EM-21.2

Category: **Assets**
Topic: **Allowance for Losses**
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Overview

The *Allowance for Losses* topic provides guidance on evaluating the adequacy of the allowance for credit losses (ACL or allowance) on an institution's loan and lease portfolios. The ACL is a valuation account that is deducted from the amortized cost basis of the loan and lease portfolio to report the net amount expected to be collected over the contractual life of the asset. Farm Credit Administration (FCA) Regulation 621.5(a) requires each Farm Credit System (System) institution to maintain an ACL in accordance with generally accepted accounting principles (GAAP). More broadly, FCA Regulation 621.3 requires institutions to prepare and maintain accurate and complete records of business transactions and to prepare financial statements and reports in accordance with GAAP. Accordingly, the ACL at System institutions should be determined in accordance with Accounting Standards Codification (ASC) Topic 326. This standard requires institutions to measure all expected credit losses for financial instruments held at the reporting date based on historical experience, current conditions, and reasonable and supportable forecasts.

Institutions need a well-documented ACL process that considers all credit risks; assesses current conditions and reasonable and supportable forecasts; and estimates the ACL needed to cover expected credit losses over the life of the loan. Sound ACL methodologies include consideration of both quantitative and qualitative factors that support management's estimation of expected credit losses in the loan and lease portfolio. Management must apply judgment to ensure the ACL is within an acceptable range of reasonably expected losses and support the determination with a well-documented analysis. FCA Bookletter BL-049 REVISED contains guidance and expectations for maintaining an adequate ACL level for assets measured at amortized cost. Failure to analyze loan and lease portfolio collectability and maintain and support an appropriate ACL in accordance with GAAP and regulatory guidance is an unsafe and unsound practice.

FCA examiners determine ACL adequacy by evaluating the overall processes used by the institution. The examiner's assessment will focus on the institution's policies, practices, methodologies, assumptions, internal controls, and the documentation maintained to support those factors. The examiner's assessment will also determine whether the ACL is reasonable in relation to portfolio risk, general economic conditions, and the institution's reasonable and supportable forecasts among other factors.

Note: This section is updated to reflect the current expected credit losses (CECL) methodology for estimating allowances for credit losses under ASC Topic 326. Refer to FCA's Informational Memorandum on New Accounting Standard on Financial Instruments – Credit Losses dated September 1, 2016, and other industry guidance.

Examination Procedures and Guidance

General

1. Allowance Level:

Evaluate the adequacy of allowance balances and related provisions.

Guidance:

FCA Regulation 621.5 requires System institutions to maintain an allowance for credit losses (ACL) determined in accordance with GAAP. As discussed in FCA Bookletter BL-049 REVISED, System institutions are expected to develop and document systematic methodologies to support the determination of the ACL and any related provisions for credit losses. An assessment of the adequacy of ACL balances must consider the adequacy of the institution's ACL processes and methodologies as evaluated under the *Policy, Procedures, Methodologies, & Controls* procedure. Sound and consistently applied methodologies should result in reasonable estimates of expected credit losses and well-supported ACL balances.

Evaluative questions and items to consider when examining the adequacy of ACL balances and related provisions include:

- ***ACL Balances:*** **Are ACL balances consistent with loan and lease portfolio trends and if not, does management's analysis support the cause for any notable difference?** Analysis should consider trends in overall ACL balances as well as the relationship (ratios) between ACL balances and other key portfolio measures including total loans, adverse or criticized loans, nonaccrual loans, and net chargeoffs (typically considered relative to the last 3-5 years). By understanding an institution's ACL methodologies, examiners should be able to identify the primary causes of any material change in ACL balances or related ratios. If the analysis indicates potential concerns with the ACL's reasonableness (an allowance that does not appear to be consistent with portfolio risk, general economic conditions, reasonable and supportable forecasts, or average historical loss rates), examiners should closely review the support for the ACL to determine if methodologies and assumptions are appropriate. Management should clearly document defensible reasons for any material change in ACL balances from one period to the next. Documentation supporting quarterly allowance determinations should be consistent with the sound practices outlined in the *Documentation* section of FCA Bookletter BL-049 REVISED. Generally, ACL balances should follow an institution's credit quality trends. For example, an increase in adverse and criticized volume would also increase ACL balances. However, under CECL, there are numerous reasons for departures from this general relationship including the following examples:
    - The institution's reasonable and supportable forecasts may anticipate improvement or decline in credit quality relative to the balance sheet date.
    - Qualitative adjustments, or unallocated amounts, may be used to reflect management's forward-looking expectations, which may differ from current conditions.

- ACL balances may change as previously unfunded commitments (off-balance-sheet exposures) are funded, or due to merger related activities (e.g., accounting for Purchased Credit Deteriorated (PCD) assets).
- Changes in ACL methodologies or processes may result in notable changes in credit loss estimates and related ACL balances.

- ***Weaknesses in ACL Methodologies, Controls, or Processes:*** **Have weaknesses been identified in the institution's ACL methodologies, controls, or processes that have the potential to significantly impact ACL balances?** As previously noted, an evaluation of the adequacy of ACL balances must consider the adequacy of ACL processes and methodologies as examined in the *Policies, Procedures, Methodologies, & Controls* procedure. The evaluation of ACL balance adequacy should also consider results of recent audits, reviews, and validations to determine whether identified weaknesses or concerns suggest potentially inaccurate or insufficient credit loss estimates. Weak or unsupported model assumptions, untimely recognition of chargeoffs, inaccurate or inadequate loss histories, weak or inadequate data quality controls, and improper portfolio segmentation are examples of factors that could materially impact credit loss estimates and ACL balances. In addition, examinations or audits may identify problems with the institution's method for determining provisions required for unfunded commitments or PCD assets, or with the support for zero loss assumptions for specified portfolio segments. Examiners should determine whether management adequately addressed previously identified concerns, or if adjustments to ACL amounts are warranted due to weaknesses identified.

