New Regulatory Guidance – Junior Liens

The federal banking and credit union regulators have issued interagency guidance for Junior Liens in 1-4 Family Residential Properties. While the guidance is specifically for these types of loans, the guidance clearly applies the concepts within this guidance as best practices concerning credit quality indicators as important for all credit portfolios.

As background to the discussion, the guidance reiterates the GAAP for loss contingencies on which SFAS 5 pool losses are based. In doing so, the emphasis is placed on obtaining and reflecting all significant factors that affect collectability as of the date of the loss evaluation. In addition, the guidance refers to the current guidance that states the following for Home Equity Lending:

> ***"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."***

The new guidance defines information that should be considered in evaluating the junior lien portfolio such as:

1. Delinquency status of senior liens associated with the institutions junior liens
2. If the senior lien has been modified
3. Gather and analyze data on senior liens associated with junior liens whether owned or serviced.
4. If serviced, the institution should use reasonably available tools to determine payment status of the serviced senior liens.
5. For institutions with significant holdings of junior liens, the periodic refreshing of credit quality indicators deemed relevant such as credit scores and loan to value ratios.

Reasonably available tools are defined as credit reports, data from third party servicers or performance data on similar senior liens in their portfolio (i.e. not other institution's performance of senior liens). If junior liens are insignificant, institutions can use judgment when determining what information about associated senior liens not owned or serviced is reasonably available.

The guidance does not mandate a period for refreshing credit quality, however, they do state "as often as necessary considering economic and housing conditions". We believe a quarterly or semi-annual refreshing would be reasonable, especially in the current environment.

The guidance repeats the concept of directional consistency. If the underlying credit risk factors for either senior or junior liens increases, the allowance level should correspondingly increase and vice versa.

The guidance lists the following credit quality indicators as appropriate:

1. Delinquency and modification status of an institution's junior liens,
2. Delinquency and modification status of senior lien loans associated with an institution's junior liens,
3. Current borrower credit score,
4. Current Loan to Value (LTV),
5. Origination channel,
6. Documentation type,
7. Property type (for example, investor owned or owner-occupied),
8. Geographic location of property,
9. Origination vintage,
10. Home equity lines of credit (HELOC) where the borrower is making only the minimum payment due
11. HELOC where current information and conditions indicate that the borrower will be subject to payment shock.

The guidance recommends the development of methodology that integrates the following:

- The increased level of borrower default risk associated with payment shocks from rising interest rates from adjustable rate liens and,
- The increased level of borrower default risk from converting interest only loans to amortizing loans.

The guidance now recommends that an institution's methodology should track the default rate on junior liens that have and have not experienced payment shock. If the default rate on loans that have experienced payment shock is higher than those that have not, the institution should determine the effect of the higher default on loans approaching conversion to amortization or approaching interest rate adjustments. The guidance requires an adjustment to historical default rates if this occurs and recommends applying additional qualitative factors to the junior liens for the additional risk.

The guidance infers that adequate segmentation of the junior portfolios by risk factors would appropriately incorporate these requirements. Using qualitative or environmental factors as separate adjustments to the allowance estimation is consistent with the current regulatory guidance on methodology.

Institutions are reminded that they should follow the agency's other policy directives for charge-offs and nonaccruals. None of the changes in this policy remove or eliminate the requirements for consistent GAAP application for revenue recognition. However, the additional factors listed above need to be included in management policy for income recognition. The policy specifically states that the consideration of these issues and factors should take place before foreclosure on senior liens. In

addition, the policy recommends that management's allowance policies should discuss how these factors are considered.

The policy directs examiners to perform the following procedures:

> ***"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 collectability of the portfolio (including those factors previously discussed) have been appropriately considered in accordance with GAAP.***
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> ***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.***
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> ***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."***

How ARCSys can help you with these new policy directives:

The ARCSys system has the following already built into the system:

- Our criteria tables, which are used for applying qualitative and environmental factors, are available and allow you to build directional consistency into your calculation
- ARCSys tracks at multiple class levels based on your design the historical charge-offs of your portfolio.
- ARCSys has built-in environmental factors for unemployment rates, consumer price index and other employment and economic data.
- ARCSys allows you to use current FICO or other credit quality indicators to apply risk factors to your portfolio.
- Our Data Warehouse will allow you to track and compare your portfolios, as well as, perform migration analysis.
- Our Discounted Cash Flow analysis allows for multiple payment streams and multiple lump sum payments. We can handle any payment stream scenario.

The Solution – ACL Calculator

At ARCSys our vision is to provide the best, most flexible software which complies with regulatory guidance and GAAP. The ACL Calculator was developed as Software as a Service (SaaS) to effortlessly automate the entire allowance calculation process including disclosures – rendering spreadsheets obsolete.

ACL Calculator handles everything:

- Detailed disclosure reports that calculate every required disclosure
- Historical losses and calculations by segment or class
- Additional risk calculations for economical, political, industry and environmental credit risks by segment or class
- SFAS 114 evaluation for fair value of collateral and present value calculations
- Troubled Debt Restructurings
- Detailed calculation reports and edit reports
- And much more!

ACL Calculator is proprietary software designed to offer you peace of mind regarding SFAS 5 and 114 requirements and the new update standard ASU 2010-20 disclosure changes. It is comprehensive, customizable, all-encompassing software that drastically minimizes the workload required to adhere to the new standard.

Best of all, it is software developed by accountants for accountants!

ARCSys – Innovative Solutions in a Regulated World