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Office of Thrift Supervision
Department of the Treasury

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This document and any attachments are superseded by the Comptroller's Handbook - Allowance for Loan and Lease Losses, and OCC Bulletins 2001-37 and 2006-47

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MEMORANDUM FOR: **CHIEF EXECUTIVE OFFICERS**

FROM: Timothy T. Ward, Deputy Director
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SUBJECT: ALLL – Observed Thrift Practices Including Sound Practices

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In 2008, OTS performed a "Horizontal Review" of the allowance for loan and lease losses (**ALLL**) methodologies at a number of our larger thrifts. The review included 1 - 4 family residential first mortgages, Option ARMs, second mortgages, and the related qualitative component of the allowance. The purpose of the review was to identify industry practices, including sound practices, in the ALLL estimation process. The review disclosed several practices that may not be in accordance with supervisory guidance and generally accepted accounting principles (**GAAP**). A summary of the findings were shared with OTS examiners in September 2008. The OTS's observations may be useful in assessing a thrift's ALLL and are presented in this memorandum.

The process of estimating the ALLL requires considerable management judgment based on a thrift's specific loan portfolio and circumstances. It is important to note that each observation identified as a sound practice is specific to the individual thrift reviewed and, if adopted by a different thrift, may not necessarily result in an improvement to its ALLL methodology and process.

I. Sound Practices

The OTS review identified the following sound practices for estimating an appropriate ALLL.

1) At inflection points, or periods of increasing or decreasing losses, an ALLL methodology that uses lagging data (e.g., historical loss rates, which are considered less predictive), is supplemented and validated with other methods that use more leading data (for example, a migration analysis[1].)

[1] A migration (to loss) analysis uses association-specific data to track the movement of assets through the various asset classifications to Loss in order to estimate the percentage of losses that are likely to be incurred from the various categories and classifications of assets currently in the association's portfolio. See Examination Handbook Section 261, Appendix B for more information.

2) ALLL methodologies for sophisticated loan products capture the features and risk layering intrinsic to each loan product. Some examples are a change in a borrower's FICO score, date of interest rate resets, change in housing market prices, borrowers' payment habits, or other trends that impact loan collectability.

3) With more sophisticated products such as Option ARMs, the portfolio is segmented into multiple risk levels when forecasting delinquency and default. For example, the loan portfolio may be segmented by past payment behavior (e.g., borrowers who make the minimum payment vs. the fully amortizing payment), or by reset date and recast projection.

4) Internal data is supplemented with external data, such as Home Price Indices (HPI) and changes in international, national, regional, and local economic conditions, in estimating the ALLL.

5) Qualitative factors are applied to specific loan portfolio segments. Alignment of a qualitative factor with the specific segment of loans impacted reflects the estimated change in collectability for various products and borrowers. Applying a qualitative factor uniformly to the entire loan portfolio may distort the factor's impact.

6) Loss rates and delinquency rates are stress-tested to (1) determine the sensitivity of the methodology to changes in primary inputs, (2) inform management of the risk of miscalculation if the credit environment changes, and (3) evaluate the appropriateness of the ALLL in a range of credit environments.

7) The ALLL is reviewed monthly to allow an institution to identify changes in trends (e.g., inflection points) much more quickly.

8) The ALLL estimate is fully documented at least quarterly.

9) Material changes in methodology are evaluated for approval by the Board of Directors.

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II. Deficiencies

The following *practices* are considered weak and do not appear to be in accordance with GAAP and/or supervisory guidance.

1) *Institutions charge-off losses only at foreclosure or when deemed uncollectible.* A sound practice is to establish charge-off policies in accordance with the Uniform Retail Credit Classification and Account Management Policy (CEO Memo #128, July 27, 2000). Institutions should assess the current value of the collateral and selling costs when a loan is no more than 180 days past due. Any loan balance in excess of that assessment should be classified Loss.

2) *Institutions stated that modifications to interest rates that reflect current market rates are not troubled debt restructurings (TDRs), even when these rates are concessions granted to borrowers.* However, if the borrower cannot obtain a loan at a similar rate and with similar terms with another lender, the modification is likely a TDR. Institutions should properly identify TDRs in accordance with GAAP and properly account for the TDRs. A loan modification is a TDR when a creditor grants a borrower a concession it would not otherwise consider because of economic or legal reasons pertaining to the borrower's financial difficulties.

