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OCC Asks National Banks to Perform Quarterly Review of Loan Loss Reserves

WASHINGTON, D.C. -- Citing a trend of weaker loan underwriting standards in the banking industry and the declining levels of coverage in some banks' loan loss reserves, the Office of the Comptroller of the Currency (OCC) today reminded the management of national banks of the need to perform quarterly evaluations of their loan loss reserves and report their findings to their boards of directors.

In an advisory letter issued to national banks, the OCC said it had identified weaknesses in allowance methodologies which need to be corrected to protect banks in the event of an onset of adverse economic conditions. Noting that the economy is healthy and bank earnings and capital are at record levels, the OCC said, "This is also an appropriate time for banks to strengthen allowance methodologies and, if necessary, the allowance itself."

A bank's allowance must be sufficient to cover losses in a bank's loan and lease portfolios that could be expected to occur based on historic experience with these portfolios while factoring in, and making adjustments for, current conditions. The OCC said it was also concerned that some banks were relying too much on unallocated reserves to offset deficient reserves for specific segments of a bank's loan and lease portfolios.

In discussing methodologies used to calculate the appropriate allowance, the OCC provided some suggestions to overcome flawed methodologies:

- Banks should use reasonable time periods, weigh recent experience more heavily and/or establish a process that accounts for changes in the delinquency rate status. For credit cards, a time period exceeding 12 months is now generally too long to calculate the percentage of delinquent loans that move from one delinquency status to the next.

- Banks should ensure that loan loss analyses include consideration of inherent losses in contractually current loans.

- Banks should ensure that they factor the full magnitude of bankruptcy losses into their forecasting.

- Banks should consider comparing previous loan and lease loss projections with actual outcomes, a process known as back testing, to check on the reliability of their projection methodologies.

The OCC said that examiners will also employ back testing and other analytical techniques to identify diverging trends between allowance coverage ratios and credit risk indicators. When examiners identify deteriorating trends in allowance coverage ratios, management's analysis will be thoroughly tested and the allowance adjusted, if appropriate. The OCC said that its examiners will work with banks to ensure that flawed methodologies are corrected promptly.

A copy of the Allowance for Loan and Lease Losses Advisory Letter (AL-97- 8) may be obtained by writing to Comptroller of the Currency, Public Reference Room (Mail Stop 1-5), Washington, D.C. 20219; faxing a request to (202) 874-4448; retrieving the document from the OCC's web page at http://www.occ.treas.gov; ordering by phone (202) 874-5043; or visiting the OCC's Public Reference Room at 250 E Street, S.W. in Washington, D.C. (9 a.m.-noon and 1-3 p.m., Monday-Friday).

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The OCC charters, regulates and supervises approximately 2,800 national banks and 66 federal branches and agencies of foreign banks in the U.S., accounting for more than half the nation's banking assets. Its mission is to ensure a safe, sound and competitive national banking system that supports the citizens, communities and economy of the United States.