BLACK | MANN & GRAHAM L.L.P.

9575 Katy Freeway, Suite 300

Houston, TX 77024

Phone: 713-871-0005

Fax: 713-871-1358

Thomas E. Black, Jr., P. C. *
Calvin C. Mann, Jr., P. C.
Gregory S. Graham, P. C.
David F. Dulock
Diane M. Gleason
Benjamin R. Idziak **
Shawn P. Black **
Margaret A. Noles
Robert J. Brewer
Regina Uhl
Ali Hedayatifar

Of Counsel
David M. Tritter

** Also Licensed in New York, Washington, West Virginia and Iowa*
*** Also Licensed in New York*

February 1, 2012

To: Clients and Friends

From: David F. Dulock

Subject: Federal Agencies Issue Guidance on Junior Lien Loan Loss Allowances – January 31, 2012

The Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency (collectively the "agencies") issued the attached supervisory guidance on allowance for loan and lease losses (ALLL) estimation practices associated with loans and lines of credit secured by junior liens on one- to four-family residential properties.

The agencies issued the guidance to reiterate policy and to remind regulated financial institutions to monitor all credit quality indicators relevant to credit portfolios, including junior liens. Examples of junior liens include second mortgages and home equity lines of credit taken out by mortgage borrowers.

The supervisory guidance reiterates key concepts included in generally accepted accounting principles and existing ALLL supervisory guidance related to the ALLL and loss estimation practices and reminds institutions to follow appropriate risk-management principles in managing junior lien loans and lines of credit.

If you are a regulated financial institution under the supervision of one of the above agencies with a loan portfolio containing junior liens, this supervisory guidance pertains to you. Otherwise, you may disregard this memorandum.

Attach:. Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1-4 Family Residential Properties

Board of Governors of the Federal Reserve System
Federal Deposit Insurance Corporation
National Credit Union Administration
Office of the Comptroller of the Currency

Interagency Supervisory Guidance on Allowance for Loan and Lease Losses Estimation Practices for Loans and Lines of Credit Secured by Junior Liens on 1-4 Family Residential Properties

January 31, 2012

Purpose

This document provides guidance related to allowance for loan and lease losses (ALLL) estimation practices associated with loans and lines of credit secured by junior liens on 1-4 family residential properties (junior liens).

Background

Amidst continued uncertainty in the economy and the housing market, federally regulated financial institutions are reminded to monitor all credit quality indicators relevant to credit portfolios, including junior liens. While the following guidance specifically addresses junior liens, it contains principles that apply to estimating the ALLL for all types of loans. This guidance reiterates key concepts included in generally accepted accounting principles (GAAP) and existing ALLL supervisory guidance related to the ALLL and loss estimation practices. Institutions also are reminded to follow appropriate risk management principles in managing junior lien loans and lines of credit, including those in the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending.*

Financial Accounting Standards Board Accounting Standards Codification (ASC) Section 450-20-25, Contingencies – Loss Contingencies – Recognition,[1] states: "An estimated loss from a loss contingency shall be accrued by a charge to income if both of the following conditions are met:

a. Information available before the financial statements are issued or are available to be issued indicates that it is probable that an asset had been impaired or a liability had been incurred at the date of the financial statements.

b. The amount of loss can be reasonably estimated."

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[1] Formerly Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies*.

The December 2006 *Interagency Policy Statement on the Allowance for Loan and Lease Losses* (IPS) states: "Estimates of credit losses should reflect consideration of all significant factors that affect the collectability of the portfolio as of the evaluation date."

The *Interagency Credit Risk Management Guidance for Home Equity Lending* states: "Financial institutions should establish an appropriate ALLL and hold capital commensurate with the riskiness of portfolios. In determining the ALLL adequacy, an institution should consider how the interest-only and draw features of HELOCs during the lines' revolving period could affect the loss curves for the HELOC portfolio. Those institutions engaging in programmatic subprime home equity lending or institutions that have higher risk products are expected to recognize the elevated risk of the activity when assessing capital and ALLL adequacy."

