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AL 97-8
Subject: Allowance for Loan and Lease Losses

AL 1997-8 has been replaced by OCC 2001-37 and OCC 2006-47.

Examining Personnel

PURPOSE

The purpose of this advisory is to: (1) alert national banks and examiners to risks associated with trends and practices relating to the allowance for loan and lease losses (allowance) recently observed at some banks, and (2) clarify the OCC's expectations concerning the allowance in the current economic environment. The OCC's core policy guidance on the allowance, as contained in the "Allowance for Loan and Lease Losses" booklet of the Comptroller's Handbook, remains unchanged.

BACKGROUND

The Comptroller has previously voiced concern about underwriting trends in the syndicated loan market and the easing of commercial underwriting standards in general. During the past year, considerable attention also has been focused on rising consumer loan delinquency, bankruptcy, and charge-off rates. These latter trends are particularly evident in credit card banks and portfolios.

Although these trends indicate increasing credit risk in the industry, OCC examiners have noted that allowance coverage is declining at some banks. Examiners also have identified weaknesses in allowance methodologies which have raised concern about the ability of some banks to maintain an adequate allowance.

Because the U.S. economy has been healthy for several years, many banks continue to enjoy record high levels of earnings and capital. Banks, however, must be prepared for the possible onset of adverse economic conditions. This is the appropriate time for the OCC to emphasize the importance of maintaining an adequate allowance and to clarify policy expectations. This is also an appropriate time for banks to strengthen allowance methodologies and, if necessary, the allowance itself.

CONCERNS

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During the past year, examiners have identified declining allowance trends in several banks. Two practices that have significantly contributed to these trends include:

o Flawed methodologies for estimating loss rates on pools of loans, including overreliance on historical loss experience without adequate consideration of, and adjustments for, current conditions.

o Overreliance on unallocated reserves to offset deficient or inadequately documented reserves for specific portfolio segments.

MANAGEMENT RESPONSIBILITIES

Adequate management of the allowance is an integral part of a bank's credit risk management process. Bank management must maintain an allowance that adequately covers probable and estimable losses in the portfolio. To ensure an adequate allowance, bank management must have a sound analytical process in place for estimating the amount of inherent loss in the loan portfolio. The bank must be able to recognize problem loans in a timely manner, estimate losses, and adjust the allowance accordingly. Bank management must evaluate the adequacy of the allowance at least quarterly and report its findings to the board of directors before preparing the bank's report of condition and income.

ESTIMATING LOSS RATES ON POOLS OF LOANS

For pools of homogenous loans, the historical rate of net losses provides a starting point for a bank's analysis. The historical loss rate on a pool of loans is not by itself, however, an adequate basis for determining an appropriate allowance allocation unless it has been adjusted to reflect current trends and conditions. In particular, flaws in the application of the roll rate (the percentage of delinquent loans that move from one delinquency status, or "bucket," to the next over a fixed period of time), migration (the dollar value of delinquent loans that move from one delinquency "bucket" to the next over a fixed period of time), and other methodologies used to estimate inherent losses can lead to an inadequate allowance allocation. Examples of flawed methodologies include:

o Using historical time periods to calculate roll-rate averages (the average roll rate over a given period of time) that exceed a reasonable duration. For example, for credit card loans, a time period exceeding 12 months is generally too long. The use of historical time periods that do not adequately reflect current conditions or other factors may cause the bank to react too slowly to current trends and may result in inadequate allowance coverage. Banks should use reasonable time periods, weight recent experience more heavily, and/or establish a process that identifies and adjusts for statistically significant shifts in roll rate percentages.

o Using loan loss analyses utilizing roll rates and/or other methodologies that do not account for inherent losses in contractually current loans. Banks should ensure that this component of the pool is not omitted from projections of loss inherent in the portfolio.

o Using roll rate and other forms of analysis that do not fully reflect the magnitude of bankruptcy losses. Bankruptcy losses frequently do not migrate through the full range of delinquency buckets; therefore they may not be captured in the actual roll-rate percentages. Banks should ensure that they factor the bankruptcy losses into migration analyses or other means of loss forecasting.

The OCC's published guidance on the allowance identifies several factors that should be considered when evaluating the historical loss rate on a pool of loans. Consideration of these qualitative factors is especially important for pools of credit card and other consumer loan products, where the fundamental characteristics of the pool can be significantly affected by collection practices or by changes in marketing approaches or underwriting standards. Management should, for example, track and analyze the volume and trends in special collection programs, including re-aged accounts. In some cases, the programs or changes may be so significant as to warrant creating a separate pool.

ANALYZING COVERAGE FOR POOLS OF LOANS

Many banks generally consider coverage of one year's losses an appropriate benchmark for most pools of loans because the probable loss on any given pool should ordinarily become apparent in

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that time frame. Banks may be able, however, to demonstrate that they can rely on something less than 12 months coverage if they have good management information systems, effective methodologies for estimating losses, and are not masking problems in the pool (e.g., "curing" or "re-aging" delinquencies that have not met appropriate criteria). They also must recognize losses in accordance with regulatory charge-off criteria. For other banks, more than 12 months coverage may be appropriate.

Bankers and examiners should verify the reasonableness and accuracy of loss estimation methodologies. "Back testing" should be considered to evaluate the accuracy of loss estimates from prior periods. Examiners will also employ ratio and other analysis techniques to identify diverging trends between allowance coverage ratios and credit risk indicators. When examiners encounter flawed loss estimation methodologies and results, and/or inappropriate "curing/re-aging" and loss recognition practices, loss coverage of more than 12 months may be justified.
When examiners identify deteriorating trends in allowance coverage ratios, management's analysis will be thoroughly tested and the allowance adjusted, if appropriate.

UNALLOCATED RESERVES

OCC guidance encourages banks to segment their loan and lease portfolios into as many components as practical. In some banks, the reserves allocated to each of the components of the portfolio may include an additional amount that is over and above estimated inherent losses. The OCC considers such additional reserves to be a prudent way to recognize the imperfect nature of most estimates of inherent loss. Unallocated reserves, however, must not be used to obfuscate the determination of overall allowance adequacy, mask significant deteriorating trends in asset quality, or "manage" earnings. Bank management is expected to have a clear and consistent methodology and supporting documentation for determining an adequate allowance, including the size of both the allocated and unallocated components. Examiners will work with banks to ensure that flawed methodologies are corrected promptly.

CONCLUSION

Every national bank must have a program to establish and regularly review the adequacy of its allowance. The allowance must be maintained at a level that is adequate to cover losses in the loan and lease portfolio that are probable and estimable on the date of the evaluation. This requires management to establish appropriate processes to recognize problem loans in a timely manner and a sound analytical process for estimating the amount of inherent loss in its loan portfolio.

ORIGINATING OFFICE

Questions concerning this advisory letter should be directed to the Credit Risk Department at (202) 874-5170.

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