit losses are not recorded as part of the ALLL. When the conditions for accrual of a loss under FAS 5 are met, an institution should maintain and report as a separate liability account, an allowance that is appropriate to cover estimated credit losses on off-balance sheet loan commitments, standby letters of credit, and guarantees. In addition, recourse liability accounts (that arise from recourse obligations on any transfers of loans that are reported as sales in

²³ It is inappropriate to use a "standard percentage" as the sole determinant for the amount to be reported as the ALLL on the balance sheet. Moreover, an institution should not simply default to a peer ratio or a "standard percentage" after determining an appropriate level of ALLL under its methodology. However, there may be circumstances when an institution's ALLL methodology and credit risk identification systems are not reliable. Absent reliable data of its own, management may seek data that could be used as a short-term proxy for the unavailable information (e.g., an industry average loss rate for loans with similar risk characteristics). This is only appropriate as a short-term remedy until the institution creates a viable system for estimating credit losses within its loan portfolio.

accordance with GAAP) should be reported in regulatory reports as liabilities that are separate and distinct from both the ALLL and the allowance for credit losses on off-balance sheet credit exposures.

When accrued interest and fees are reported separately on an institution's balance sheet from the related loan balances (i.e., as other assets), the institution should maintain an appropriate valuation allowance, determined in accordance with GAAP, for amounts that are not likely to be collected unless management has placed the underlying loans in nonaccrual status and reversed previously accrued interest and fees.²⁴

Responsibilities of Examiners

Examiners should assess the credit quality of an institution's loan portfolio, the appropriateness of its ALLL methodology and documentation, and the appropriateness of the reported ALLL in the institution's regulatory reports. In their review and classification or grading of the loan portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio, including the value of any collateral. In reviewing the appropriateness of the ALLL, examiners should:

- Consider the effectiveness of board oversight as well as the quality of the institution's loan review system and management in identifying, monitoring, and addressing asset quality problems. This will include a review of the institution's loan review function and credit grading system. Typically, this will involve testing a sample of the institution's loans. The sample size generally varies and will depend on the nature or purpose of the examination.²⁵
- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL, including whether management's assumptions, valuations, and judgments appear reasonable and are properly supported. If a range of credit losses has been estimated by management, evaluate the reasonableness of the range and management's best estimate within the range. In making these evaluations, examiners should ensure that the institution's historical loss experience and all significant qualitative or environmental factors that affect the collectibility of the portfolio (including changes in the quality of the institution's loan review function and the other factors previously discussed) have been

²⁴ Refer to the agencies' regulatory reporting instructions for the Call Report, TFR, or 5300 for further guidance on placing a loan in nonaccrual status.

²⁵ In an examiner's review of an institution's loan review system, the examiner's loan classifications or credit grades may differ from those of the institution's loan review system. If the examiner's evaluation of these differences indicates problems with the loan review system, especially when the loan classification or credit grades assigned by the institution are more liberal than those assigned by the examiner, the institution would be expected to make appropriate adjustments to the assignment of its loan classifications or credit grades to the loan portfolio and to its estimated credit losses. Furthermore, the institution would be expected to improve its loan review system. (Attachment 1 discusses effective loan review systems.)

appropriately considered and that management has appropriately applied GAAP, including FAS 114 and FAS 5.

- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review the appropriateness and reasonableness of the overall level of the ALLL. In some instances this may include a quantitative analysis (e.g., using the types of ratio analysis previously discussed) as a preliminary check on the reasonableness of the ALLL. This quantitative analysis should demonstrate whether changes in the key ratios from prior periods are reasonable based on the examiner's knowledge of the collectibility of loans at the institution and its current environment.
- Review the ALLL amount reported in the institution's regulatory reports and financial statements and ensure these amounts reconcile to its ALLL analyses. There should be no material differences between the consolidated loss estimate, as determined by the ALLL methodology, and the final ALLL balance reported in the financial statements. Inquire about reasons for any material differences between the results of the institution's ALLL analyses and the institution's reported ALLL to determine whether the differences can be satisfactorily explained.
- Review the adequacy of the documentation and controls maintained by management to support the appropriateness of the ALLL.
- Review the interest and fee income accounts associated with the lending process to ensure that the institution's net income is not materially misstated.²⁶

As noted in the "Responsibilities of the Board of Directors and Management" section of this policy statement, when assessing the appropriateness of the ALLL, it is important to recognize that the related process, methodology, and underlying assumptions require a substantial degree of management judgment. Even when an institution maintains sound loan administration and collection procedures and an effective loan review system and controls, its estimate of credit losses is not a single precise amount due to the wide range of qualitative or environmental factors that must be considered.

