Industry financial results clearly show the continued stress in thrift loan and investment portfolios. The operating environment remains challenging with increased levels of unemployment, weakened residential real estate markets and mounting strains in the commercial real estate market. The combination of these factors has led to a growing level of nonperforming loans and foreclosures. Additionally, there is a larger level of performing loans or investments with underlying credit or documentation issues. Accordingly, OTS is issuing this reminder regarding the importance of accurately accounting for credit losses or impairments of investments.

Asset quality reviews continue to be a significant focus on safety and soundness examinations. Examiners continue to identify situations where institutions have not provided for timely charge offs of nonperforming loans or other-than-temporary impairment of investments or established an adequate level of loan loss allowances relative to the thrift’s risk exposures. Of particular concern is the increasing number of institutions identified by examiners that do not have policies, procedures and written documentation related to impaired loans that is consistent with accounting standards and interagency guidance.

The calculation of the allowance for loan and lease losses (ALLL) represents one of the most significant estimates included in an institution’s financial statements. Accordingly, it is imperative that each institution maintain an ALLL in accordance with generally accepted accounting principles (GAAP) that is the result of a comprehensive and consistently applied process.

The ALLL should be maintained at a level appropriate to absorb estimated losses inherent in the loan and lease portfolio, and should be well documented with clear explanations of the supporting analysis, methodology and rationale. You should consider all significant factors, both positive and negative, that affect the collectability of loans. Institutions that primarily use lagging data in their ALLL methodology should supplement and validate it with other methods that use more leading data when available. In addition, effective procedures to identify impaired loans and troubled debt restructurings are needed, as well as enhanced valuation analysis to ensure that the resulting loans are accounted for at appropriate valuations. The result should be an ALLL that is prudent and appropriate but not excessive.
Finally, the declining market value of many thrift investments requires regular review for potential impairment. Examiners continue to identify situations where institutions have not provided for timely recognition of other-than-temporary impairment.

Thrift management is responsible for maintaining appropriate accounting systems and documentation to support appropriate loan loss recognition and investment impairment. As we approach year end financials and prepare for 2010, OTS encourages thrift management to reassess your institution’s processes and systems for estimating credit losses and maintaining an appropriate ALLL.

In addition, Board of Directors should ensure that annual external audits include appropriate review procedures to assess the effectiveness of the accounting for ALLL, appropriate loan loss and investment impairment recognition, and financial reporting and disclosures. For public filers the Securities and Exchange Commission recently issued disclosure guidance that provides a useful summary for your information.¹

OTS has issued guidance on the following topics:

- **CEO Letter #325**, Guidance on Prudent Commercial Real Estate Loan Workouts
- **CEO Letter #320**, Accounting Considerations Related to Other-Than-Temporary Impairment of Securities
- **CEO Letter #315**, Regulatory and Accounting Issues Related to Modifications and Troubled Debt Restructurings of 1-4 Residential Mortgage Loans
- **CEO Letter #304**, ALLL - Observed Thrift Practice Including Sound Practices
- **CEO Letter #250**, Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL) and Questions and Answers on Accounting for Loan and Lease Losses
- **CEO Letter #142**, Policy Statement on Allowance for Loan and Lease Losses Methodologies and Documentation for Banks and Savings Institutions

OTS encourages thrift management teams to review and apply the guidance in the CEO Letters (available on the OTS web site) to ensure understanding of and compliance with OTS supervisory requirements and expectations. Further it is management’s responsibility to ensure that the thrift’s independent auditor is aware of OTS’s requirements and expectations related to identifying, recording, and reporting impairment of loans and investment securities.

Please contact your OTS Regional Accountant with any questions about this guidance.