Position Paper

Environmental Factor (EF)
As to the calculation of the Environmental Factor the most recent OCC Policy Statement includes the following citations and directives regarding the EF.

"While historical loss experience provides a reasonable starting point for the institution's analysis, historical losses, or even recent trends in losses, do not by themselves form a sufficient basis to determine the appropriate level for the ALLL."

"When estimating credit losses on each group of loans with similar risk characteristics, an institution should consider its historical loss experience on the group*, adjusted for changes in trends, conditions, and other relevant factors* that affect repayment of the loans as of the evaluation date."

"Credit loss and recovery experience may vary significantly *depending upon the stage of the business cycle*. For example, an over reliance on credit loss experience during a period of economic growth will not result in realistic estimates of credit losses during a period of economic downturn."

"After determining the appropriate historical loss rate for each group of loans with similar risk characteristics, management should consider those *current 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

"For example, if **declining credit quality trends** relevant to the types of loans in an institution's portfolio are evident, the ALLL level as a percentage of the 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 portfolio should generally **decrease.**"

The primary purpose of the EF is to adjust the allowance calculation for the Homogeneous Pools, to accommodate changes in the current climate in which the credit union is operating.

To accomplish this goal a statistically based model has been created that takes into account the most significant predictors of changes in risk. Using a combination of statistical test, most notably, multiple regression and MANOVA the predictors were identified and the impact on homogeneous pool allowance was quantified.

The variables are:
- Net credit change (measured by credit migration);
- Delinquency;
- Local foreclosure rates;
- Unemployment rates; and
- Local bankruptcy rates (last 3 are combined in a Economic Stress Score).

The three variable in the EF are measured independently to increase precision of the measurement. Scores for each variable are summed to arrive at the EF percentage.

These three variables give the credit union two internal measures and three external measures which improves the validity of the measurement.