

Financial Managers update

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ALLL models

Extra caution essential when utilizing loss-allowance models

Institutions need to exercise extra caution when utilizing ALLL models to determine loss allowances in today's difficult economic environment, an industry modeling specialist warns.

High-quality performance of such models is essential, as asset-quality indicators for the industry have continued to worsen.

The FDIC said that for the fourth quarter of 2009, net charge-offs for the industry totaled \$53 billion, an increase of 37.2% over the similar 2008 period. It also noted that the annualized net charge-off rate of

2.89% for the period was the highest quarterly rate reported in 26 years.

Modeling specialist Bill McGuire, president, McGuire Performance Solutions, Scottsdale, Ariz., warns that as losses have risen, examiners have been intensifying their scrutiny of the models to ensure that they are operating effectively and complying with regulatory guidelines.

Qualitative adjustments

Examiners are especially taking a close look at "qualitative adjustments" for loss allowances, which require judgments by management. In

addition, they are likely to further intensify the scrutiny of ALLL-model validations, McGuire said. He made his remarks in a recent FMS webinar.

Regulators have noted these typical weaknesses in ALLL models, methodologies, and governance:

- Lagging credit metrics used in a fast-changing environment
- Credit-risk metrics not forward-looking and not stress-tested
- Qualitative risk factors not applied
- Inadequate board oversight, often due to poor reporting

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Acquiring troubled banks

There's opportunity for growth—but you must be careful

A number of smaller institutions are acquiring troubled banks in a long-term growth strategy that takes advantage of current opportunities involving FDIC-assisted assets.

Acquiring institutions are drawn to the low costs and high earnings potential of obtaining such troubled entities. For healthy institutions, the most common way to get involved is by bidding on FDIC sales of whole banks.

At press time, 57 institutions had failed so far this year, versus 148 failures during all of 2009 and 30 for all of 2008. Of the 148 institutions

that failed in 2009, 130 were sold through purchase and assumption agreements, according to FDIC data.

Acquisition benefits

Most acquirers view the FDIC-assisted transactions—especially those including a loss-sharing feature—as a relatively safe way to expand their franchises. The risk-reducing feature provides FDIC reimbursement of a portion of the acquirer's expected future losses.

Both acquisition specialists and CFOs who have successfully completed such transactions say

that the benefits enable acquiring institutions to:

- Obtain a new deposit franchise
- Increase market share
- Enter a new market
- Increase economies of scale

Under a loss-sharing agreement, the FDIC agrees to absorb a significant portion of the losses, typically 80% to a stated threshold and 95% when the losses exceed the stated thresholds. Thus, the thresholds require the "assuming bank" to absorb either 20% or 5%

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- Insufficient ALLL model documentation
- Model governance (user controls and policies) not sufficient
- Lack of independent ALLL process and model validation

“The regulators are sort of a lagging indicator on credit conditions—but they are now putting full force into their reviews of ALLL allocations to make sure that they cover any future credit risks,” McGuire said.

He stressed that the factors which must be weighted when considering credit risk include both static measures, derived at a loan’s origination, and dynamic measures over the life of the loan. “The dynamic measures have become much more important recently, because of the incredibly fast changes in both the economy and the financial markets,” he added.

Blend inputs

Usually, you think of regulators as just wanting a number produced by the ALLL model—but that is not really the case right now. Instead, it’s imperative to blend together quantitative and qualitative inputs.

Purely quantitative data on current and future conditions is still essential, but there also must be a qualitative or “judgmental” review that takes into account any volatile economic factors.

In reviewing the key aspects of an ALLL model’s structure, McGuire said that the model brings together these essential factors: loan-detail data; credit risk metrics involving the institution’s history, peer and industry data, and current and future conditions; and a calculation engine.

“When you break the ALLL model down into its basics, it’s not a complex animal,” he explained. “Really all ALLL models are the same—they are really just a platform.”

“Each lending franchise is unique, leading to the need to customize these models tremendously,” he said. “Most of these, in my experience, are Excel-based—and tend to be produced by the institutions.”

One of the most important components is loan-detail data, he said.

“We will want to be able to look at each loan held in portfolio, and evaluate it on the basis of credit-risk metrics.” Such metrics are based on the institution’s historical data, such as how the loan portfolio has behaved over time.

“Your institution’s recent credit-loss experience provides clues to future outcomes that can be precisely quantified. The future rarely equals the past—so any backward-looking ALLL credit-loss estimate must be qualitatively adjusted.”

*Bill McGuire, President
McGuire Performance Solutions
Scottsdale, Ariz.*

When initially setting up a model, it’s essential to make sure that the model correctly differentiates loan data in terms of the accounting requirements under FAS 5, covering groups of loans, and FAS 114, applying to specifically identified, individual loans. “That will be the initial building point that has to be correctly defined,” McGuire said.

Importantly, he warned: “If the data coming into the model are not correct—or the fundamental setup between FAS 5 and FAS 114 is not correct—then we’re going to have difficulty getting to the right answer.”

Following this, the next thing to consider conceptually is “loan segment risk” related to FAS 5. This involves looking at groups of loans and assigning an “on-average” expected credit loss to each of those groups.

“We need to have our total loan portfolio stratified into individual buckets, or types of loans, that are homogenous in the sense that they share fundamental risk characteristics,” McGuire explained. Thus, a practical approach is to

separate homogenous loans into logical segments by loan types, and break that out by loan-risk class.

