

Allowance for Loan and Lease Loss Procedure | 2011

Procedure Name:	Allowance for Loan and Lease Loss Procedure	Review Date:	[Review Date]
Applies To:	All Special Assets Group Associates, All Finance Associates	Revised Date:	[Review Date]
Owning Department:	Corporate Finance		

Requirement Of:	This procedure is in accordance with the Allowance for Loan and Lease Loss Policy and is a requirement of applicable Federal and State Laws and Regulations, Supervisory Guidance Interagency Policy Statements, and financial accounting standards (FAS).
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1. Procedure Purpose/Tasks	
1.1 Purpose	This procedure explains how X Bank ("Bank") identifies and mitigates potential Allowance for Loan and Lease Loss (ALLL) risks and how ALLL responsibilities are managed according to FAS, generally accepted accounting principles (GAAP), and all applicable state and federal regulations.
1.2 Systems/Tools/Forms needed to complete the procedure	None
1.3 Standards	<p>The process for determining an appropriate ALLL and Provisions for Loan and Lease Losses (PLLL) requires deep knowledge and skillful management of the Bank's loan portfolio holdings.</p> <p>Establish Bank ALLL and PLLL allocations in order to:</p> <ul style="list-style-type: none"> • Provide a comprehensive, well-documented, and consistently applied analysis of the Bank's loan portfolio in accordance with regulatory guidance. • Maintain and document an effective loan review system and controls to identify, monitor, and address asset quality problems in an accurate and timely manner. • Consider all loans. • Identify and evaluate on an individual basis, impaired loans for reserve amounts under FAS 114, before separating the remaining loan portfolio into similar risk pools for analysis under FAS 5. • Consider the varying risks and other factors that could affect collection probability. • Consider current loan valuations for impaired loans evaluated under FAS 114. • Use current and reliable data. • Consider current economic conditions or Bank-specific conditions. • Assess qualitative impact using a risk-based approach. • Use a clear methodology to consolidate loss estimates and ensure ALLL balances are recorded in accordance with GAAP.

ALLL procedures provide guidance on the following:

- Methodology
- Specific allocations
- Pool allocations
- Management factors
- Consolidating loss estimates
- ALLL methodology validation

The Bank's ALLL methodology elements require associates to do the following:

- Provide detailed internal and independent analysis of the loan and lease portfolio on a regular basis.
 - **Associate loan and lease review:** Associates ensure appropriate risk ratings at all times by reviewing each loan in their respective loan portfolios at least annually for all pass risk rated loans, and quarterly for all loans risk rated 7 and higher.
 - **Independent loan and lease review:** The Loan Portfolio Integrity department performs a portfolio review by loan sampling on an ongoing basis to ensure ALLL allocations are properly assessed.

Refer to the Risk Rating Policy for more details.

- Base ALLL methodology on current and reliable information.
- Document ALLL methodology in writing, with clear explanations of supporting analyses and rationale.
- Apply ALLL methodology to all loans on both an individual and/or group basis.
- Evaluate all loans for impairment on an individual basis under FAS 114. Segment the remaining loan portfolio into groups of loans with similar risk for evaluation and analysis under FAS 5.
- Consider all known relevant internal and external factors, including current collateral values, less the costs to sell, that may affect collection.
- Require competent and well-trained personnel to perform analysis, estimates, reviews, and other ALLL methodology functions.
- Systematically consolidate loss estimates and record ALLL balances in accordance with GAAP.

ALLL methodology consists of the following components:

- **Specific allocations:** Specific reserve amounts are allocated to individually evaluated, impaired loans. Evaluation techniques include:
 - Estimate of expected future cash flows discounted at the loan's effective interest rate
 - Observable market price or the fair value of collateral for collateral dependent loans

Evaluate all non-accrual commercial loans \$100,000 or greater, and all non-accrual non-commercial loans \$500,000 or greater, on an individual basis. Non-accrual commercial loans less than \$100,000 and non-accrual non-commercial loans less than \$500,000 are included in the Pool Allocations.

- **Pool allocations:** Estimated credit losses for loans segregated into similar risk pools. Measure pool allocations according to FAS 5 and ASC 450-20.
- **Management factors:** Qualitative or environmental factors that may cause estimated credit losses for pool allocations to differ from historical loss rates.

Loan impairment: Consider a loan impaired when the Bank is unable to collect principal or interest payments according to the loan agreement. Determine impairment by considering the following factors:

- Current payment status
- Collateral value
- Probability of collecting scheduled principal and interest payments

Do not classify loans with insignificant payment delays or shortfalls as impaired. Management determines the significance of payment delays and payment shortfalls on a case-by-case basis by considering the following factors:

- Length of payment delays
- Reasons for the delay
- Client's prior payment record
- Shortfall amount in relation to the principal and interest owed

Troubled Debt Restructures (TDRs): The Bank periodically may agree to modify loan terms or pricing based on loans with similar characteristics and risk levels. TDRs grant concessions outside normal loan policies or pricing models to clients experiencing financial difficulties. Granting TDR status requires an individual evaluation for loan impairment. Refer to the Troubled Debt Restructure Policy for more detail.