- ***Weaknesses in Risk Identification or Risk Management:*** **Have examinations or audits identified weaknesses in credit risk identification or risk management that may impact credit loss estimates or the adequacy of the ACL?** The adequacy of ACL processes relies on effective credit risk identification and risk management processes. For example, many ACL models rely on internal risk classifications (i.e., Probability of Default (PD) or Uniform Classification System (UCS) ratings) as a primary input to credit loss estimates. If internal risk classifications are inaccurate or if credit review processes are insufficient, credit loss estimates will also be inaccurate. Weaknesses in loan portfolio management or loan underwriting may also result in a higher level of unmitigated credit risk than contemplated in ACL methodologies. Examiners should determine whether management addressed previously identified concerns, or if adjustments to ACL amounts are warranted due to weaknesses identified.

- ***ACL Accounting:*** **Were quarterly entries to the financial statements appropriate based on the ACL analysis?** ASC Subtopic 326-20 requires management to record an ACL at each financial reporting date. If the ACL required per the current analysis is different than the amount recorded in the previous financial statements, entries in the current quarter should include provisions or reversals to the appropriate accounts. The following are considerations for adjusting financial statements:
  - If the ACL analysis was not based on the most recent quarter-end information (e.g., the initial analysis may have been prepared on information as of 1 month prior to quarter end), it should be adjusted for any significant subsequent changes or events. Management should document the nature and underlying rationale of any adjustments. It is important these adjustments are consistent with GAAP.

- Adjustments to the ACL should be consistent with management's best estimate of expected credit losses and should not be unduly influenced by factors like earnings or capital levels. Failure to adjust the ACL in accordance with GAAP is a violation of FCA Regulations 621.3 and 621.5(a).

- In accordance with ASC Subtopic 326-20 and FCA Regulation 621.5(c), financial asset chargeoffs are deducted from the ACL and recorded in the period in which the asset is deemed uncollectible. See High-Risk Asset Accounting and Reporting for additional guidance regarding the timing of chargeoffs.

- ASC Subtopic 326-20 requires institutions to consider expected recoveries in estimating credit losses. Expected recoveries should be included when determining any needed adjustments to the ACL. Expected recoveries of amounts previously charged off or expected to be charged off that are included in the ACL should not exceed the aggregate of any amounts previously charged off or anticipated to be charged off (in prior period ACL analysis).

- If there are significant changes needed in the ACL balance, management should clearly determine whether the events causing the change occurred in the current period and not in prior periods. If changes should have been made in prior periods, consider whether the institution needs to re-state its financial statements for shareholders and re-file Call Reports. While changes in estimates are treated prospectively, material errors should cause re-statement of the financial statements and Call Reports.

2. Policy, Procedures, Methodologies, & Controls:

Evaluate the adequacy of allowance related policy, procedures, methodologies, and controls for estimating credit losses in conformance with GAAP and FCA guidance.

Guidance:

The ACL should be based on a comprehensive, well-documented, and consistently applied loan and lease portfolio analysis that is conducted quarterly. The CECL framework requires forecasting of credit losses over the financial asset's entire contractual life and provides flexibility in the methodologies institutions can use to estimate credit losses. Loss estimates should consider all significant quantitative and qualitative factors that affect portfolio collectability. The basis for these estimates should not be limited to historical loss experience. Under CECL, credit loss estimates are based on additional considerations including the following:

- Management's judgment and assumptions.
- Current portfolio specific lending conditions.
- The probable impact of general economic conditions as reflected in key economic indicators.
- Reasonable and supportable forecasts of these factors.

Arriving at an appropriate ACL involves a high degree of management judgment and typically results in a range of estimated losses. Accordingly, the institution needs to support and document its best estimate of expected credit losses within this range in accordance with GAAP. Under the CECL framework, processes should also facilitate the enhanced financial statement disclosures required to adhere to GAAP. The following guidance addresses key components of effective ACL policies and procedures, methodologies, and related controls.

Policies and Procedures: The board and management must establish policy and procedure guidance to ensure the ACL is consistent with GAAP and regulatory requirements. The guidance should require an ACL assessment at least quarterly. If this assessment determines the ACL is inadequate or excessive, the guidance should require a timely ACL provision or reversal to ensure financial statement accuracy. Evaluative questions and items to consider when examining ACL policies and procedures include:

- ***Board Policy*: Does the institution have an effective board policy to establish and maintain the ACL consistent with GAAP and regulatory requirements? Has the board provided sufficient direction over the ACL process?** FCA Regulation [621.5(b)] requires institutions to develop, adopt, and consistently apply ACL policies and procedures. The board's policy should direct management to develop, document, and maintain an appropriate, systematic, and consistent process to ensure the ACL and related provisions for credit losses on loans are adequate and fully supported. ACL policies should specifically address the institution's unique goals, systems, risk profile, and personnel as they relate to the ACL process as well as board reporting expectations. The board should review ACL-related policies at least annually. FCA Bookletter [BL-049 REVISED] provides additional guidance on key factors to be addressed in the board's policy.

- ***Management Operating Procedures:* Do operating procedures ensure sufficient and well documented ACL processes that are consistent with board policy, GAAP, regulatory requirements, and other FCA guidance?** FCA Regulation [621.5(b)] requires institutions to develop and implement suitable procedures that translate board policy into appropriate processes and practices that comply with GAAP and regulatory requirements. Procedures should describe the methodology for assessing expected loss exposure and estimating ACL needs to help ensure an effective and consistent ACL process. Procedures should also identify the information and documentation requirements to support the ACL process. The following should be addressed in operating procedures:

    - *Allowance processes* – Management procedures should document the key aspects of ACL processes. Specifically, procedures should outline the processes for the following:

        - Acquiring and managing the data necessary to support ACL processes.
        - Segmenting the loan and lease portfolio into risk pools.
        - Establishing the contractual term applicable to loan and lease assets.
        - Establishing reasonable and supportable forecasts.
        - Applying credit loss methodologies.
        - Applying any qualitative adjustments.
        - Reverting to historical losses for periods beyond reasonable and supportable forecasts.
        - Estimating credit losses on off-balance-sheet exposures and Purchased Credit Deteriorated (PCD) assets as well as determining and supporting any unallocated allowance amounts.

