Adequacy of Valuation Allowances

A valuation allowance is a contra account, established and maintained through charges against current earnings to absorb losses inherent in an institution's portfolio. Valuation allowances established to absorb unidentified losses inherent in an institution's overall loan and lease portfolio are referred to as the allowance for loan and lease losses (ALLL); those established to absorb losses identified for specific assets are referred to as specific valuation allowances (SVAs).

Since 1986, OTS has used the term "general valuation allowances" (GVAs) to denote allowances for losses inherent in an institution's portfolio of loans, investments and other assets. The federal bank regulatory agencies use the term ALLL. The main difference between the two terms is that the ALLL is for losses inherent in a bank's loan and lease portfolio, not other assets. In order to promote regulatory uniformity among the OTS and the federal bank regulatory agencies, effective on June 30, 1994, OTS has: (1) adopted the term ALLL in lieu of GVAs for an institution's loan and lease portfolio; and (2) removed the requirement that general allowances be held on non-loan and lease assets, including real estate owned (except as noted below). With respect to allowances for losses inherent in an institution's loan and lease portfolio, the ALLL is equivalent to and should be accounted for and reported just as GVAs were accounted for and reported prior to the policy change. The ALLL also receives the same capital treatment as GVAs for loans and leases.

LINKS

Program

Questionnaire

Appendix A

Appendix B

OTS expects thrift institutions to carry non-loan and lease assets on their balance sheets in accordance with OTS policy and generally accepted accounting principles as appropriate for the asset. If significant problems with an institution's valuation methodologies for such assets are noted, however, general allowances may be required for these assets until the problem is corrected.

Section 563.160, Classification of Certain Assets, requires savings associations to classify all assets[1] and establish prudent valuation allowances to absorb losses. The regulation specifies that, for assets classified Substandard or Doubtful, savings associations shall establish prudent general allowances for losses. For assets or portions thereof classified Loss, savings associations shall either establish an SVA for 100% of the portion classified Loss or charge off such amount. The rule further specifies that adequate valuation allowances, consistent with generally accepted accounting principles (GAAP), be established for classified assets and that allowances consistent with the practices of the federal banking agencies may be used for supervisory purposes.

Because of the uncertainty surrounding the likelihood of repayment or realization of classified assets, the determination of the adequacy of valuation allowances requires considerable judgment. Further,

[1] Examination Handbook Section 260, Classification of Assets, presents a discussion on asset classification.

when economic conditions change, valuation allowances that once may have been considered adequate may prove inadequate. Understandably, disagreement between examiners and institution management over the amount of valuation allowances considered adequate is not uncommon.

To ameliorate such disparities and to provide uniform guidelines on the determination of the adequacy of the allowance, the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Federal Reserve Board, and the Office of Thrift Supervision (the agencies) issued the Interagency Policy Statement on the Allowance for Loan and Lease Losses (ALLL)[2] on December 21, 1993. The Policy Statement is provided in Appendix A.

Additional OTS Guidance on the Interagency Policy Statement

Below is additional information to aid examiners in their implementation of the Interagency Policy Statement.

Quantitative Guidance

The quantitative guidance discussed in the Interagency Policy Statement should be viewed as an analytical tool—not the ending point—for the quantitative analysis of the adequacy of allowances, after a review of an institution's asset review system and allowance methodology. The guidance is not intended to be used as a "ceiling." The appropriate level of allowances must be based on institution-specific factors. As discussed in footnote 10 of Appendix A, an allowance level greater than or less than the percentages used in the quantitative guidance for Substandard and Doubtful assets may be appropriate, based on institution-specific factors. For example, if an institution can demonstrate, based on an analysis of its historical net loss experience, adjusted for current conditions and trends, that its single-family home loans classified Substandard are expected to experience a net loss rate of less than 15%, both the institution and examiners should use this information—rather than the general 15% guidance—in their analysis of the adequacy of allowances.

Similarly, the general guidance of 15% for Substandard assets may not be appropriate for loans where losses have been recognized in accordance with Examination Handbook Section 260, "Valuation and Classification of Troubled, Collateral-Dependent Loans." The ALLL for these assets should focus on losses that result from the use of an inappropriate value methodology or assumptions that persistently result in overvaluation. The ALLL should be based on the association's historical loss experience for similarly valued assets, adjusted for current conditions and trends.

As discussed in the Interagency Policy Statement, in analyzing the adequacy of allowances, institutions are encouraged to segment their portfolios into components that have similar risk characteristics, such as risk classification and type of loan. For example, as illustrated above, Substandard assets should not be assessed as a single pool of assets if they have substantially different credit risk characteristics or are subject to different accounting standards.

[2] The ALLL must not include the portion of loans and leases classified Loss regardless of whether the Loss amount was measured in an aggregate analysis or on an individual loan basis.

Other Issues in the Policy Statement

The following notes provide clarification and guidance on issues discussed in the Interagency Policy Statement:

- In the first bullet under the "Responsibility of the Board of Directors and Management" section of the Policy Statement, reference is made to the "remaining effective lives of the loans." The remaining effective life of a classified asset is considered by OTS to be the estimated time necessary for the resolution of the asset, i.e., the asset's disposal or its return to a performing status.

