Regulatory Bulletin

Handbook: **Thrift Activities** RB 6 was rescinded 5/4/90. It was incorporated into Thrift Activities 261.
Subjects: **Adequacy of Allowances**

Section: 261
RB 6

December 12, 1988

Adequacy of Valuation Allowances

RESCINDED

Summary: This Bulletin announces the initial distribution of the new Thrift Activities Section 261, Adequacy of Allowances.

For Further Information Contact:
The FHLBank District in which you are located or the Thrift Activities Division of the Office of Regulatory Activities, Washington, DC.

Regulatory Bulletin 6

Attached to this bulletin is the previously unreleased Section 261, Adequacy of Valuation Allowances, of the Thrift Activities Regulatory Handbook. This section should be inserted under the Asset Quality tab of the handbook. It will be reprinted and incorporated into the next update of the handbook. At that time, this regulatory bulletin will be rescinded.

Section 261 discusses management's responsibility to establish and evaluate the adequcy of valuation allowances. Normally, the asset classification system should provide the basis for management's valuation allowance methodology. In general, the valuation allowance should be sufficient to cover those assets classified as loss, estimated loss exposure on other classified assets, and some applicable percentage of assets not classified.

Attachment

— *Darrel W. Dochow, Executive Director*

Introduction

Given the historical concentration of thrift industry lending in low risk loans, the inflationary spiral and the lower loan-to-value ratios of prior decades, the need for loss allowances was not pronounced until the 1980s. Typically, when a thrift suffered a loss, a direct charge to earnings was made. Most commonly, the loss was both recognized and realized upon disposition of the asset, which was usually a parcel of real estate owned (REO) acquired through foreclosure. Losses on specific assets were sometimes recognized prior to disposition, with provisions for such losses being typically that amount by which the institution's investment in the loan or REO exceeded the appraised value of the security property.

However, with the expanded lending and investment authorities brought about by deregulation and other contributing factors, asset quality problems and losses have become more pervasive. As a result, maintenance of adequate valuation allowances has become an important consideration in both the management and the regulation of thrift institutions.

As mandated by the Competitive Equality Banking Act (CEBA), the classification of certain assets regulation (12 C.F.R. 561.16c) was expanded to include all assets, rather than just loans and certain other assets as previously required. The requirements for insured institutions to classify their assets on a regular basis and to establish prudent general valuation allowances sufficient to absorb estimated losses or exposure inherent in the asset structure are also included in CEBA. Also, institutions must continue to either charge-off against the general valuation allowance or establish specific valuation allowances for 100% of the loss classifications, whether classified by the institution or by an examiner.

An institution's general valuation allowance is created and increased through charges to income. For regulatory purposes, an institution's total valuation allowance is comprised of:

- Specific valuation allowances for amounts classified Loss (in lieu of charging off such amounts). Specific valuation allowances are allocations from the general valuation allowances and represent loss estimates relating to specific assets. Specific valuation allowances have the practical effect of reducing the book values of related assets to amounts considered to be ultimately collected or realized.
- General valuation allowances include loss potential or exposure estimates based on individual asset analysis, historical loss experience and qualitative factors.

For regulatory purposes, general valuation allowances are included in regulatory capital.

The classification of assets regulation also specifies that valuation allowances be established for classified assets on a basis consistent with generally accepted accounting principles (GAAP) or consistent with the practices of the federal banking agencies. Therefore, notwithstanding the requirements of GAAP, additional allowances can be required of an institution for supervisory purposes to ensure safety and soundness. The regulation additionally stipulates that when, in an examiner's judgement, existing valuation allowances are inadequate, the institution shall establish or increase general and/or specific valuation allowances in an appropriate amount as determined by the examiner, subject to approval by the Principal Supervisory Agent (PSA).

As required in the classification of assets regulation, it is management's responsibility to establish and evaluate the adequacy of valuation allowances. Such evaluations should be conducted at least quarterly. It is not the examiner's responsibility to initially ascertain the amount of valuation allowances, but rather to determine that management has fulfilled its responsibility to use reasonable judgement based on reliable information to estimate an appropriate allowance. It is the examiner's responsibility to initially evaluate the adequacy of the process and procedures employed by management. Management should maintain adequate documentation to support the procedures employed, the assumptions made, and the conclusions reached.

In evaluating managment's process for maintaining adequate valuation allowances, the examiner must evaluate whether management's process appropriately considers all pertinent factors. The examiner should recognize that a sound process gives due consideration to both quantitative and qualitative factors, and is thus partially subjective in nature. The level, severity and trends of classified assets, economic trends, and the institution's prior net loss experience (gross losses less recoveries) should carry considerable weight in both management's evaluation process and in the examiner's final determination of allowance adequacy based on examination findings. As a general rule, notwithstanding current conditions and trends to the contrary, the total valuation allowance should be maintained at a level which correlates to the institution's typical loss experience in recent years.