    - *Documentation requirements* – Procedures should appropriately address documentation expectations related to the ACL analysis process. Appropriate supporting documentation contributes to the control environment, builds discipline and consistency into the ACL determination process, and improves the process for estimating credit losses by helping to ensure all relevant factors are considered. This includes addressing items such as key judgments, assumptions, and analyses, as well as summaries of results and recommendations. Procedures should clearly identify documentation standards, giving consideration to the elements specifically outlined in ASC Topic 326 and in the *Documentation* section of FCA Bookletter BL-049 REVISED.

  - *ACL controls and validations* – Procedures should address controls over ACL processes and activities to validate ACL methodologies on an ongoing basis. This would include addressing the factors outlined in the *Monitoring, Reporting, and Other Controls* subsection below, including data controls, model risk management, ACL performance analysis and periodic validation (e.g., determining if loss estimates are consistent with realized loss rates over time), and third-party risk management practices as applicable.

Allowance Methodologies: As discussed in FCA Bookletter BL-049 REVISED, System institutions are expected to develop and document systematic methodologies to support the determination of their ACL. It is critical that ACL methodologies incorporate management's current judgment about loan portfolio quality through a disciplined and consistently applied process. This process is influenced by several institution-specific factors, such as risk profile, operational complexity, organizational structure, business environment and strategy, management style, loan administration procedures, and management information systems. Additionally, the board and management should consider the unique and varied characteristics of the portfolio (e.g., commodity, geographic, and repayment source concentrations, loan terms, trends in loan-to-value ratios and collateral values, effects of weather-related or environmental conditions). Regardless of the loss estimation techniques employed, sound ACL processes should address core components common to all ACL methodologies as discussed below. Evaluative questions and items to consider when examining allowance methodologies include:

- ***Data:* Has management ensured that information systems adequately support ACL determinations, and historical loss information and other data sets are relevant to the institution's loan portfolio?** As discussed in FCA Bookletter BL-049 REVISED, one of management's responsibilities is ensuring information systems appropriately support the determination of the ACL and allow for access to the necessary data elements. Processes should be in place to collect and maintain all data relevant to supporting ACL processes. Loss estimation under CECL may require a broad range of data elements, and data needs will vary depending on the methodologies used. Generally, the primary focus will be on collecting and maintaining data elements relevant to assessing the collectability of loan cash flows. Historical loss information, including chargeoff and recovery data, generally provides a basis for assessing and estimating expected credit losses. These data elements may be based on internal or external information, or a combination. When the institution supplements its own data with third-party (external) data sets, methodologies should establish and document how the data utilized is relevant in comparison to its own portfolio. For example, the PD loss factors used in ACL processes at many System institutions may be based on loss histories from the broader population of System loan assets. Management should consider whether third-party historical loss information should be adjusted for differences in factors such as portfolio mix or underwriting practices, or differences in current lending conditions relative to the historical period being evaluated. ACL documentation should reasonably support the appropriateness of external data sets and any management adjustments. Common data sets used to support ACL determinations might include the following:
  - Loan type (e.g., production or real estate, fixed rate or floating)

- Collateral type (including unsecured)
    - Origination and maturity dates
    - Interest rate or index
    - Prepayments (dates and amounts)
    - Chargeoffs and recoveries (dates and amounts)
    - Renewal dates and terms
    - Internal risk ratings (e.g., PDs and Loss Given Defaults (LGDs))
    - Accounting classifications
    - Past due status

- ***Segmentation:*** **Do the institution's processes result in appropriate asset segmentation based on risk characteristics, including the identification of assets to be evaluated for credit losses individually, collateral-dependent assets, and zero-loss considerations?** Credit losses are estimated, and the ACL is determined based on any appropriate method under ASC Subtopic 326-20. Under ASC Subtopic 326-20, credit losses are estimated collectively for pools of assets that share similar risk characteristics (e.g., portfolio segments). For assets that do not share risk characteristics with other financial assets, credit losses are estimated individually. ASC Subtopic 326-20 also includes guidance related to collateral-dependent assets and zero-loss considerations. Items to consider when segmenting the portfolio include:

    - *Asset segmentation* – Assets evaluated collectively are segmented or pooled based on one or more specified characteristics or combination of characteristics. Common characteristics used for segmentation might include credit scores, risk ratings, collateral type or coverage level, industry, or vintage (i.e., year originated). ASC Topic 326 does not prescribe processes or methods for determining portfolio segments; therefore, management's rationale for segmentation decisions should be documented and well supported. Segmentation or pools can be based on both credit (e.g., credit score, PD, LGD, UCS Classification, or delinquency status) and noncredit (e.g., vintage, product type, or term to maturity) characteristics. In certain situations, re-segmenting portions of the portfolio may be appropriate. Portfolio segmentation should be periodically reviewed to ensure pooled assets continue to share the same risk characteristics. When an asset is determined to no longer share characteristics with the other assets in its pool, it should be moved to a different portfolio segment (as appropriate given its risk characteristics) or evaluated individually if it no longer shares risk characteristics with any other financial asset segment.

    - *Individual asset evaluation* – When an asset no longer shares common risk characteristics with any pool of financial assets in the portfolio, it should be evaluated for credit losses individually. ASC Subtopic 326-20 does not specify how institutions should identify assets for individual evaluation. The institution should have its own policies and criteria to identify those assets whose risk characteristics have changed (e.g., increased credit risk) and can no longer be evaluated for credit losses as part of a pool. Factors to consider and review in individual asset analysis could include changes in credit classification, performance classification, delinquency status, default, or bankruptcy. ASC Subtopic 326-20 does not prescribe a set methodology for estimating credit losses on assets evaluated individually, except for collateral-dependent loans in certain circumstances as discussed below. The methodologies employed may be like those used for assets evaluated collectively, or the institution may use completely different processes. For example, the institution could use a discounted cash flow (DCF) methodology for estimating losses on assets evaluated individually even if DCF methods are not used for assets evaluated collectively. If an asset is evaluated on an individual basis, it cannot be included in any pools subject to collective evaluation.