- This same section makes reference to the "imprecision inherent in most estimates of expected credit losses." It is OTS's position that if an association's loss allowance has historically been sufficient to cover actual losses, then the margin for imprecision can be minimal.

- Regarding the reference to the "nature and volume of the portfolio" in the section on "Factors to Consider in the Estimation of Credit Losses," nature refers to the type and risk profile of the loans in a portfolio. Volume refers to the mix of such loans. If an institution has typically maintained loan volumes of 55% of its single-family mortgage portfolio in fixed-rate, 30-year loans, 10% in adjustable-rate loans and 5% in construction loans, and then went to a 40%, 20%, and 10% mix, its analysis of its historical loss experience should change accordingly. Similarly, within a portfolio of credit card loans, if an institution with a historical loss experience of only 1% for its credit card portfolio changes from a policy of individually underwriting each account to a mass mailing campaign, the institution's historical loss rate should not be applied to the new credit card accounts. Instead, an industry average rate would be more appropriate until the institution had established a historical loss rate for the new accounts.

- The seventh bullet in the same section indicates that the existence or changes in credit concentrations should be considered in the ALLL evaluation process. OTS does not consider it to be an adverse concentration of credit for an institution to have a high percentage of its portfolio in residential and consumer loans made in the institution's primary lending area.

- Also, the discussion on ratio analysis in this section of the Policy Statement does not mean that if an institution has a lower level of allowance to loans, or allowance to classified or past-due loans, than similar-sized institutions, that its allowance is inadequate. Institutions with primarily low-risk loans in their portfolio, such as one- to four-family residential mortgage loans, generally experience a lower level of net losses and would therefore require a smaller allowance than an institution with high concentrations of commercial, nonresidential, and construction loans.

- Footnote 9 of the Policy Statement states that if an institution has an insufficient basis for determining its historical net charge-off rate for nonclassified loans, the examiner may use the industry average net charge-off rate. This could occur if there were no available data, as in cases where the institution offered a new product and had no historical loss data, or if the institution had substantially changed its underwriting such that old historical data would not accurately reflect losses expected within the next 12 months.

Guidelines Specific To Certain Asset Types

While the policy guidelines for the assessment of the ALLL in the Interagency Policy Statement are generally useful for all types of assets, the following guidelines, specific to certain types of unique or high-risk assets, should also be used.

Real Estate Owned (REO). Since foreclosure generally becomes necessary only when the security property can not be sold by the borrower for an amount sufficient to satisfy the loan, foreclosure generally indicates a lack of demand for the property at that price. Further, if the association holds the property for a long period of time, it may indicate a reluctance to sell the property for a loss. In any event, the property should be carried at its fair value and a Substandard classification is often appropriate. Examination Handbook Section 251, Real Estate Owned and Repossessed Assets, and Section 260, Classification of Assets, provide guidance on the classification of REO.

In 1992, the American Institute for Certified Public Accountants (AICPA) issued Statement of Position No. 92-3 (SOP 92-3), which held that there is a rebuttable presumption that foreclosed assets are held by financial institutions for sale and, thus, should be carried (maintained with quarterly adjustments as necessary) at the lower of (1) cost or (2) fair value minus the estimated cost to sell.

OTS policy does not automatically require general allowances on REO. However, general allowances should be established when the association is likely to experience losses on the disposition of REO or is likely to incur costs during the holding period for REO that are not reflected in the carrying value. The level of any required general allowances on REO should be based on the association's historical net loss experience, adjusted for current conditions and trends.

Noninvestment Grade Corporate Debt Securities. FIRREA mandated the divestiture of all noninvestment grade corporate debt securities from savings associations as soon as prudently possible, but in all cases by July 1, 1994. Such securities held by a savings association that mature after that date should be carried at the lower of cost or market value (LOCOM). Amounts in excess of market value are classified Loss, and the remaining book value should be classified Substandard.

Securities that mature before July 1, 1994 are not automatically subject to LOCOM; however, any depreciation in book value over market price should be classified Doubtful. The remaining book value should be classified Substandard.

Securities subject to LOCOM accounting treatment do not ordinarily require additional general allowances, except for private placements and other thinly traded securities where the quoted market price cannot be independently confirmed.

Letters of Credit. Letters of credit (LOCs) should be reviewed and classified, as appropriate, based on the same criteria used for the classification of commercial loans. Letters of credit should be classified if disbursement is likely and a credit weakness exists with the account party.

In such cases, examiners should determine the appropriate classification and require valuation allowances for the particular circumstances. Letters of credit are discussed in Section 215 of the Examination Handbook.

For example, an association issues a $1 million standby LOC as credit support to guarantee payment on a $10 million securitized pool of automobile loans on behalf of the investors (LOC beneficiaries). If the delinquency level within the pool became so large that the seller/issuer of the pool was unable to meet the terms of the securities contract (partial default), the beneficiaries would be able to collect the $1 million from the LOC issuer, which in turn would attempt to collect from the seller. If the collateral was insufficient to satisfy the obligation and repay the LOC issuer, a loss would result. Examiners should review the LOC agreement and the performance of the collateral pool to determine the appropriate classification. An example of a problem LOC follows:

Year 1: No significant problems have surfaced, but LOC issuer has poorly documented the credit and financial capacity of the bond issuer and has inadequate documentation of the pool's performance. Delinquency levels begin to rise. The likelihood of payment under the LOC agreement cannot be determined. The LOC is listed as Special Mention. The ALLL is set at the institution's historical loss experience for similar credits, which is 3% ($30,000).

