The CEIS Quarterly

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On My Mind...

CEIS' President, Joe Hill, shares his thoughts

Frequently when I meet with our clients Bank Boards and Senior Management, I am asked to share any insight that I may be able to provide regarding emerging market activity, in respect to lending trends, as

well as on the Regulatory front. Having a client base of 135 commercial lending institutions, we definitely encounter a plethora of emerging trends and focus points, some more critical than others. With portfolio growth remaining strong in the market, there are a few elements of that growth that should be monitored closely. competition is stiff among Community Banks for commercial transactions, and we are observing that competition has driven some lenders to book more covenant light deals, book more non-recourse CRE transactions, and in the process grow their portfolio concentrations within the Multi family segment in the Mid-Atlantic and Northeast regions. Some direct examples of these activities are illustrated in CRE Underwriting Trends - NY & NJ which CEIS released in the second half of 2015.

In regards to emerging regulatory focus areas, we have seen that as institutions grow their CRE portfolios to 300% or more to capital, regulators want to make sure the Bank has the internal systems, and policies and process' to manage those concentrations. The Interagency guidance Concentrations in Commercial Real Estate Lending specifically speaks to these matters. Being a community bank, CRE lending is the foundation of your commercial portfolio - so institutions that are nearing or surpassing the 300% to capital level is not unheard of. One risk management tool which is useful in defending your CRE growth is having concentrations analyzed and having a stress testing program in place at the portfolio level, whether performed internally or by a third party such as CEIS.

Joseph J. Hill

Industry News and Events

Industry Events

OCC Releases 2016 Schedule of Workshops for Directors of National Community Banks and Federal Savings Associations

FDIC Releases Economic Scenarios for 2016 Stress Testing

Comptroller of the Currency Discusses Expanding 18-Month Exam Cycle for More Community Banks and Savings Associations

This quarter we would like to spotlight CEIS' Executive Mr. Christopher "Kit" Webbe. Mr. Webbe provides general loan review, structured finance review, and international client loan review. His international specialties take him overseas to Mexico, Costa Rica, and Venezuela to perform consulting for CEIS' international clients. Kit is fluent in Spanish, which obviously comes in handy on those international assignments. Kit has over 30 years of experience as a commercial banker and consultant and is a regular writing contributor as well as a speaker at various industry events.
During his Banking days, he held titles such as Senior Credit Officer, Chief Inspector, and agency General Manager.

To view Christopher's full bio and his contact information

Common Questions about the "ALLL-Important" ALLL Validation

Understanding regulatory expectations and the benefit of having an ALLL Validation

The Allowance for Loan and Lease Losses always seems to be in the news these days. Whether it's a CECL related discussion, using more qualitative vs. quantitative data, having a granular transparent system instead of a black box approach, or just how institutions are lowering their reserves because of the current environment. Well, we are going to provide some background on ALLL Validations, including what the purpose is as well as what regulatory expectations are for having your ALLL methodology validated.

#1) Why is an ALLL Methodology validation necessary?

A validation is a necessity because it is a regulatory requirement. The [2006 Interagency Policy Statement on the Allowance for Loan and Lease Losses] requires a periodic validation by a party who is independent of the credit approval and ALLL estimation processes. The validation represents a review of the ALLL methodology and its application in order to confirm its effectiveness. The [2011 Supervisory Guidance on Model Risk Management] more broadly requires validation to verify that models are performing as expected, in line with their objectives and business uses. Keep in mind that a model can be as simple as an Excel spreadsheet, or it can be a more complex model purchased from a third party vendor software provider, or if you have the resources it could have been developed in house at your institution. Determining the right model for the right portfolio is a whole another article.

Secondly, validation of such an important balance sheet item provides peace of mind for directors and management. Given where we are in the credit cycle, problem loan levels are down and charge offs have been declining. As a result, reserves determined by analysis of qualitative factors are increasingly important. The use of management's judgment is particularly important in the assessment of these qualitative factors and can be challenging to support or defend. A validation is particularly useful in defending these more subjective elements of the methodology.

#2) What should be included in a ALLL Methodology Validation?

A validation will determine whether the ALLL methodology is in compliance with GAAP (ASC 450-20 / FAS 5 and ASC 310-10 / FAS 114) and regulatory requirements, is applied accurately and as described, and whether the methodology is appropriate based on the Bank's loan portfolio size, complexity, concentrations and other characteristics.

A validation includes a review of the models assumptions, key data inputs and calculations, the supporting analysis and documentation, and the governance. A validation also includes assessing whether the model and its results "make sense" given the characteristics of the given loan portfolio and recent trends and conditions. A validation can also provide suggestions to further enhance the methodology based on industry "best practices".

#3) Does using a third parties software platform exclude us from having to have a validation?

No, a methodology validation is still needed to ensure that the use of the software does result in an ALLL methodology that is appropriate for the Bank's portfolio and complies with GAAP and Interagency Guidance.

A software platform typically allows users to make selections for various components of the methodology – a validation is needed to ensure that those selections are individually and collectively appropriate for the Bank. These selections include features such as the timeframe for calculating historical losses, the use of weighted averages for different loss periods, ranges of potential adjustments for qualitative factors, actual qualitative adjustments applied in the calculation, assumptions used in impairment analyses, etc. In addition, the software is only as good as the information and data fed into it – data quality and accuracy is essential and should be validated.

#4) Can we have someone here at the Bank do the validation?

Yes, the [Interagency Policy statement on the ALLL] specifically notes that the party validating the ALLL could be the internal audit staff, a risk management unit, an external auditor (subject to applicable audit independence standards) or another contracted third party from outside the institution. The party must be completely independent of the Bank's credit approval and ALLL estimation processes, as well as the development of the ALLL methodology and its application. The Policy even notes that the validation can be divided amongst various independent parties.

Ms. Elizabeth Williams

Using a third party provides many benefits, these include:

- A third party should have access to industry "best practices" - Between our validation work and our loan review engagements, CEIS sees the ALLL methodologies for well over one hundred banks or credit unions every year; they are all different! If you are struggling with a particular aspect of the ALLL, chances are we will have seen how other banks have handled that same issue.

- You will gain a perspective on current areas of regulatory focus. Based on our discussions with clients, regulators and other industry experts, we have a good sense of the current **"hot topics"**. Wouldn't you rather hear it from us instead of the regulators?

- Clear Independence – you may face questions from your regulator about whether the internal party validating the ALLL is truly independent. If utilizing a third party, the independence test is clearly well defined.

- Expertise spanning the entire process – Internal parties may have the necessary skills and knowledge to assess certain parts of the process but typically can't pose an effective challenge over all aspects of the methodology.

If your regulator hasn't already asked for your ALLL validation, they will! Regulators are increasingly focused on processes and controls, including validation. Why not get ahead of the issue and schedule a validation ahead of your next exam?

Contact CEIS to discuss your options

888-967-7380

About CEIS Review

CEIS Review is an independently owned consulting firm founded in 1989 by proven commercial lenders and specializes in matters related to the commercial loan portfolio.

Our core services are Loan Review, loan portfolio Stress Testing, Loan Loss Reserve Methodology Validation or Advisement, portfolio acquisition review (Due Diligence), Credit Risk Management Process Review, Structured Finance Review (Leveraged Lending), and commercial loan policies.

CEIS Review has provided consulting services to more than 200 banks domestically and abroad, thus solidifying ourselves as a proven and trusted resource within the banking community