- *Collateral-dependent assets* – Credit losses on collateral-dependent assets should be evaluated individually. Under ASC Subtopic 326-20, an asset is collateral-dependent if the repayment is expected to be provided substantially through the operation or sale of the collateral, and the borrower is experiencing financial difficulty (based on management's assessment). ASC Subtopic 326-20 allows, but does not require, institutions to use the fair value of the underlying collateral at the reporting date when determining the net carrying amount of the asset, and the related ACL. If the fair value of the collateral is less than the amortized cost of the loan, the difference is recognized as an ACL and related provisions are recognized, as necessary. The institution could expect zero credit losses when the fair value of the collateral is equal to or in excess of the amortized cost of the related loan asset. When repayment is expected to come from the sale of collateral, the fair value of the collateral is adjusted to reflect anticipated costs to sell. When the institution determines foreclosure is probable, expected credit losses must be measured based on the fair value of the underlying collateral as described here.

- *Zero credit losses* – For some assets or portfolio segments, there may be no expectation of credit losses (i.e., management anticipates there will be zero losses over the asset's lifetime). ASC Subtopic 326-20 does not require the measurement of expected credit losses on assets or groups of assets where historical credit loss information, adjusted for current conditions and reasonable and supportable forecasts, suggests expected credit losses are zero. This contrasts with assets where the probability of loss is remote, in which case a loss estimation is still required. Management must document support for the zero-loss determination of an asset or pool of assets. Factors that could support a zero-loss determination include, a long history of zero credit losses, or principal and interest payments that are fully and unconditionally guaranteed by the United States government. Since characteristics that support a zero-loss determination may change over time, management should periodically reassess whether the zero-loss expectation remains appropriate. Except in specified instances (e.g., collateral dependent loans, loans supported by collateral maintenance provisions), it is not appropriate to assume zero losses on an asset due solely to the presence of collateral with a current value that exceeds a loan's amortized cost basis. Processes should consider potential future changes in collateral values and historical loss experience for assets covered by similar types of collateral.

- ***Contractual Term:* Do the institution's processes support determining appropriate contractual terms of an asset, including consideration of prepayments, extensions, or renewals?** Under ASC Subtopic 326-20, expected credit losses are estimated over the contractual term of financial assets in the portfolio. An asset's contractual term should reflect expected prepayments and may be adjusted for renewals or extensions under certain conditions. This means that an asset's term as used for CECL purposes may differ from the stated contractual term in lending agreements. The processes for determining the contractual term used for assets and pools of assets should be documented and supported and consider the following:

- Estimated prepayments can be considered as a separate input into the allowance methodology or could be embedded in the credit loss information (e.g., historical losses). If the institution uses a DCF methodology, prepayments should be reflected in the estimated future principal and interest cash flows.

- The institution should not consider expected extensions, renewals, or modifications in determining an asset's contractual term if the option(s) were not included in the original lending agreement or they are unconditionally cancellable by the institution. When applicable, methodologies should include an assessment of the probability the borrower will make use of embedded extension or renewal options.

- ***Credit Loss Methodology*: Are credit loss methodologies appropriate for the assets being evaluated and are methodologies consistently applied over time?** There are a variety of acceptable methods for estimating credit losses under ASC Topic 326. The institution may use different methodologies for different portfolio segments or assets evaluated for losses individually (versus what is used for assets evaluated collectively). In any case, the selected method should be appropriate for the assets being evaluated and applied consistently over time. Documentation should support all key management decisions in establishing and adjusting the ACL methodologies, as well as reviewing and validating methodologies as business processes or conditions change. FCA Bookletter BL-049 REVISED provides further guidance on documenting the credit loss methodology. A key component of ACL methodologies is the model. Since most credit loss methodologies are quantitative models, the ACL model(s) should be governed in accordance with the institution's overall model risk management (MRM) framework. Model validation, change controls, staffing, separation of duties, and model development should all be consistent with the institution's own MRM guidance and FCA's *Model Risk Management* procedure in the *Direction & Control of Operations* Examination Manual topic. The following are examples of common credit loss methodologies used by System institutions:

  - *Loss Rate Methods* – These methods are relatively simplistic, and use expected net loss rates derived from historical loss information. The loss rate is applied to the outstanding balance of a given asset at a set time. These methods may use different pooling methods, including open pools, closed pools, or the weighted average remaining maturity (i.e., WARM). Qualitative adjustments may be required to incorporate forward looking information.

  - *PD/LGD Methods* – These methods estimate losses as the product of an asset's PD, LGD, and exposure at default. Under CECL, all three factors may be adjusted to reflect current conditions and reasonable and supportable forecasts. For example, in a PD transition or migration model, institutions develop a forward-looking estimate of how an asset's PD will change over time (e.g., a PD curve). The forward-looking estimate is driven by the relevant economic indicators management believes will impact borrowers in the portfolio.

  - *Vintage Methods* – These methods are a type of loss rate method that use closed pools of assets to evaluate expected losses. Pools are based on an origination period (a vintage). Vintage methods work best for portfolios with large data sets (many loans) and predictable loss patterns.

- *Roll Rate Methods* – These methods segment the portfolio based on delinquency status and estimate losses based on the roll-rate (rate at which assets migrate to loss) and LGD.

- *Discounted Cash Flow (DCF) Methods* – These methods estimate losses by assessing the collectability of an asset's cash flows over time. DCF methods can be applied at the individual asset or collective pool level. The ACL is determined as the net difference between the amortized cost basis for the assets in question and the net present value of the DCFs from the asset.

- ***Reasonable and Supportable Forecasts:*** **Do the institution's processes appropriately incorporate reasonable and supportable forecasts?** ASC Subtopic 326-20 requires institutions that use historical data to estimate credit losses, to adjust this data to reflect current conditions and reasonable and supportable forecasts. However, the ASC allows discretion on how this requirement is applied. For example, there is no prescriptive guidance on methods for establishing forecasts or setting the length of the forecast period. Processes for determining the reasonable and supportable period and forming forecasts should be applied consistently and systematically and be well documented and supported. ACL processes should include an evaluation of forecasts and forecast periods at each reporting date (i.e., each time ACL analysis is completed). The following includes key concepts for developing reasonable and supportable forecasts:

  - Forecasts will generally address anticipated changes in the lending or economic environment that are relevant to assessing asset collectability. The institution should consider qualitative and quantitative factors that relate to the environment in which they operate and are specific to borrowers or portfolio segments. Forecasts may incorporate internally- and externally-sourced data. While institutions are not required to search out all possible relevant information or incur undue costs or efforts, reasonably available and relevant information should be considered. ACL documentation should detail the relevance of data utilized for forming reasonable and supportable forecasts.