Impaired loans include all modified loans classified as TDRs and loans on non-accrual status. FAS 114 requires a creditor to measure impairment of a loan based on:

- Present value of expected future cash flows
- Loan's observable market price, or the fair value of the collateral if the loan is collateral-dependent

When specific loans, or portions thereof, are deemed uncollectable, charge-offs are recommended against the ALLL.

The Bank uses three different measures to quantify impairment loss:

1. **Expected future cash flows.** Base the loan's present value on an estimate of expected future cash flows from the impaired loan, discounted at the loan's effective interest rate. If the interest rate is floating or adjustable, calculate the effective interest rate by fixing the rate at the date the loan became impaired. The Bank considers estimated costs to sell on a discounted basis in measuring impairment, if those costs are expected to reduce the cash flows available to repay the loan. Conduct this evaluation on the date impairment was first recognized and at each quarterly reporting period. Use the present value of expected future cash flows for any non-collateral-dependent loan. Most TDR's are evaluated using this method.

2. **Fair value of collateral.** This approach is used for collateral-dependent loans. A loan is collateral-dependent if repayment of the loan is expected to be provided solely by the underlying collateral. The Bank determines the fair market value of the collateral using appraisals or other qualified valuation assumptions, and documents any adjustments made to the fair market value. The Bank also considers other factors affecting the current fair value of the collateral since the appraisal was performed, and whether appraised values of impaired collateral-dependent loans are actually realized. Reduce the collateral value by the costs to sell. Use the resulting value to determine the fair value of the collateral. Conduct this evaluation on the date impairment was first recognized and at each quarterly reporting period.

Expense costs related to the ongoing maintenance of the collateral, such as annual valuations, taxes, repairs, and yard maintenance, when paid.

3. **Observable market price:** The Bank may also use the loan's observable market price derived from a third party purchaser of loans, if a market price exists.

Pool allocations: Bank management divides the loan portfolio into pools by identifying risk characteristics common to specific groups of loans.

Calculate loss histories for each of these pools by aggregating historical losses less the recoveries within each pool. Annualize this number over a two year time span to calculate a moving 8-quarter average. The length of time may vary according to the relevance of past periods to the current period.

Express the series of calculations as the following equation:

$(H+M) \times P = R$, where:

- H = Historical loss factor for the pool
- M = Management factor aggregate adjustment for the pool
- P = Total loans within the risk rating category within the pool
- R = Required reserve amount for the risk rating category within the pool

Management factors: Use management factors to assess uncertainties potentially affecting probable loss estimations. This component reflects the imprecision inherent in the underlying methodology assumptions used for estimating allocated and general reserves in the portfolio. Examples include:

- Changes in lending policies and procedures, including changes in underwriting standards and collection, charge-off, and recovery practices.
- Changes in international, national, regional, and local economic and business conditions and developments.
- Changes in the nature and volume of the portfolio.
- Changes in the terms of loans.
- Changes in the experience, ability, and depth of lending management, and other relevant staff.
- Changes in the volume and severity of past due loans, volume of nonaccrual loans, and volume and severity of adversely classified or graded loans.
- Changes in the quality of the Bank's loan review system.
- Changes in the value of underlying collateral for collateral-dependant loans.
- Existence and effect of any concentration of credit, and changes in the level of such concentrations.
- Effect of other external factors, such as competition, and legal and regulatory requirements on the level of estimated credit losses in the institution's existing portfolio.

Management uses a risk-based approach to determine the appropriate adjustments for each management factor. Use a matrix containing definitions of stable, low, moderate, and high risk levels to assess individual factors and determine individual adjustments for each loan pool.

Each of these adjustment factors are individually supported and justified. A discrete narrative for each reflects current information, events, circumstances, and conditions influencing the adjustment. Include the following in each narrative:

- Factor descriptions
- Analysis of how each factor has changed over time
- Explanation of how the impact was estimated
- Any other available data that supports the adjustments

Consolidating loss estimates: Bank management prepares a quarterly report summarizing the ALLL and PLLL amounts to be reported in the financial statements. Include the following elements in the report:

- Estimated probable losses incurred for each evaluated category (individually evaluated impaired loans, homogeneous pools), and any other loan groups collectively evaluated for impairment.
- Aggregate probable loss.
- Summary of the current ALLL balance.
- Amount by which the ALLL will be adjusted. Ensure no material

