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Office of Thrift Supervision
Department of the Treasury

Director

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Rescinded by CEO 250.

December 21, 1993

MEMORANDUM FOR CHIEF EXECUTIVE OFFICERS

FROM: Jonathan L. Fiechter
Acting Director

SUBJECT: Interagency Policy Statement on the Allowance for Loan and Lease Losses

In September 1992, the Office of Thrift Supervision (OTS) issued a proposed policy statement on general valuation allowances (GVAs) that described the general processes we expect institutions to have in place for the determination of adequate GVAs. In addition, the proposal included quantitative guidance for both management and OTS examiners to use to assess the overall adequacy of GVAs. The public comments we received on the proposed policy statement were generally favorable, though many commenters suggested that we work with the other Federal bank regulatory agencies to develop and issue common interagency guidance on allowances.

Over the past year, we have undertaken such an effort, and the attached "Interagency Policy Statement on the Allowance for Loan and Lease Losses" is the result of these efforts[1]. This Policy Statement is effective immediately. It includes guidance on both the responsibilities of management for the assessment and establishment of an adequate allowance and guidance for the agencies' examiners to use to assess institutions' allowance policies and levels.

There are a few points about the Interagency Policy Statement that I want to highlight. First, this document is focused on allowances for the loan and lease portfolio and does not address allowances on other assets (e.g., real estate owned, investments in subsidiaries, real estate held for investment, etc.). Allowances on these other assets should continue to be established based on current OTS policy.

Second, the Policy Statement reaffirms our current policy that examiners will generally accept management's assessment of the adequacy of allowances when management has: effective systems and controls to identify, monitor, and address asset

1. For savings associations, the Allowance for Loan and Lease Losses is included in General Valuation Allowances.

quality problems; analyzed all significant factors that affect the collectibility of the portfolio in a reasonable manner; and, established an acceptable allowance evaluation process that meets the objectives discussed in the Statement.

Third, the quantitative guidance discussed on page 9 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 evaluation process. The guidance is not intended to be used as a "floor" or "ceiling." The appropriate level of allowances that an institution should have must be based on institution-specific factors. As discussed in footnote 10 on page 9, 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 that an institution has recognized losses in accordance with Thrift Activities Regulatory Handbook Section 260, "Valuation and Classification of Troubled, Collateral-Dependent Loans." GVAs 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 level of GVAs 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, for 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.

The goal of the Interagency Policy Statement is to provide uniform guidance for the determination of adequate allowances and to ensure that all insured institutions and examiners are clear about the agencies' allowance policies. Please contact your Regional Office if you have any questions about it.

cc: Regional Directors

Attachment