  - Reasonable and supportable forecast periods may vary by portfolio segment, or individual forecast inputs depending on the variability or volatility of elements considered.

  - ASC Subtopic 326-20 does not require establishing forecasts covering the entire contractual term of assets in the portfolio. The forecast length is not an accounting choice. It is an assumption relevant to the ACL determination that should be supported and administered appropriately. For periods beyond a reasonable and supportable forecast, institutions should revert to historical loss information as discussed later in this guidance.

  - While some institutions may be able to develop reasonable and supportable forecasts covering longer periods of time, an institution cannot assert an inability to develop a forecast, and thus, use only historical loss information.

- ASC Subtopic 326-20 does not require management to develop detailed economic forecasts if forward-looking information relevant to estimating credit losses is incorporated into loss estimates through other means, such as a well-supported qualitative adjustment. ASC Subtopic 326-20 allows forward-looking information to be incorporated into estimated credit losses either quantitatively or qualitatively. In all instances, management's decisions and processes should be documented and supported.

- ***Qualitative Adjustments:*** **Do the institution's processes include appropriate and well-supported qualitative adjustments for factors not already captured in the loss estimation process, if needed?** As part of the ACL process, the institution should consider the need to qualitatively adjust loss estimates for information not already captured in the loss estimation process. The need for qualitative adjustments should be considered at each reporting date and any qualitative adjustment should be well documented and supported. Adjustments can be incorporated into the ACL as stand-alone amounts added to or deducted from the ACL, adjustments to individual inputs to the ACL model (e.g., model overlays), or a combination of the two. Factors that could necessitate a qualitative adjustment could include the following:
  - Credit concentrations (e.g., commodity, geographic, collateral type).
  - Changes in lending policies or underwriting standards.
  - Identified weaknesses in risk identification or credit review function.
  - Significant changes in lending staff tenure or expertise.
  - Environmental factors such as natural disasters.
  - Stress testing results reflecting the impacts of factors such as changes in commodity prices or collateral values.

- ***Reversion Methods and Periods:*** **Do the institution's processes include appropriate methods for reverting to historical losses for periods beyond the reasonable and supportable forecast?** Under ASC Subtopic 326-20, institutions are not required to develop forecasts beyond what is reasonable and supportable. In many cases, an asset's contractual term may extend beyond the reasonable and supportable forecast horizon. Under such conditions, the ACL methodology should revert to historical loss information for the remainder of the forecast horizon. ASC Subtopic 326-20 does not prescribe a specific reversion methodology or a set reversion period. Accordingly, the reversion to historical loss information could occur at a given point in the forecast horizon, gradually on a straight-line basis, or based on another well-supported, systematic methodology. As with the forecast period, the reversion period and methodology are not accounting policy determinations. They are model inputs and assumptions which should be regularly evaluated to ensure they remain appropriate. The following includes key concepts for applying reversion methods and periods:
  - Historical losses are not required to be based on long-term historical average loss rates. Loss rates for the reversion period could be based on multiple historical periods or losses that occurred during a specific historical period. Management's choices should be relevant to the remaining contractual term of the assets evaluated (i.e., the term not covered by reasonable and supportable forecasts) and be well supported and documented.

    - Management may utilize different reversion periods and methodologies for different portfolio segments. ASC Subtopic 326-20 does not require applying the same approach to all portfolio segments.
    - Historical loss information is not adjusted to reflect existing or expected economic conditions. However, management may adjust for differences in the current portfolio mix of assets (relative to the portfolio during the historical loss period).
    - The portion of the ACL determined based on the reversion period could comprise a significant portion of the overall ACL compared to amounts derived using reasonable and supportable forecasts. Accordingly, documented support for reversion methods is as critical as documented support for forecasts.

- ***Off-Balance-Sheet Exposures:*** **Does the institution have appropriate processes to account for reserves on off-balance-sheet items?** Per Subtopic ASC 326-20, a reserve for credit losses is needed for off-balance-sheet exposures (e.g., unfunded commitments or letters of credit) the institution is legally obligated to fund, unless the obligation is unconditionally cancellable by the issuer. When estimating credit losses on off-balance-sheet exposures, the institution may use processes similar to those used for on-balance-sheet items like loans. However, processes should also consider the likelihood funding will occur, and the amount expected to be funded over the contractual life of the asset. Because these amounts have not been disbursed, this reserve is separate from the ACL and is a liability account on the balance sheet. Management should conduct quarterly analyses to support the reserve amount.

- ***Unallocated Amounts:*** **Do processes appropriately support and document unallocated allowance amounts?** The ACL may include an unallocated amount (i.e., an amount of the ACL not specifically attributed to any given portfolio segment or individually evaluated asset). For example, a qualitative adjustment may potentially result in an unallocated amount. When the ACL includes an unallocated amount, the reason and support for the amount should be documented and supported. Documentation should address why the amount is necessary, and how it has changed over time based on changes in the factor that necessitated the adjustment.

- ***ACL on Assets Acquired via Merger:*** **Do the institution's processes appropriately address Purchased Credit Deteriorated (PCD) assets, such as those acquired in a merger?** Loans acquired in a business combination are initially recorded at fair value and should be evaluated for credit impairment at the acquisition date. Under ASC Subtopic 326-20, acquired loans (whether acquired in a merger or otherwise) are designated as either non-PCD or PCD at the acquisition date. The PCD designation is for loans that have experienced a more-than-insignificant deterioration in credit quality since origination. This designation will determine how the institution will record the ACL for acquired loans. The following are key considerations when determining the ACL for acquired assets:
    - For non-PCD loans, an initial ACL is created through a provision expense immediately following the close of an acquisition (i.e., Day 1). The Day 1 provision expense on the acquired non-PCD portfolio is the initial provision for credit losses on acquired loans and unfunded commitments. Following Day 1 provision expenses, the non-PCD portfolio is treated the same as the remainder of the loan portfolio.