	<p>differences exist between the consolidated loss estimate and the final ALLL balance reported in the financial statements. A material difference at the Bank is defined as a 10% plus or minus difference between the consolidated loss estimate and the final ALLL balance reported in the financial statements. If there is a material difference, review the ALLL for an adjustment, and review the ALLL methodology for changes.</p> <ul style="list-style-type: none"> Detailed loss estimate schedules reconciled to the summary report to support the ALLL analysis. <i>Note: These schedules are completed only on an as-needed basis.</i> <p>The Bank's Board of Directors reviews and approves the final summary.</p> <p>Validating ALLL methodology: The Bank prepares the following to regularly validate ALLL methodology and determine any deficiencies:</p> <ul style="list-style-type: none"> Review of trends in loan volume, delinquencies, loan restructurings, and concentrations Review of previous charge-offs and recovery history, including an evaluation of timeliness of the entries, and recording both the charge-offs and the recoveries Periodic review by an independent third party Appraisal process evaluation <p>Bank management supports the validation process with the work papers from the ALLL review function, and any summary findings from independent reviewers. The Board reviews findings and acknowledges the review in Board meeting minutes. The Board reviews documentation describing and supporting the change if the methodology is changed based upon the findings of the validation process.</p>
1.4 Tasks associated to the procedure	Reserve for future associated desktop processes.
1.5 Control Management (Physical or Time bound)	<p>The Board is responsible for the following:</p> <ul style="list-style-type: none"> Reviewing and approving the ALLL Policy at least annually. Reviewing and approving the prepared ALLL calculations at least quarterly. Approving the level of the ALLL and required PLLL at least quarterly. Remedying any deficiency in the ALLL within the quarter if discovered prior to filing the Consolidated Reports of Condition and Income for that quarter. Any immaterial changes subsequent to the Board's approval and prior to the release of earnings may be approved by the chief executive officer (CEO). Alternatively, re-submit material changes to the full Board for its approval. Ensuring the Bank has the necessary processes, personnel, and control systems in place to ensure proper adherence to ALLL calculation and reporting. Requiring management to periodically validate and revise the ALLL methodology.

The Board or its designated committee ensures that the ALLL and the methodology used to determine the ALLL is reviewed and verified by loan portfolio integrity department at least annually. In addition, the Bank's external auditors will complete an annual ALLL review in conjunction with the annual audit of the financial statements, to test and verify for GAAP adequacy and compliance.

Bank Management is responsible for the following distinct tasks:

- Certifying officers (CEO and CFO) are responsible for the final ALLL adequacy sign-off recommended by the controller and the chief credit officer (CCO).
- The controller is responsible for preparing and reviewing the ALLL Analysis of Adequacy and ensuring that changes in GAAP or regulatory rules affecting the ALLL are researched, analyzed, communicated, and implemented.
- The CCO is responsible for ensuring the loan grading system is accurate and that all impaired loans are recorded on a timely and accurate basis.
- The Loan Portfolio Integrity department is responsible for independently and objectively reviewing and ensuring significant problem loans are identified and accurately graded, and identifies all impaired loans on a timely basis.
- The Special Asset Group (SAG) ensures that FAS 114 calculations are accurate and well-documented.
- Associates are responsible for properly evaluating risk grade ratings, collateral, and the probability for loss on all commercial loans in the portfolio.
- The Audit Committee oversees and monitors ALLL internal controls. The internal control system randomly tests loan boarding sheets to ensure critical information such as the loan's purpose, federal call report codes, other collateral codes, and other important data is accurately recorded.
- The Loan Operations department is responsible for accurate input into the loan system. This includes assigning all codes needed to properly segregate the loan portfolio for regulatory, Board, and management reporting purposes. The Loan Operations department conducts periodic tests of the codes to ensure ongoing accuracy
- The Internal Audit department uses sampling techniques to test loan input data and determine loan segmentation information accuracy.

The Bank's internal controls system ensures the ALLL process is maintained in accordance with GAAP and supervisory compliance by incorporating the following:

- Controls providing assurance of the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures.
- Controls assuring that the Bank's financial statements are prepared in accordance with GAAP and ALLL supervisory guidance.
- Controls that include a well-defined loan review process.
- Controls ensuring the Bank promptly charges off loans and leases, or portions of loans and leases that are deemed uncollectable.

	The CFO, CCO, and controller are responsible for adhering to all ALLL policies and procedures.
1.6 Retention Requirements	The Bank retains all client documents in accordance with Johnson Financial Group Record Retention Guidelines.

2. Reference Information	
2.1 Associated Policy	Allowance for Loan and Lease Loss Policy ORE Policy Risk Rating Policy Troubled Debt Restructure Policy
2.2 Related Documents	ALLL Approval Process Map FAS 114 and FAS 5 Process Map Addition to Other Real Estate Charge Off Process Map Collateral Valuation Process Map Foreclosure Bid Sheet Loan Risk Rating Process Map Management Factor Matrix ORE Adjustment to Carrying Value Process ORE Booking to Bank General Ledger Process ORE Expense Bill Payment Process ORE Offer to Purchase Acceptance Process ORE Process Map
2.3 Associated Regulations	Applicable Federal and State Laws and Regulations FAS 66 Accounting For the Sales of Real Estate FAS 114 Accounting by Creditors for Impairment of a Loan FAS 118 Accounting by Creditors for Impairment of a Loan-Income Recognition and Disclosures Interagency Policy Statement issued July 2, 2001 (SR 01-17 Sup)) Interagency Policy Statement issued December 13, 2006 (SR 06-17) Statement of Financial Accounting Standards No. 5, "Accounting for Contingencies" (FAS 5, ASC 450-20) Statement of Financial Accounting Standards No. 114, "Accounting by Creditors for Impairment of a Loan" (FAS 114, ASC 310)