An institution's ability to estimate credit losses on specific loans and groups of loans should improve over time as substantive information accumulates regarding the factors affecting repayment prospects. Therefore, examiners should generally accept management's estimates when they assess the appropriateness of the institution's reported ALLL, and not seek adjustments to the ALLL, when management has:

²⁶ As noted previously, accrued interest and fees on loans that have been reported as part of the respective loan balances on the institution's balance sheet should be evaluated for estimated credit losses. The accrual of the interest and fee income should also be considered. Refer to GAAP and the agencies' regulatory reporting instructions for further guidance on income recognition.

- Maintained effective loan review systems and controls for identifying, monitoring and addressing asset quality problems in a timely manner.
- Analyzed all significant qualitative or environmental factors that affect the collectibility of the portfolio as of the evaluation date in a reasonable manner.
- Established an acceptable ALLL evaluation process for both individual loans and groups of loans that meets the GAAP requirements for an appropriate ALLL.
- Incorporated reasonable and properly supported assumptions, valuations, and judgments into the evaluation process.

If the examiner concludes that the reported ALLL level is not appropriate or determines that the ALLL evaluation process is based on the results of an unreliable loan review system or is otherwise deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. The examiner's comments should cite any departures from GAAP and any contraventions of this policy statement and the 2001 Policy Statement or the NCUA's 2002 IRPS, as applicable. Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process, including the materiality of any error in the reported amount of the ALLL.

ALLL Level Reflected in Regulatory Reports

The agencies believe that an ALLL established in accordance with this policy statement and the 2001 Policy Statement or the NCUA's 2002 IRPS, as applicable, falls within the range of acceptable estimates determined in accordance with GAAP. When the reported amount of an institution's ALLL is not appropriate, the institution will be required to adjust its ALLL by an amount sufficient to bring the ALLL reported on its Call Report, TFR, or 5300 to an appropriate level as of the evaluation date. This adjustment should be reflected in the current period provision or through the restatement of prior period provisions, as appropriate in the circumstances.

Paperwork Reduction Act

The agencies do not intend this policy statement and the FAQs to create any new information collection requirements under the Paperwork Reduction Act. To the extent this policy statement and the FAQs involve information collection requirements, they are already required by GAAP or existing information collections for which the agencies have jointly or individually received approval.

Attachment 1

Loan Review Systems

The nature of loan review systems may vary based on an institution's size, complexity, loan types, and management practices.²⁷ For example, a loan review system may include components of a traditional loan review function that is independent of the lending function, or it may place some reliance on loan officers. In addition, the use of the term "loan review system" can refer to various responsibilities assigned to credit administration, loan administration, a problem loan workout group, or other areas of an institution. These responsibilities may range from administering the internal problem loan reporting process to maintaining the integrity of the loan classification or credit grading process (e.g., ensuring that timely and appropriate changes are made to the loan classifications or credit grades assigned to loans) and coordinating the gathering of the information necessary to assess the appropriateness of the ALLL. Additionally, some or all of this function may be outsourced to a qualified external loan reviewer. Regardless of the structure of the loan review system in an institution, an effective loan review system should have, at a minimum, the following objectives:

- To promptly identify loans with potential credit weaknesses.
- To appropriately grade or adversely classify loans, especially those with well-defined credit weaknesses that jeopardize repayment, so that timely action can be taken and credit losses can be minimized.
- To identify relevant trends that affect the collectibility of the portfolio and isolate segments of the portfolio that are potential problem areas.
- To assess the adequacy of and adherence to internal credit policies and loan administration procedures and to monitor compliance with relevant laws and regulations.
- To evaluate the activities of lending personnel including their compliance with lending policies and the quality of their loan approval, monitoring, and risk assessment.
- To provide senior management and the board of directors with an objective and timely assessment of the overall quality of the loan portfolio.
- To provide management with accurate and timely credit quality information for financial and regulatory reporting purposes, including the determination of an appropriate ALLL.

²⁷ The loan review function is not intended to be performed by an institution's internal audit function. However, as discussed in the banking agencies' March 2003 *Interagency Policy Statement on the Internal Audit Function and its Outsourcing*, some institutions seek to coordinate the internal audit function with several risk monitoring functions such as loan review. The policy statement notes that coordination of loan review with the internal audit function can facilitate the reporting of material risk and control issues to the audit committee, increase the overall effectiveness of these monitoring functions, better utilize available resources, and enhance the institution's ability to comprehensively manage risk. However, the internal audit function should maintain the ability to independently audit other risk monitoring functions, including loan review, without impairing its independence with respect to these other functions.