Examiners may find that management employs various methods to estimate potential losses in maintaining an adequate general valuation allowance. For example, the general valuation allowance may consist or be comprised of the following:

- Estimates for larger assets classified other than loss based on an analysis of the individual asset;

- Estimates for smaller assets classified other than loss. These estimates are commonly derived by applying a net loss percentage based on historical experience to the total amount in each classification category (exclusive of larger assets evaluated on an individual basis);

- Estimates for pools of similar assets not classified such as residential mortgage loans, consumer loans and credit card loans which are characterized by large volumes of relatively small loans with homogenous or similar characteristics. These estimates are also commonly derived through application of historical loss percentages; and

- Estimates which reflect management's subjective assessment of portfolio trends.

Historical net loss percentages are determined by tracking the disposition of assets adversely classified in prior years to ascertain what portion or percentage of such assets were ultimately deemed loss. For the above discussed methods, as well as any other methods involving percentage applications, management should be able to demonstrate that the percentages used are consistent with the institution's historical loss experience and are appropriate for current loss expectations.

However, management and examiners should not evaluate loss exposure only from a historical perspective or on the basis of peer group comparisons ignoring other relevant data and factors. Changes in the following factors may indicate a need to adjust historical loss percentages:

- Level, severity and trend of classified assets;

- Level and trend of delinquent and nonaccrual loans;

- Renewal and extension policy and practices;

- Recent loss experience trends;

- Concentrations of credit;

- Size of individual credit exposure (few large loans versus numerous small loans);

- Current and anticipated economic conditions;

- Trends in portfolio volume, maturity, and composition;

- Off balance sheet risk;

- Charge-off, collection and recovery policies, procedures, and their effectiveness;

- The quality of management and lending personnel; and

- The effectiveness of the institution's lending policies, procedures and practices.

Definitions

Total Valuation Allowance: The combined total of specific and general valuation allowances.

Charge-Off. To reduce the carrying basis of an asset by the amount classified loss.

General Valuation Allowance: That portion of the total valuation allowance containing loss potential or exposure estimates for assets classified other than loss, pools or portfolios of similar type assets not classified, and/or qualitative factors.

Provision for Losses: A charge against earnings to establish or augment the total valuation allowance.

Specific Valuation Allowance: That portion of the total valuation allowance representing classified loss amounts relating to specific assets.

Examination Objectives

To determine if policies, practices, and procedures regarding an institution's establishment of valuation allowances are adequate.

To determine if management is operating in conformance with established guidelines.

To determine if valuation allowances are adequate to cover estimated losses.

To determine compliance with applicable laws and regulations.

To initiate corrective action when policies, practices, or procedures are deficient or when violations of laws or regulations have been noted.

Examination Procedures

Level I

1. Obtain the institution's written policies and procedures regarding the establishment and maintenance of adequate asset valuation allowances. If no written policies and procedures exist, determine from discussion with management the methods and procedures employed in determining the adequacy of asset valuation allowances.

2. Determine through review of written policy and procedures and records whether management conducts an evaluation of the adequacy of valuation allowances at least quarterly; whether management's review encompasses and gives adequate consideration to all pertinent factors and is documented to support conclusions reached; and whether criteria and procedures have been established for charging off loans and other assets.

Level II

3. Test the institution's compliance with its own established policies and procedures while performing the remaining examination procedures. Determine if any previously cited deficiencies have been corrected.

4. Obtain a listing of internally identified problem assets and any corresponding specific valution allowances which have been established for such assets.

5. Prepare or obtain from the examiner assigned Lending Risk Assessment a detailed list of classified loans identified in the various loan departments.

6. Prepare or obtain from the examiner in charge (EIC) a schedule of assets, other than loans, which were classified during the examination.

7. Determine through discussions with the EIC and the examiner assigned Lending Risk Assessment the existence of any adverse trends or other conditions that might negatively impact the adequacy of the valuation allowances.

8. Determine from comparing the schedules obtained in procedures 4 and 5 the extent, if any, to which assets classified Loss during the examination exceed the specific valuation allowances which have been established for such assets by managment and the impact either additions required to specific allowances or charge-offs will have on the general valuation allowance.

9. Based on an evaluation of the level and severity of assets classified Substandard and Doubtful and other pertinent factors, determine the adequacy of the existing specific and general valuation allowances.

10. Discuss findings, including inadequate allowances and/or any weaknesses in or nonconformance with policies, practices, and procedures with management and request, as necessary, that management make any appropriate adjustments during the examination to increase specific valuation allowances and/or the general valuation allowance to levels considered adequate. Determine management's agreement or opposition to such request.

11. Prepare comments for the examination report regarding the adequacy of valuation allowances, including any deficiencies reviewed with management, any remedial actions recommended, and any corrective action taken or to be taken. If manage-

ment's concurrence with any requested adjustments has not been obtained, prepare appropriate comments for the report of examination which will facilitate follow-up supervisory action.

12. Update the work papers with any information which will facilitate future examinations.

References

Code of Federal Regulations (12 C.F.R.)

*Insurance Regulations (Yellow Tab)**

§ 561.16c	Classification of Certain Assets
§ 563.17-2	Re-evaluation of Assets; Adjustment of Book Value; Adjustment Charges
§ 571.1a	Classification of Certain Assets

* The reference is to the colored tabs in the *Supervisory Service*, United States League of Savings Institutions, Chicago, Illinois.