3) *Institutions place loans on nonaccrual status when "deemed uncollectible" and do not reverse accrued but uncollected interest through current earnings.* An institution's nonaccrual policy should require that a loan be placed on nonaccrual status in a timely manner, generally when 90-days delinquent, and accrued but uncollected interest should be reversed through current earnings when it is probable that the interest will not be collected in cash from the borrower.

4) *Institutions refresh or increase interest reserves on construction loans and continue to accrue interest income even when the borrower cannot make out of pocket payments and the construction project shows signs of trouble.* Interest income accrual from interest reserves on construction loans should only continue when it is probable that interest will be received in cash from the borrower and collection of principal is also probable.

5) *Institutions have varying look-back periods and use simple averages to calculate charge-off or delinquency rates.* The December 2006 Interagency Policy Statement (**IPS**) states that a look-back period will depend upon the relevance of the past periods' loss experience to the current period or a point in the credit cycle. Institutions should ensure they have a reasonable look-back period and that they give appropriate weighting to loss rates within those periods.

6) *Institutions do not validate their ALLL methodology.* The December 2006 IPS states that the allowance methodology should be validated. Validation can be accomplished through a review by a party independent of the credit department, back-testing the model through a comparison of actual losses to model estimates, or by comparing results of the ALLL estimate using more than one methodology.

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III. Expanded Review: Option ARMs and Second Mortgages

Thrifts should exercise caution when forming conclusions on the appropriateness of the ALLL and conduct an analysis of each specific portfolio. The wide diversity in sophistication and success of ALLL methodologies indicate that **no one single method has emerged as a best method for estimating losses**. For example:

1) Highly complex, sophisticated, resource intensive models are not always the best for accurately forecasting losses. Econometric models can be good tools, but they are only as good as the inputs and the design.

2) While the diversity in option ARM products make econometric modeling a good approach, model development, periodic validation, and recalibration are imperative.

3) In stable economic environments and in periods of stable losses, simpler methodologies may suffice. However, in less stable environments and in periods of rapidly changing delinquency and loss rates, caution should be used when relying solely on simple methodologies. For example, institutions sometimes supplement simple models with migration analysis.

4) Models that rely on lagging data are inadequate in changing loss rate environments. While historical charge-offs can be a good predictor of future losses in a portfolio, they may not be predictive in periods of rapidly changing loss rates.

5) Thrifts use average historical loss rates to estimate the ALLL with adjustments for a wide variety of factors, both internal and external, including: delinquency reports, real estate market trends, occupancy reports, employment statistics, FICO scores, LTV ratios, geographic concentrations, types of loan documentation, changes in home pricing, and other seasonal and regional factors.

6) Stale loss rates are problematic. An institution should consider the current point in the business cycle before deciding on the length of its historical look-back period when calculating loss rates. An alternative is to give greater weight to loss rates of more recent periods or periods within comparable credit cycles. Institutions are encouraged to retain historical data as a starting point for use in comparable credit cycles.

7) Generally, an estimate of net charge-offs over the next 12 months is used to ensure the ALLL is appropriate. However, this rate could vary. For example, loans with effective lives longer than 12 months often have workout periods over an extended period of time. This may indicate that the estimated credit losses should be calculated based on a rate greater than the annualized net charge-off rate. An institution should document the effective life of its loan pools and the rationale for the time horizon included in its charge-off rate.

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Again, the wide range of sophistication and success indicates that **no single successful method has emerged for predicting losses on loans**. The ALLL methodology is not an exact science but relies heavily on management expertise and judgment. Even though a model with an adequate set of risk characteristics and appropriate weighting for each variable can be a good tool for the ALLL estimation process, significant judgment is still required. Factors such as experience, ability of the lending staff, and the quality of the institution's loan review system remain key when estimating an appropriate ALLL. Regardless of model sophistication, the inputs must be reasonable to generate an appropriate estimate of ALLL. Migration analysis is a solid middle ground for loans with no complex features.