Year 2: Delinquency levels become so large that the bond issuer must make payments from its own limited cash reserves. The LOC is classified Substandard, and an ALLL of 15% ($150,000) is required.

Year 3: Bond issuer defaults and the investors demand payment under the terms of the LOC agreement. During the course of the year, the full $1 million is paid to the investors. The payment by the association results in an extension of credit (loan) to the bond issuer. Since the collateral will primarily be used to repay investors, it is believed that the association will incur a significant loss. The loan is classified Doubtful with an ALLL of 50% ($500,000). The association or examiner might just as appropriately charge off the loan at this point, depending on the perceived likelihood of repayment.

End of Year 3: Issuer files bankruptcy and bondholders stand to lose some of their investment. Because the LOC issuer has no security and his interest was subordinate to the bondholders, the issuer charges off the $1 million advanced under the LOC.

Migration Analysis

One method to determine the adequacy of valuation allowances is migration analysis. Generally, problem assets either improve or deteriorate over time. If a classified asset is not paid off or upgraded, it often deteriorates (or migrates) to a worse classification. If corrective action is not successful, a loss is often incurred. Migration analysis uses the association's net loss data to track such movements in order to estimate the percentage of losses that are likely to be incurred from different categories of assets within the current portfolio.

Migration analysis incorporates many of the important factors that relate to an association's historical loss experience: collection efficiency, historical area economic conditions, management effectiveness, and overall asset quality. It does not, however, factor in changes that may affect the association's future losses. If an association experiences changes in underwriting, loan volume, or in area economic conditions, etc., adjustments must be made. Another disadvantage of migration analysis is that it requires an accurate and fairly detailed breakdown of the association's portfolio by asset category. If this information is not available, it must be generated before such analysis can be performed. Finally, the analysis must span a meaningful time period.

Appendix B offers guidelines on migration analysis. This method is not mandatory, but it is offered as a tool to help determine the adequacy of valuation allowances. The decision to use this method should be based on factors such as:

- the availability of historical loss data;
- the amount of adjustments that have to be made;[3] and
- whether other methods to assess the adequacy of the ALLL would be more accurate, or would be at least as accurate, but could be derived more efficiently.

Deficiencies in Valuation Allowances

The examination procedures at the end of this Section can be simplified into two steps. The examiner will: (1) assess management's valuation allowance policies and calculation methodology and (2) perform his/her own analysis to assess the adequacy of the association's allowances. If the examiner's estimate of the appropriate ALLL departs significantly from the institution's ALLL, the examiner must thoroughly review the process and methodology used by the association to determine its ALLL. The examiner should discuss the association's process with management and come to a conclusion as to what is appropriate given the findings.

Unless otherwise instructed by the OTS regional office, the examiner in charge (EIC) should obtain his/her field supervisor's concurrence as to the amount of and reasons for any recommended increases in the ALLL prior to any discussions with management. This is to ensure that any requirements for additional allowances are reasonable and justified.

Examiner Documentation

The report of examination (ROE) comment must reasonably support the examiner's conclusions about the association's ALLL. Examination findings must also be adequately documented in the examination work papers. As with all examination work papers, ALLL work papers should contain concise analysis and clear conclusions, provide sufficient documentation of findings, be properly indexed, and reference all pertinent information sources. In addition, documentation supporting the ALLL must include:

- clear documentation of the examiner's calculation methodologies;
- a comparison of the examiner's estimate of an adequate ALLL with the institution's actual ALLL and an analysis of the reason(s) for any difference; and
- a well-defined conclusion as to whether the institution's ALLL is adequate.

[3] For example: an association had previously experienced an annual net loss rate of 6 basis points in its portfolio of one- to-four-family mortgage loans. Then, possibly due to a change in credit administration or a decline in economic conditions, losses increased to 12 basis points. The historical loss data must be adjusted to reflect current trends and economic conditions. At some point, adjustments may become so large that the usefulness of the resulting data becomes suspect.

REFERENCES

Code of Federal Regulations (12 CFR)

Subchapter D: Regulations Affecting all Savings Associations

§ 561.13	Consumer Credit Classified as a Loss
§ 563.160	Classification of Certain Assets
§ 563.172	Re-Evaluation of Real Estate Owned

OTS Examination Handbook

Section 240	Troubled Debt Restructuring
Section 251	Real Estate Owned and Repossessed Assets
Section 260	Classification of Assets

Financial Accounting Standards Board, Statement of Financial Accounting Standards (SFAS)

No. 5	Accounting for Contingencies
No. 15	Accounting for Debtors and Creditors for Troubled Debt Re-structuring
No. 114	Accounting by Creditors for Impairment of a Loan