- For PCD loans, the institution must recognize an initial ACL using the expected credit loss model. The institution must also recognize a corresponding adjustment of the purchase price by adding the initial ACL to the purchase price to arrive at the Day 1 amortized cost basis. There is no effect on earnings for the initial (Day 1) ACL estimates on PCD assets. At each reporting date after initial recognition, management should adjust the ACL as necessary through recognition of either a provision expense or a reversal, consistent with the process for the remainder of the portfolio. The method used for determining the initial ACL estimate should be consistently applied to determine ACL amounts in subsequent periods.

- Per ASC Subtopic 326-20, some indicators of loans that have experienced more-than-insignificant credit quality deterioration may include the following:

    - Were delinquent at the acquisition date.
    - Have been downgraded since origination.
    - Have been placed in nonaccrual status.
    - Credit spreads have widened beyond the thresholds stated in the board policy.

- Some non-impaired loans acquired in a merger may have no initial ACL. The institution may establish an ACL subsequent to merger if credit conditions associated with these loans deteriorate.

- Loans acquired at or directly subsequent to origination would generally not be PCD assets, and any related allowance would be established via provisions to the ACL and a related charge to current period earnings.

- ***Shared Assets:* Are effective processes in place to coordinate with other System institutions on shared assets to ensure consistency in loan classifications, allowances on individual loans, and chargeoffs?** FCA expects loan classifications, allowance amounts, and chargeoffs on loans to the same borrower to be reported consistently among System institutions sharing in those loans. FCA Bookletter BL-065 outlines expectations for institutions to ensure a system is in place to identify and report shared-asset exposure. The institution should have documented processes for ensuring coordination with other System institutions involved in the same shared asset. However, the institution should still perform its own independent analysis since it is ultimately responsible for assigning its own classifications, allowances, and chargeoffs. There may be instances where differences are warranted (e.g., the System lead's classification, allowance, or chargeoff is deemed to be inaccurate). These differences should be justified and documented.

Monitoring, Reporting, and Other Controls: FCA Bookletter BL-049 REVISED discusses factors that sound internal control systems should include with respect to ACL processes. Specifically, controls should help maintain the reliability and integrity of information used in the ACL process and ensure complete and sufficient ACL documentation. Additionally, a sound control system should provide reasonable assurance the level of the ACL is adequate and maintained in accordance with GAAP. Another key control is an effective audit and review program to provide assurances over ACL and risk identification processes. The board and management share primary responsibility for accurate financial statements and the overall ACL process. FCA Bookletter BL-049 REVISED further discusses board and management responsibilities. Internal reporting, including relevant board and board committee meeting materials and records, should evidence appropriate board and management oversight. Evaluative questions and items to consider when examining monitoring, reporting, and other controls include:

- ***Personnel:* Have the board and management ensured that personnel responsible for the institution's ACL processes are qualified, competent, and performing appropriately?** The ACL is one of the most significant estimates in financial statements and regulatory reports, and the ACL process requires significant judgement and analysis. Accordingly, the board and management should ensure that personnel responsible for determining the ACL are appropriately qualified and competent in performing their duties. Staffing allocated to the ACL process should be appropriate for the institution's complexity and risk profile. Management responsible for the ACL process should have a sound understanding of accounting principles and regulatory requirements guiding the ACL process. In addition, the institution should ensure appropriate cross-functional participation in ACL processes as needed. For example, the credit risk management function will likely have a key role in determining ACL assumptions, and information technology (IT) personnel will likely have a key role in administering data and the IT infrastructure underlying ACL processes. Processes should promote appropriate coordination amongst relevant stakeholders.

- ***Performance Analysis:* Does the institution have processes in place to monitor the performance of the ACL process and ensure processes are sufficiently designed and functioning as intended?** The board and management should periodically evaluate the performance of their ACL process to ensure amounts recorded reflect a reasonable estimate of expected credit losses. Depending on the outcome of these activities, ACL processes may need adjustment. The following are performance analysis examples:

    - Periodic back testing may provide insight into the ACL model's ability to accurately estimate credit losses. Back testing may evaluate overall model performance by comparing projected losses to actual chargeoffs, or it may focus on specific model assumptions. For example, back testing could compare prepayments projected by the model to actual prepayments observed over a given period or compare projected loan balances to actual balances at a given point in time, to test the model's ability to estimate an asset's contractual term. Because interpreting the results of back testing is not always straightforward, management should exercise judgement in determining whether results suggest the need for changes in ACL processes or assumptions.

    - In sensitivity analysis, management evaluates how changes to scenarios, assumptions, or inputs could impact loss estimates and reveal how sensitive the model outputs are to these factors. Understanding a model's sensitivity to changes in key assumptions or inputs provides insight into the significance of those inputs or assumptions, as well as how changes to conditions (as reflected by assumptions) might impact credit loss estimates.

    - Using ratios that evaluate the relationship between the ACL and other relevant factors (e.g., total loan volume, adverse or criticized loan volume, chargeoffs, delinquencies) can help support the ACL's adequacy and overall reasonableness. Using these ratios to compare ACL levels to that of peers should be approached with caution given potential differences in portfolios or economic conditions. It is also inappropriate to adjust well supported ACL amounts to maintain a targeted or minimum ratio (e.g., a minimum ACL/Total Loans ratio).

- Beyond management's own analysis, ACL methodologies and any changes to methodologies should be periodically validated by parties who are independent of the ACL process (which includes external third parties). Validations should establish whether the loss estimation process remains appropriate for the portfolio and the institution's complexity and risk profile. The annual external audit of the institution's financial statements, including a review of the ACL completed by an independent public accountant, is not the same as a validation of ACL methodologies.

