



BOARD OF GOVERNORS
OF THE
FEDERAL RESERVE SYSTEM

WASHINGTON, D.C. 20551

DIVISION OF BANKING
SUPERVISION AND REGULATION

SR 12-3

January 31, 2012

TO THE OFFICER IN CHARGE OF SUPERVISION AT EACH FEDERAL RESERVE BANK AND TO EACH DOMESTIC BANKING ORGANIZATION SUPERVISED BY THE FEDERAL RESERVE

SUBJECT: Interagency Guidance on Allowance Estimation Practices for Junior Lien Loans and Lines of Credit

Applicability to Community Banking Organizations: This guidance applies to all banking organizations with junior lien loans, including those with \$10 billion or less in consolidated assets.

The Board of Governors of the Federal Reserve System, together with the Federal Deposit Insurance Corporation, the National Credit Union Administration, and the Office of the Comptroller of the Currency, has issued the attached guidance addressing allowance estimation practices for junior lien loans and lines of credit (collectively, junior liens).

Domestic banking organizations supervised by the Federal Reserve are reminded to consider all credit quality indicators relevant to their junior liens. Generally, this information should include the delinquency status of senior liens associated with the institution's junior liens and whether the senior lien has been modified. Institutions should ensure that during the allowance for loan and lease loss (ALLL) estimation process sufficient information is gathered to adequately assess the probable loss incurred within junior lien portfolios.

In addition, based on the rapid growth in home equity lending during the 2003-2007 timeframe, a significant volume of home equity lines of credit (HELOCs) will be approaching the end of their draw periods in the next several years and will either convert to amortizing loans or have principal due as a balloon payment. An institution with a significant number of HELOCs should ensure that its ALLL methodology appropriately captures the elevated borrower default risk associated with any upcoming payment shocks.

This guidance applies to institutions of all sizes. The guidance states that an institution should use reasonably available tools to determine the payment status of senior liens associated with its junior liens, such as credit reports, third party services or in certain cases, a proxy. It is expected that large, complex institutions would find most tools reasonably available and would use proxies in limited circumstances.

The guidance does not add to or modify existing regulatory reporting requirements issued by the agencies or current generally accepted accounting principles (GAAP). This guidance reiterates key concepts included in GAAP and existing supervisory guidance related to the ALLL. Institutions also are reminded to follow appropriate risk management principles in managing junior lien loans and lines of credit, including the May 2005 *Interagency Credit Risk Management Guidance for Home Equity Lending*.

Reserve Banks are asked to distribute this letter to financial institutions supervised by the Federal Reserve in their districts, as well as to their own application, supervisory, and examination staff. Questions regarding the attached guidance should be addressed to Joanne Wakim, Senior Accounting Policy Analyst, Accounting Policy and Disclosure, at (202) 912-4302; Laurie F. Priest, Manager, Accounting Policy and Disclosure, at (202) 452-2750; or Steven P. Merriett, Assistant Director and Chief Accountant, at (202) 452-2531. In addition, questions may be sent via the Board's public website.¹

Michael S. Gibson
Director

Attachment:

- [*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*](#)

Cross references to:

- [SR letter 06-17](#), "Interagency Policy Statement on the Allowance for Loan and Lease Losses"
- [SR letter 05-11](#), "Interagency Credit Risk Management Guidance for Home Equity Lending"
- [SR letter 00-8](#), "Revised Uniform Retail Credit Classification and Account Management Policy"

¹ See <http://www.federalreserve.gov/apps/contactus/feedback.aspx>.