Responsibilities of Management

Consideration of All Significant Factors

Institutions should ensure that during the ALLL estimation process sufficient information is gathered to adequately assess the probable loss incurred within junior lien portfolios. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien loan has been modified. Institutions with significant holdings of junior liens should gather and analyze data on the associated senior lien loans it owns or services. When an institution does not own or service the associated senior lien loans, it should use reasonably available tools to determine the payment status of the senior lien loans. Such tools include obtaining credit reports or data from third-party services to assist in matching an institution's junior liens with its associated senior liens. Additionally, an institution may, as a proxy, use the relevant performance data on similar senior liens it owns or services. An institution with an insignificant volume of junior lien loans and lines of credit may use judgment when determining what information about associated senior liens not owned or serviced is reasonably available.

Institutions with significant holdings of junior liens should also periodically refresh other credit quality indicators the organization has deemed relevant about the collectibility of its junior liens, such as borrower credit scores and combined loan-to-value ratios (CLTVs), which include both the senior and junior liens. Institutions should refresh relevant credit quality indicators as often as necessary considering economic and housing market conditions that affect the institution's junior lien portfolio. As noted in the December 2006 IPS, "changes in the level of the ALLL should be directionally consistent with changes in the factors, taken as a whole, that evidence credit losses." For example, if declining credit quality trends in the factors relevant to either junior liens or their associated senior lien loans are evident, the ALLL level as a percentage of the junior lien portfolio should generally increase, barring unusual charge-off activity. Similarly, if improving credit quality trends are evident, the ALLL level as a percentage of the junior lien portfolio should generally decrease.

Institutions routinely gather information for credit risk management purposes, but some may not fully use that information in the allowance estimation process. Institutions should consider all reasonably available and relevant information in the allowance estimation process, including information obtained for credit risk management purposes. As noted above, ASC Topic 450 states that losses should be accrued by a charge to income if information available prior to issuance of the financial statements indicates that it is probable that an asset has been impaired. The December 2006 IPS states that "estimates of credit losses should reflect consideration of all significant factors." Consequently, it is considered inconsistent with both GAAP and supervisory guidance to fail to gather and consider reasonably available and relevant information that would significantly affect management's judgment about the collectibility of the portfolio.[2]

Adequate Segmentation

Institutions normally segment their loan portfolio into groups of loans based on risk characteristics as part of the ALLL estimation process. Institutions with significant holdings of junior liens should ensure adequate segmentation within their junior lien portfolio to appropriately estimate the allowance for high-risk segments within this portfolio. A lack of segmentation can result in an allowance established for the entire junior lien portfolio that is lower than what the allowance would be if high-risk loans were segregated and grouped together for evaluation in one or more separate segments. The following credit quality indicators may be appropriate for use in identifying high-risk junior lien portfolio segments:

- Delinquency and modification status of an institution's junior liens,
- Delinquency and modification status of senior lien loans associated with an institution's junior liens,
- Current borrower credit score,
- Current CLTV,
- Origination channel,
- Documentation type,
- Property type (for example, investor owned or owner-occupied),

[2] "Portfolio" refers to loans collectively evaluated for impairment under ASC Topic 450; this supervisory guidance may also be applicable to junior lien loans that are subject to measurement for impairment under ASC Subtopic 310-10, Receivables – Overall (formerly Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan*) and ASC Subtopic 310-30, Loans and Debt Securities Acquired with Deteriorated Credit Quality (formerly AICPA Statement of Position 03-3, *Accounting for Certain Loans or Debt Securities Acquired in a Transfer*).

- Geographic location of property,
- Origination vintage,
- Home equity lines of credit (HELOCs) where the borrower is making only the minimum payment due, and
- HELOCs where current information and conditions indicate that the borrower will be subject to payment shock.

In particular, institutions should ensure their ALLL methodology adequately incorporates the elevated borrower default risk associated with payment shocks due to (1) rising interest rates for adjustable rate junior liens, including HELOCs,[3] or (2) HELOCs converting from interest-only to amortizing loans. If the default rate of junior liens that have experienced payment shock is higher than the default rate of junior liens that have not experienced payment shock, an institution should determine whether it has a significant amount of junior liens approaching their conversion to amortizing loans or approaching an interest rate adjustment date. If so, to ensure the institution's estimate of credit losses is not understated, it would be necessary to adjust historical default rates on these junior liens to incorporate the effect of payment shocks that, based on current information and conditions, are likely to occur.

Adequate segmentation of the junior lien portfolio by risk factors should facilitate an institution's ability to track default rates and loss severity for high-risk segments and its ability to appropriately incorporate these data into the allowance estimation process.