Loan Classification or Credit Grading Systems

The foundation for any loan review system is accurate and timely loan classification or credit grading, which involves an assessment of credit quality and leads to the identification of problem loans. An effective loan classification or credit grading system provides important information on the collectibility of the portfolio for use in the determination of an appropriate level for the ALLL.

Regardless of the type of loan review system employed, an effective loan classification or credit grading framework generally places primary reliance on the institution's lending staff to identify emerging loan problems. However, given the importance and subjective nature of loan classification or credit grading, the judgment of an institution's lending staff regarding the assignment of particular classification or grades to loans should be subject to review by: (i) peers, superiors, or loan committee(s); (ii) an independent, qualified part-time or full-time employee(s); (iii) an internal department staffed with credit review specialists; or (iv) qualified outside credit review consultants. A loan classification or credit grading review that is independent of the lending function is preferred because it typically provides a more objective assessment of credit quality. Because accurate and timely loan classification or credit grading is a critical component of an effective loan review system, each institution should ensure that its loan review system includes the following attributes:

- A formal loan classification or credit grading system in which loan classifications or credit grades reflect the risk of default and credit losses and for which a written description is maintained, including a discussion of the factors used to assign appropriate classifications or credit grades to loans.²⁸
- Identification or grouping of loans that warrant the special attention of management²⁹ or other designated "watch lists" of loans that management is more closely monitoring.
- Documentation supporting the reasons why particular loans merit special attention or received a specific adverse classification or credit grade and management's adherence to approved work out plans.
- A mechanism for direct, periodic, and timely reporting to senior management and the board of directors on the status of loans identified as meriting special attention or adversely classified or graded and the actions taken by management.

²⁸ A bank or savings association may have a loan classification or credit grading system that differs from the framework used by the banking agencies. However, each institution that maintains a loan classification or credit grading system that differs from the banking agencies' framework should maintain documentation that translates its system into the framework used by the banking agencies. This documentation should be sufficient to enable examiners to reconcile the totals for the various loan classifications or credit grades under the institution's system to the banking agencies' categories.

²⁹ For banks and savings associations, loans that have potential weaknesses that deserve management's close attention are designated "Special Mention" loans.

- Appropriate documentation of the institution's historical loss experience for each of the groups of loans with similar risk characteristics into which it has segmented its loan portfolio.³⁰

Elements of Loan Review Systems

Each institution should have a written policy that is reviewed and approved at least annually by the board of directors to evidence its support of and commitment to maintaining an effective loan review system. The loan review policy should address the following elements which are described in more detail below: the qualifications and independence of loan review personnel; the frequency, scope and depth of reviews; the review of findings and follow-up; and workpaper and report distribution.

Qualifications of Loan Review Personnel

Persons involved in the loan review or credit grading function should be qualified based on their level of education, experience, and extent of formal credit training. They should be knowledgeable in both sound lending practices and the institution's lending guidelines for the types of loans offered by the institution. In addition, they should be knowledgeable of relevant laws and regulations affecting lending activities.

Independence of Loan Review Personnel

An effective loan review system uses both the initial identification of emerging problem loans by loan officers and other line staff, and the credit review of loans by individuals independent of the credit approval process. An important requirement for an effective system is to place responsibility on loan officers and line staff for continuous portfolio analysis and prompt identification and reporting of problem loans. Because of frequent contact with borrowers, loan officers and line staff can usually identify potential problems before they become apparent to others. However, institutions should be careful to avoid over-reliance upon loan officers and line staff for identification of problem loans. Institutions should ensure that loans are also reviewed by individuals who do not have control over the loans they review and who are not part of, and are not influenced by anyone associated with the loan approval process.

While larger institutions typically establish a separate department staffed with credit review specialists, cost and volume considerations may not justify such a system in smaller institutions. In some smaller institutions, an independent committee of outside directors may fill this role. Whether or not the institution has an independent loan review department, the loan review function should report *directly* to the board of directors or a committee thereof (although senior management may be responsible for appropriate administrative functions so long as they do not compromise the independence of the loan review function).

³⁰ In particular, institutions with large and complex loan portfolios are encouraged to maintain records of their historical loss experience for credits in each of the categories in their loan classification or credit grading framework. For banks and savings associations, these categories should either be those used by, or should be categories that can be translated into those used by, the banking agencies.

Some institutions may choose to outsource the credit review function to an independent outside party. However, the responsibility for maintaining a sound loan review process cannot be delegated to an outside party. Therefore, institution personnel who are independent of the lending function should assess control risks, develop the credit review plan, and ensure appropriate follow-up of findings. Furthermore, the institution should be mindful of special requirements concerning independence should it consider outsourcing the credit review function to its external auditor.