Some of the modeling inputs include a segmentation of loans in terms of business criteria and risk-related characteristics. This process involves creating summary-level “parent categories” and sub-stratifications. For example, summary-level loan segments might include: commercial (not secured); commercial and CRE (secured); residential real estate; installment loans; signature lines (not secured); and signature lines (home equity).

However, McGuire noted that there are some exceptions to this. Loans that are pulled out of the segmented groups include those that do not fit neatly into the segmented categories, and those that are impaired.

Segment level

Once the existing portfolio is stratified into such segments and the exceptions pulled out, the loss allowance can be calculated at the segment level. “We multiply our credit-risk factor times the balance in that category—that will be the incremental contribution to the overall allowance for loan losses,” he said.

After the segments are created and loans categorized, the institution also can fine-tune its credit-loss adjustments and multipliers, so that it appropriately assigns a higher credit-loss expectation to a lower quality loan. To calculate expected losses, the modeler must come up with credit-loss potential by segment. “It’s a percentage of the balance that I expect not to perform,” McGuire said.

In part, this can be derived from the institution’s own loss history, by asking how well each of these segments has performed over a certain time period. In addition, it also makes sense to compare that data with other peer and industry data as a reference.

However, McGuire cautioned that capturing peer data is “easier said than done,” because sources of granular data are scarce. He advised that a good way to go after peer-industry data is to start with institutions of similar asset

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size and geography, based on FDIC or NCUA data. And from there, try to find an institution that has the same type of lending patterns for relevant comparisons.

“We have to be careful with that—each lending franchise and each lending footprint is unique,” he added. “But there is some value to looking over your shoulder at what’s happening in the bigger picture.”

As for qualitative loss-adjustment factors, right now the biggest question involves the impact of ongoing business and economic conditions: how will the recovery affect loss outcomes?

“You want to look not just behind—you also want to look forward,” McGuire advised.

Another modeling step involves FAS 114 considerations. “This is going to be a smaller part of your portfolio—it applies only to specific, individually identified loans,” he said.

For example, if a loan looks especially risky or out of place, it should be pulled out of the loan pools and individually assessed. Such loans are assigned a unique loss allowance, based upon the degree of impairment, he added. “So there is a specific reserve associated with them.”

For example, a number of loans in commercial real estate

(CRE) portfolios were at one time in a FAS 5 pool, but “have now migrated down to FAS 114, because of the uncertainty associated with the underlying soundness of the loans,” he said. “The same would be the case for many residential real estate loans.”

McGuire noted that if there is impairment, FAS 114 provides three different ways to determine this: assessing the fair value under FAS 157; looking at the value of collateral for loans that are collateralized; or assessing loan prices in current observable markets.

Not surprisingly, he pointed out that quantifying expected credit-loss inputs by loan segment is often the most challenging ALLL-model construction task. Two traditional approaches for addressing this have been ratio analyses of an institution’s specific credit-loss history and the use of peer or industry credit-loss historical data.

Importantly, these approaches can now be augmented by a new modeling best practice involving the statistical analysis of institution-specific default probabilities. Such a statistical approach more effectively enables CFOs to make qualitative, future-looking ALLL adjustments, McGuire said.

“Your institution’s recent credit-loss experience provides clues to

future outcomes that can be precisely quantified,” he said. “The future rarely equals the past—so any backward-looking ALLL credit-loss estimate must be qualitatively adjusted.”

He emphasized that statistically-based default models can successfully identify loans with high credit-risk exposure. The findings are consistent with traditional ratio-based ALLL model credit-loss estimates—but often more credit risk is forecast.

The statistical method enables an institution to link a borrower’s loan-to-value data and FICO history in ways that correlate with outcomes, including a probability of default. CFOs can utilize such statistical analyses to help fine-tune their loss calculations.

“Advantages of the statistical method are in its quantification,” McGuire said. “The statistical methodology has no emotion.”

In other advice for CFOs, he said that since the basis for qualitative adjustments involves judgments by loan officers or management, it’s important for this process to be carefully defined and documented. This should include stipulating the frequency of reviews and specific criteria for changes, such as credit quality or external environmental factors.

You may review further insights about models in the AL Modeling category of the News Archive on the FMS web site at www.fmsinc.org. **FMS**

Fannie-Freddie update

Administration seeks comments on housing finance system

Following recent *Update* coverage on the future of troubled mortgage-finance giants Fannie Mae and Freddie Mac, the Treasury and HUD issued a list of questions seeking public comments on the future of the housing finance system.

The questions have been designed to generate input from a wide variety of constituents and apparently represent a tentative first step towards replacing Fannie and Freddie, given recent pressure from Congress on this issue. (See *FMS*, April 20, 2010 for related details.)

In recent testimony before the House Financial Services committee, Treasury secretary Timothy Geithner said that the administration will develop

a “comprehensive reform proposal” to deliver to Congress, but did not indicate a timetable.

Geithner said that the list of questions seek comments on the appropriate role of government in housing policy and housing finance, as well as the design of mortgage products and protection for consumers who use them. “A well functioning housing finance system is critical to the long-term stability of the housing market,” he said.

FMS members are advised to consider submitting comments on this important issue. You may review the questions in the Treasury category—or by using the search function—of the News Archive on the FMS web site at www.fmsinc.org. **FMS**