- ***Data Controls:* Does the institution have appropriate controls in place to ensure data used in the loss estimation process is accurate, complete, and relevant?** ACL processes may use multiple variables and loan-level data elements. As discussed in FCA Bookletter BL-049 REVISED, control processes should include measures to ensure the reliability and integrity of information used in the ACL process. For example, control processes should include measures to ensure all required loan-level data fields are accurately populated at origination and periodically validated. Control processes should also include a reconciliation process to ensure that data imported and used is complete (e.g., all loans that should be included have been included). As the ACL process directly impacts financial reporting, there may be significant overlap between data controls and internal controls over financial reporting.

- ***Loan Review Process and Audit Coverage:* Does the institution have a reliable credit review program and appropriate internal audit coverage over ACL processes?** An effective credit review program serves as a valuable control to ensure risk identification is accurate and the information used to determine the ACL is reliable. It is essential that management accurately classify the risk in individual assets as the baseline to estimating expected lifetime credit losses. The institution may use the System's risk rating guidance which uses a dual approach, PD and LGD. Other methods, such as the UCS, can also be used, but System institutions generally use the System's risk rating guidance for a higher degree of granularity in identifying portfolio risk. Refer to the *Risk Identification* Examination Manual topic for examining risk ratings, UCS classification processes, and related audits. Additionally, ACL processes should be considered for audit periodically as outlined in FCA Bookletter BL-049 REVISED. Refer to the *Audit* procedure for examining ACL audits.

- ***Model Risk Management:* Are the models used for estimating credit losses and supporting the ACL process managed in accordance with the institution's MRM framework and the guidance outlined in FCA's *Model Risk Management* procedure in the *Direction & Control of Operations* Examination Manual topic?** ACL models should be included in the institution's model inventory, which should accurately represent each model's risk, materiality, and validation status. Model validation, change controls, staffing, separation of duties, and new model development should be consistent with the guidance in the institution's MRM framework and FCA's *Model Risk Management* procedure, recognizing that application of this guidance varies based on model risk and materiality. *Note: Examiners completing this procedure should focus on the specific model(s) being used; the overall MRM framework is examined using the Model Risk Management procedure referenced above.*

- ***Third-Party Vendor Models:* Does the institution appropriately manage its risk exposures on any ACL processes or components provided by third parties or vendors?** The institution may contract with third parties or vendors for all, or part of the credit loss estimation process. ACL model vendors should provide ongoing support with appropriate model updates, as needed, including a description of the changes and potential impacts on results. The institution's third-party risk management processes should be commensurate with the level of risk and complexity of the third-party relationships. Refer to the *Third-Party Risk Management* and *Model Risk Management* procedures in the *Direction & Control of Operations* Examination Manual topic for information on examining the institution's outsourcing and model risk management processes.

- ***ACL Documentation and Reporting:* Does the institution maintain adequate documentation to support ACL processes and does reporting allow for effective board oversight?** Documentation is critical to an institution's ACL processes and should provide evidence the ACL is consistently maintained at an adequate level and determined in accordance with GAAP. An institution's documentation should clearly support that selected methodologies and processes accomplish this objective. Effective oversight is crucial to the board's understanding of the ACL processes and determination that the level of the ACL is adequate. Board oversight relies on effective reporting. Reporting should address any revisions to ACL methodologies or processes, management's documented ACL analysis and recommended level, performance analysis, and any relevant audit results. Examiners should see the *Documentation* and *Board of directors' responsibilities* sections of the FCA Bookletter BL-049 REVISED for additional guidance on FCA's documentation and oversight expectations.

Refer to the following documents, including guidance developed by other federal regulatory agencies, for further information on evaluating ACL methodologies, processes, and controls:

- ASC Subtopic 326 Financial Instruments - Credit Losses
- Federal Register notice: Interagency Policy Statement on Allowances for Credit Losses (federalreserve.gov)
- OCC Comptroller's Handbook - Allowance for Credit Losses - April 2021

3. Audit:

Determine if the institution conducts an effective audit (scope, reporting, and followup) of the allowance for losses.

Guidance:

The internal audit and review program is a key mechanism for ensuring that ACL processes are functioning effectively and in compliance with regulations and policies. FCA Bookletter BL-049 REVISED notes that a sound internal control system provides for audits of the allowance process and the adequacy of the level maintained. The internal auditor or other qualified, independent party should review ACL processes and adequacy to ensure compliance with applicable criteria. The audit risk assessment and scope should address ACL processes, and audit or review frequency should be commensurate with the complexity of the institution's operations and risk profile. A reliable audit program provides the board reasonable assurance that ACL processes are sound and related reporting is complete and accurate.

Note: This procedure focuses on evaluating the reliability and effectiveness of internal audits and reviews in this topical area. Refer to the *Audit & Review Programs* topic in the Examination Manual for guidance on examining the overall internal audit and review program.

Evaluative questions and items to consider when examining the audit or review of the ACL include:

- ***Audit Coverage:* Is there periodic audit or review coverage of the ACL?** Audit or review coverage and frequency should be appropriate relative to risks, changes in the operating environment, regulatory requirements, and periodic testing needs. Coverage should also be consistent with the institution's risk assessment results and annual audit plan.

- ***Scope and Depth:* Are audit or review scope and depth sufficient to conclude on the accuracy, completeness, and timeliness of the ACL process and results?** The scope and depth of work, including transaction testing, should cover the primary processes and controls within the area being audited or reviewed and be sufficient to determine if internal controls are functioning as intended and regulatory requirements are met. The scope and depth of coverage should be documented and consistent with the approved audit or review plan and engagement contract (if applicable). Audit or review workpapers should be examined to verify the actual scope and depth of work performed. The workpapers may indicate the scope and depth deviated from what was identified (or implied) in the audit plan. For example, workpapers may indicate the work performed was limited to evaluating the existence of policies and procedures and didn't include reviewing other controls, such as training or reporting, or testing compliance with regulations or institution guidance. If the work deviated materially from the original planned scope, internal audit should notify the board (or Audit Committee, if so delegated) of the reasons for the change. Specific items that should be considered in the audit or review scope include:

    - ACL policies and procedures.

    - Compliance with ACL policies, procedures, accounting requirements, FCA regulations, and other FCA guidance.

    - Monitoring and control processes (e.g., reporting, management oversight, delegated authorities, separation of duties, management information systems and data).

