Allowances for Loan and Lease Losses in the Current Economic Environment: Loans Secured by Junior Liens on 1-4 Family Residential Properties

Allowance Concepts and Requirements

The Interagency Policy Statement on the Allowance for Loan and Lease Losses, issued by the federal financial institution regulatory agencies in December 2006,[1] states that the allowance for loan and lease losses (ALLL)

> represents one of the most significant estimates in an institution's financial statements and regulatory reports. Because of its significance, each institution has a responsibility for developing, maintaining, and documenting a comprehensive, systematic, and consistently applied process for determining the amounts of the ALLL and the provision for loan and lease losses (PLLL). To fulfill this responsibility, each institution should ensure controls are in place to consistently determine the ALLL in accordance with GAAP [i.e., generally accepted accounting principles], the institution's stated policies and procedures, management's best judgment, and relevant supervisory guidance.
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> As of the end of each quarter, or more frequently if warranted, each institution must analyze the collectibility of its loans and leases held for investment (hereafter referred to as "loans") and maintain an ALLL at a level that is appropriate and determined in accordance with GAAP. [Footnote omitted.]

An appropriate ALLL covers estimated credit losses on:

- Loans that an institution individually evaluates and determines to be impaired under Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*;[2] and
- Groups of loans with similar risk characteristics that the institution evaluates collectively for impairment under Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5).[3]

According to the Interagency Policy Statement, the term "estimated credit losses" means an estimate of the current amount of loans that it is probable the institution will be unable to collect given facts and circumstances as of the evaluation date. Estimates of credit losses should reflect consideration of all significant factors that affect the collectibility of the portfolio as of the evaluation date.[4]

The Interagency Policy Statement further notes that changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses, keeping in mind the characteristics of an institution's loan portfolio. In this regard, if declining credit quality trends relevant to the types of loans in an institution's portfolio are evident, which is generally the case in the current economic environment, the ALLL level as a percentage of the portfolio should generally increase, barring exceptionally high charge-off activity.

In particular, institutions are reminded that, when estimating credit losses on each group of loans with similar risk characteristics under FAS 5, they should consider their historical loss experience on the group, *adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans in the group as of the ALLL evaluation date.

Considerations Related to Loans Secured by Junior Liens on 1-4 Family Residential Properties

The need to consider all significant factors that affect the collectibility of loans is especially important for loans secured by junior liens on 1-4 family residential properties, both closed-end and open-end, in areas where there have been declines in the value of such properties. Thus, consistent with the Interagency Policy Statement, after determining the appropriate historical loss rate for each group of junior lien loans with similar risk characteristics, an institution's management should consider those current qualitative or environmental factors that are likely to cause the estimated credit losses on these loans as of the ALLL evaluation date to differ from the group's historical loss experience.

As noted in the Interagency Policy Statement, these qualitative or environmental factors include, but are not limited to, changes in the volume and severity of past due loans in each group of junior lien loans and changes in economic and business conditions and other developments that affect the collectibility of the junior lien loans. Furthermore, given the unique nature of junior lien loans, other factors that an institution should take into account would include, for example:

- Changes in the repayment status of the junior lien borrowers' loans secured by first (and any other more senior) liens on the same 1-4 family residential properties, including the extent and severity of delinquencies and the volume of senior lien loan modifications that represent troubled debt restructurings, regardless of whether the junior lien loans themselves are current or past due;
- Changes in the value of the junior lien borrowers' underlying real estate collateral, including the extent to which these borrowers' more senior lien loan balances, or the combined balances of the more senior lien loans and the institution's junior lien loan, currently exceed the value of the underlying real estate; and
- The institution's policies regarding the initiation of foreclosure action on junior lien loans and the submission of bids on foreclosure sales initiated by more senior lienholders when the value of the underlying real estate collateral is insufficient to adequately protect the institution's junior lien position.

The FDIC recognizes that determining the appropriate level for the ALLL for each group of loans with similar risk characteristics under FAS 5 is inevitably imprecise and requires a high degree of management judgment. Nevertheless, delaying the recognition of estimated credit losses on junior lien loans secured by 1-4 family residential properties by failing to properly consider the current effect of more senior liens on the collectibility of an institution's existing junior lien loans is an inappropriate application of GAAP. Additional supervisory action may also be warranted based on the magnitude of the deficiencies in this aspect of the institution's ALLL process. Furthermore, the failure to timely recognize estimated credit losses could delay appropriate loss mitigation activity, such as restructuring junior lien loans to more affordable payments or reducing principal on such loans to facilitate refinancings. Examiners will continue to evaluate the effectiveness of an institution's loss mitigation strategies for loans as part of their assessment of the institution's overall financial condition.

[1] http://www.fdic.gov/news/news/financial/2006/fil06105a.pdf.(PDF Help)

[2] In the Financial Accounting Standards Board's Accounting Standards Codification™, see Section 310-10-35, Receivables – Overall – Subsequent Measurement.

[3] In the Accounting Standards Codification™, see Subtopic 450-20, Contingencies – Loss Contingencies.

[4] Thus, under GAAP, the purpose of the ALLL is not to absorb all of the risk in the loan portfolio, but to cover probable credit losses that have already been incurred.