Qualitative or Environmental Factor Adjustments

As noted in the December 2006 IPS, institutions should adjust a loan group's historical loss rate for the effect of qualitative or environmental factors that are likely to cause estimated credit losses as of the evaluation date to differ from the group's historical loss experience. Institutions typically reflect the overall effect of these factors on a loan group as an adjustment that, as appropriate, increases or decreases the historical loss rate applied to the loan group. Alternatively, the effect of these factors may be reflected through separate standalone adjustments within the ASC Subtopic 450-20 component of the ALLL.

When an institution uses qualitative or environmental factors to estimate probable losses related to individual high-risk segments within the junior lien portfolio, any adjustment to the historical loss rate or any separate standalone adjustment should be supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments. In addition, changes in the allowance allocation for junior liens should be

[3] Forecasts of future interest rate increases should not be included in the determination of the ALLL. However, if rates have risen since the last rate adjustment, the effect of the increase on the amount of the payment at the next rate adjustment should be considered.

directionally consistent with changes in the factors taken as a whole that evidence credit losses on junior liens, keeping in mind the characteristics of the institution's junior lien portfolio.

Charge-off and Nonaccrual Policies

Banking institutions should ensure that their charge-off policy on junior liens is in accordance with the June 2000 *Uniform Retail Credit Classification and Account Management Policy*.[4] As stated in the December 2006 IPS, "when available information confirms that specific loans, or portions thereof, are uncollectible, these amounts should be promptly charged off against the ALLL."

Institutions also should ensure that income recognition practices related to junior liens are appropriate. Consistent with GAAP and regulatory guidance, institutions are expected to have revenue recognition practices that do not result in overstating income. Placing a junior lien on nonaccrual, including a current junior lien, when payment of principal or interest in full is not expected is one appropriate method to ensure that income is not overstated. An institution's income recognition policy should incorporate management's consideration of all reasonably available information including, for junior liens, the performance of the associated senior liens as well as trends in other credit quality indicators. The policy should require that consideration of these factors takes place before foreclosure on the senior lien or delinquency of the junior lien. The policy should also explain how management's consideration of these factors affects income recognition prior to foreclosure on the senior lien or delinquency of the junior lien to ensure income is not overstated.

Responsibilities of Examiners

To the extent an institution has significant holdings of junior liens, examiners should assess the appropriateness of the institution's ALLL methodology and documentation related to these loans, and the appropriateness of the level of the ALLL established for this portfolio. As noted in the December 2006 IPS, for analytical purposes, an institution should attribute portions of the ALLL to loans that it individually evaluates and determines to be impaired under ASC Subtopic 310-10 and to groups of loans that it evaluates collectively under ASC Subtopic 450-20. However, the ALLL is available to cover all charge-offs that arise from the loan portfolio.

Consistent with the December 2006 IPS, in their review of the junior lien portfolio, examiners should consider all significant factors that affect the collectibility of the portfolio.

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[4] Charge-off policy guidance for credit unions is set forth in NCUA Letter to Credit Unions 03-CU-01, dated January 2003, *Loan Charge-off Guidance.*

In reviewing the appropriateness of an institution's allowance established for junior liens, examiners should:

- Evaluate the institution's ALLL policies and procedures and assess the methodology that management uses to arrive at an overall estimate of the ALLL for junior liens. This should include whether all significant qualitative or environmental factors that affect the collectibility of the portfolio (including those factors previously discussed) have been appropriately considered in accordance with GAAP.
- Review management's use of loss estimation models or other loss estimation tools to ensure that the resulting estimated credit losses are in conformity with GAAP.
- Review management's support for any qualitative or environmental factor adjustments to the allowance related to junior liens. Examiners should ensure that all relevant qualitative or environmental factors were considered and adjustments to historical loss rates for specific risk segments within the junior lien portfolio are supported by an analysis that relates the adjustment to the characteristics of and trends in the individual risk segments.
- Review the interest income accounts associated with junior liens to ensure that the institution's net income is not overstated.

If the examiner concludes that the reported ALLL for junior liens is not appropriate or determines that the ALLL evaluation process is deficient, recommendations for correcting these deficiencies, including any examiner concerns regarding an appropriate level for the ALLL, should be noted in the report of examination. Examiners should cite any departures from GAAP and regulatory guidance, as applicable. Additional supervisory action may also be taken based on the magnitude of the observed shortcomings in the ALLL process.