

rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.

c. Measuring and Documenting Loan Losses Under Statement 114—Fully Collateralized Loans

Question: In the staff's view, what is an example of an acceptable documentation practice for a registrant to adequately support its determination that no allowance for loan losses should be recorded for a group of loans because the loans are fully collateralized?

Interpretive Response: Consider the following fact pattern: Registrant D has \$10 million in loans that are fully collateralized by highly rated debt securities with readily determinable market values. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to maintain a loan-to-value ratio with sufficient margin to absorb volatility in the securities' market prices. Registrant D's collateral department has physical control of the debt securities through safekeeping arrangements. In addition, Registrant D perfected its security interest in the collateral when the funds were originally distributed. On a quarterly basis, Registrant D's credit administration function determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. If there are any collateral deficiencies, Registrant D notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Registrant D has historically not incurred any material losses on these loans. Registrant D believes these loans are fully-collateralized and therefore does not maintain any loan loss allowance balance for these loans.

Registrant D's management summary of the loan loss allowance includes documentation indicating that, in accordance with its loan loss allowance policy, the collateral protection on these loans has been verified by the registrant, no probable loss has been incurred, and no loan loss allowance is necessary.

Documentation in Registrant D's loan files includes the two independent market quotes obtained each quarter for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Registrant D's loan loss allowance policy includes a discussion of how to determine when a

loan is considered "fully collateralized" and does not require a loan loss allowance. Registrant D's policy requires the following factors to be considered and its findings concerning these factors to be fully documented:

- Volatility of the market value of the collateral;
- Recency and reliability of the appraisal or other valuation;
- Recency of the registrant's or third party's inspection of the collateral;
- Historical losses on similar loans;
- Confidence in the registrant's lien or security position including appropriate:
 - Type of security perfection (e.g., physical possession of collateral or secured filing);
 - Filing of security perfection (i.e., correct documents and with the appropriate officials); and
 - Relationship to other liens; and
 - Other factors as appropriate for the loan type.

In the staff's view, Registrant D's documentation supporting its determination that certain of its loans are fully collateralized, and no loan loss allowance should be recorded for those loans, is acceptable under FRR 28.

4. Applying a Systematic Methodology—Measuring and Documenting Loan Losses Under Statement 5

a. Measuring and Documenting Loan Losses Under Statement 5—General

Question 1: In the staff's view, what are some general considerations for a registrant in applying its systematic methodology to measure and document loan losses under Statement 5?

Interpretive Response: For loans evaluated on a group basis under Statement 5, the staff believes that a registrant should segment the loan portfolio by identifying risk characteristics that are common to groups of loans.¹ Registrants typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Regardless of the segmentation method used, the staff normally would expect a registrant to maintain documentation to support its conclusion that the loans in each segment have similar attributes or characteristics. As economic and other business conditions change, registrants often modify their business strategies,

which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. The staff normally would expect registrants to maintain documentation to support these segmentation adjustments.²

Based on the segmentation of the loan portfolio, a registrant should estimate the Statement 5 portion of its loan loss allowance. For those segments that require an allowance for loan losses,³ the registrant should estimate the loan losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance.⁴ The registrant should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation.⁵

Facts: After identifying certain loans for evaluation under Statement 114, Registrant E segments its remaining loan portfolio into five pools of loans. For three of the pools, it measures loan impairment under Statement 5 by applying historical loss rates, adjusted for relevant environmental factors, to the pools' aggregate loan balances. For the remaining two pools of loans, Registrant E uses a loss estimation model that is consistent with GAAP to measure loan impairment under Statement 5.

Question 2: What documentation would the staff normally expect Registrant E to prepare to support its loan loss allowance for its pools of loans under Statement 5?

Interpretive Response: Regardless of the method used to determine loan loss measurements under Statement 5, Registrant E should demonstrate and document that the loss measurement

² Segmentation of the loan portfolio is a standard element in a loan loss allowance methodology. As indicated in paragraph 7.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale."

³ An example of a loan segment that does not generally require an allowance for loan losses is a group of loans that are fully secured by deposits maintained at the lending institution.

⁴ FRR 28 refers to a "systematic methodology to be employed each period" in determining provisions and allowances for loan losses. As indicated in FRR 28, the staff normally would expect that the systematic methodology would be documented "to help ensure that all matters affecting loan collectibility will consistently be identified in the detailed [loan] review process."

⁵ *Ibid.* Also, as indicated in paragraph 7.05 of the Audit Guide, the loan loss allowance methodology "should be well documented, with clear explanations of the supporting analyses and rationale." Further, as indicated in paragraph 7.14 of the Audit Guide, "[t]he institution's conclusions about the appropriate amount [of the allowance] should be well documented."

¹ Paragraph 7.07 of the Audit Guide indicates that "[e]ach segment [of the loan portfolio] should contain loans with similar characteristics, such as risk classification, past-due status, and type of loan."