Frequency of Reviews

Loan review personnel should review significant credits³¹ at least annually, upon renewal, or more frequently when internal or external factors indicate a potential for deteriorating credit quality in a particular loan, loan product, or group of loans. Optimally, the loan review function can be used to provide useful continual feedback on the effectiveness of the lending process in order to identify any emerging problems. A system of ongoing or periodic portfolio reviews is particularly important to the ALLL determination process because this process is dependent on the accurate and timely identification of problem loans.

Scope of Reviews

Reviews by loan review personnel should cover all loans that are significant and other loans that meet certain criteria. Management should document the scope of its reviews and ensure that the percentage of the portfolio selected for review provides reasonable assurance that the results of the review have identified any credit quality deterioration and other unfavorable trends in the portfolio and reflect its quality as a whole. Management should also consider industry standards for loan review coverage consistent with the size and complexity of its loan portfolio and lending operations to verify that the scope of its reviews is appropriate. The institution's board of directors should approve the scope of loan reviews on an annual basis or when any significant interim changes to the scope of reviews are made. Reviews typically include:

- Loans over a predetermined size.
- A sufficient sample of smaller loans.
- Past due, nonaccrual, renewed and restructured loans.
- Loans previously adversely classified or graded and loans designated as warranting the special attention of management³² by the institution or its examiners.
- Insider loans.
- Loans constituting concentrations of credit risk and other loans affected by common repayment factors.

³¹ Significant credits in this context may or may not be loans individually evaluated for impairment under FAS 114.

³² See footnote 29.

Depth of Reviews

Reviews should analyze a number of important aspects of the loans selected for review, including:

- Credit quality, including underwriting and borrower performance.
- Sufficiency of credit and collateral documentation.
- Proper lien perfection.
- Proper approval by the loan officer and loan committee(s).
- Adherence to any loan agreement covenants.
- Compliance with internal policies and procedures (such as aging, nonaccrual, and classification or grading policies) and laws and regulations.
- Appropriate identification of individually impaired loans, measurement of estimated loan impairment, and timeliness of charge-offs.

Furthermore, these reviews should consider the appropriateness and timeliness of the identification of problem loans by loan officers.

Review of Findings and Follow-Up

Loan review personnel should discuss all noted deficiencies and identified weaknesses and any existing or planned corrective actions, including time frames for correction, with appropriate loan officers and department managers. Loan review personnel should then review these findings and corrective actions with members of senior management. All noted deficiencies and identified weaknesses that remain unresolved beyond the scheduled time frames for correction should be promptly reported to senior management and the board of directors.

Credit classification or grading differences between loan officers and loan review personnel should be resolved according to a pre-arranged process. That process may include formal appeals procedures and arbitration by an independent party or may require default to the assigned classification or grade that indicates lower credit quality. If an outsourced credit review concludes that a borrower is less creditworthy than is perceived by the institution, the lower credit quality classification or grade should prevail unless internal parties identify additional information sufficient to obtain the concurrence of the outside reviewer or arbiter on the higher credit quality classification or grade.

Workpaper and Report Distribution

The loan review function should prepare a list of all loans reviewed (including the date of the review) and documentation (including a summary analysis) that substantiates the grades or classifications assigned to the loans reviewed. A report that summarizes the results of the loan review should be submitted to the board of directors at least quarterly.³³ In addition to reporting current credit quality findings, comparative trends can be presented to the board of directors that identify significant changes in the overall quality of the portfolio. Findings should also address the adequacy of and adherence to internal policies and procedures, as well as compliance with laws and regulations, in order to facilitate timely correction of any noted deficiencies.

³³ The board of directors should be informed more frequently than quarterly when material adverse trends are noted.

Attachment 2

International Transfer Risk Considerations

With respect to international transfer risk, an institution with cross-border exposures should support its determination of the appropriateness of its ALLL by performing an analysis of the transfer risk, commensurate with the size and composition of the institution's exposure to each country. Such analyses should take into consideration the following factors, as appropriate:

- The institution's loan portfolio mix for each country (e.g., types of borrowers, loan maturities, collateral, guarantees, special credit facilities, and other distinguishing factors).
- The institution's business strategy and its debt management plans for each country.
- Each country's balance of payments position.
- Each country's level of international reserves.
- Each country's established payment performance record and its future debt servicing prospects.
- Each country's socio-political situation and its effect on the adoption or implementation of economic reforms, in particular those affecting debt servicing capacity.
- Each country's current standing with multilateral and official creditors.
- The status of each country's relationships with other creditors, including institutions.
- The most recent evaluations distributed by the banking agencies' Interagency Country Exposure Review Committee.