    - Analysis supporting the ACL.

    - Identification of assets to be individually evaluated for credit losses and resulting credit loss provisions, including sufficient transaction testing to ensure established criteria are followed.

    - Management of all significant ACL models, including consistency with the institution's overall model risk management framework.

    - Fraud-related threats and vulnerabilities, as well as anti-fraud controls.

- ***Reliability of Results:* Did FCA identify any concerns with audit or review reliability?** It is important to understand the scope and depth of the audit or review being examined, as discussed above, when evaluating audit or review reliability. With this understanding, the following are key considerations when evaluating the reliability of audit or review results:

    - *FCA Testing* – Evaluate the reliability of internal audit or review work by comparing the results to FCA's examination results in this area. This comparison often includes FCA testing transactions that were covered in the internal audit or review (transactions are often loans or loan applications, but may include other types of transactional activity, as well). In addition to the audit or review report, examiners should request and review the workpapers and hold discussions with the auditor to obtain a more thorough understanding of work completed. This can be especially important if the audit or review report is not sufficiently detailed or FCA's examination work and testing identifies potential concerns. Auditors and reviewers complete line sheets, flowcharts, control matrices, standard work programs, workpaper forms, or other relevant audit evidence when conducting and supporting their work. (IIA Standards 2240, 2300, 2310, and 2320) Workpapers should adequately document the work performed and support the final report. If FCA identifies weaknesses that were not identified in the audit or review, the cause for any discrepancy should be determined.

  - *Audit/Review Staffing* – Whether internal or outsourced, auditors and reviewers conducting the work need to be qualified, independent, and objective to ensure reliable results. They should have the right mix of knowledge, skills, and other competencies needed to perform the work. (IIA Standard 2230) Additionally, auditors and reviewers need to be independent of the activities they audit so they can carry out their work freely and objectively. (IIA Standards 1100, 1112, 1120, and 1130) For example, audit and review staff should not be involved in developing and installing procedures, preparing records, operating a system of internal controls, or engaging in any other activity that they would normally review. Examiners should evaluate the staffing on the individual audit or review being examined as part of determining the reliability of results.

  - *Institution Review of Work Performed* – The institution should complete an independent review of the workpapers to ensure audit or review objectives and scope were met and the results and conclusions were reliable and supported. (IIA Standard 2340) Examples could include a supervisory review of in-house audit work by the CAE or other audit staff, or a review of outsourced work by the Chief Audit Executive (CAE) or audit coordinator. Examiners should consider whether the institution completed these reviews, and if any concerns were identified, when concluding on audit or review reliability.

- ***Reports:*** **Does the internal audit or review report sufficiently communicate ACL review results and recommendations, if applicable?** Examiners should consider the following when evaluating the audit or review report:

  - Is the report prepared and communicated in accordance with the institution's guidelines?

  - Is an executive summary or overview included to provide the board with a general conclusion on audit or review results?

  - Is the report accurate, concise, supported, and timely in communicating the audit or review objectives, scope, results, conclusions, and recommendations? (IIA Standards 2330, 2400, 2410, 2420, 2440, and 2450)

  - Are conclusions and recommendations realistic and reasonable, with material and higher risk issues clearly identified and prioritized?

  - Are conclusions and recommendations supported by convincing evidence and persuasive arguments (condition, criteria, cause, and effect)?

  - Do results in the workpapers align with report conclusions?

- Does the report conclude whether the institution adheres to policies, procedures, and applicable laws or regulations, and whether operating processes and internal controls are effective?

- Does the report address potential vulnerabilities to fraud, if applicable?

- ***Corrective Action:*** **Are management responses to audit or review findings in this area reasonable, complete, and timely? Have corrective actions been effective?** Audits and reviews are only effective if corrective action is taken to remedy the weaknesses identified. As such, there should be a reasonable, complete, and timely management response to the audit or review report. Management commitments and agreements or any areas of disagreement should be documented in the report or in a separate memo or tracking system. (IIA Standards 2500 and 2600) If corrective actions are not resolving the issues or concerns in a timely manner, examiners should further investigate the reasons. For example, this could indicate the audit or review did not sufficiently identify the underlying causes or materiality of weaknesses, sufficient resources are not being directed toward corrective actions, or weaknesses exist in the institution's corrective action process, including board oversight of the process.

4. Transaction Testing:

Examine individual assets to assess accuracy of the recorded allowance, compliance with regulatory requirements and the institution's guidance or standards, and reliability of allowance-related internal controls.

Guidance:

The ACL examination should be supplemented as necessary with transaction testing conducted as part of FCA's loan examination. This testing should determine if policies, procedures, and internal controls are working as intended when establishing allowances on individual loans. When selecting a loan sample, examiners should consider including assets that no longer share common risk characteristics with other loans and should be evaluated individually; loans flagged for individual analysis due to changes in risk rating, credit classification, performance classification, delinquency status, default, or bankruptcy; and other adversely classified loans that have not been identified for individual asset evaluation.

Some specific objectives of ACL-related transaction testing are to determine the following:

- Reasonableness of the risk rating decision.

- Adequacy of the collateral evaluation, including whether it reasonably reflects the current fair value. This should be supported by a recent inspection to verify existence and condition, and be adjusted for current conditions and distressed sale values if applicable. Liquidation values should be used if that is the anticipated collection method.

- Reasonableness and support for the cost to sell estimate. This should factor in the costs to acquire and market the assets and be reasonable based on the asset type. The fair value of the collateral less the costs to sell is the amount the institution anticipates collecting upon disposition and is commonly referred to as the net realizable value.

- Accuracy of the individual asset's allowance calculation (i.e., expected losses).

- Accuracy of internal audit or review testing and related conclusions.
- Consistency in reporting allowances on shared assets. Any differences should be justified and documented.

When evaluating the allowance for credit loss calculation for assets evaluated individually, examiners should consider whether the institution appropriately addressed the need for immediate loss recognition. In addition, it is important that risk ratings are accurate to support the overall allowance determination. Transaction testing for chargeoffs and risk ratings is addressed in the *Risk Identification* Examination Manual topic.