

7535-01-U

NATIONAL CREDIT UNION ADMINISTRATION

Allowance For Loan and Lease Losses Methodologies and Documentation for Federally-Insured Credit Unions

AGENCY: National Credit Union Administration

ACTION: Notice of Final Interpretive Ruling and Policy Statement (IRPS) 02-3.

SUMMARY: The National Credit Union Administration (NCUA) is adopting an Interpretive Ruling and Policy Statement on *Allowance for Loan and Lease Losses (ALLL) Methodologies and Documentation for Federally-Insured Credit Unions* (the IRPS). The federal banking agencies recently issued a final policy statement intended to clarify the banking agencies' expectations regarding methodologies and documentation support for the ALLL. The Securities and Exchange Commission (SEC) issued parallel guidance in a Staff Bulletin. Likewise, it is necessary for the NCUA to issue analogous guidelines for federally-insured credit unions in order to clarify the NCUA's expectations regarding methodologies and documentation support for the ALLL. This IRPS is intended to provide the necessary parallel guidance for federally-insured credit unions.

The IRPS provides guidance on the design and implementation of ALLL methodologies and supporting documentation practices. The guidance recognizes that credit unions should adopt methodologies and documentation practices that are appropriate for their size and complexity.

DATES: The IRPS is effective upon issuance.

FOR FURTHER INFORMATION CONTACT: Karen Kelbly, Program Officer, Office of Examination and Insurance, at the above address or telephone (703) 518-6389.

SUPPLEMENTARY INFORMATION:

I. Keypoints

- Credit union management is responsible for establishing an appropriate ALLL and documenting their methodology.
- Credit union methodologies should conform to generally accepted accounting principles (GAAP).
- Credit unions with lending portfolios comprised of homogeneous pools of consumer loans (such as credit card and automobile loans) and mortgage loans will find methodology and documentation requirements discussed herein to be less burdensome than those for credit unions with lending portfolios comprised of larger-balance, non-homogeneous loans. Simply put, credit unions must review all loans (by groups, as appropriate) for relevant internal and external factors,

loss history, collateral values, and methods to ensure they are applied consistently when estimating probable existing losses but, when appropriate, modify loss estimates for new factors affecting collectibility.

- The Statement of Financial Accounting Standard (FAS) 5 discussions throughout this document will be most relevant to the majority of credit unions.
- Independent review of management's methodology and documentation practices by the supervisory committee, internal or external auditors is emphasized.
- Illustrations are provided that may be useful to a credit union in enhancing their own ALLL estimation methodology and documentation practices.

II. Background

On March 10, 1999, the Federal Deposit Insurance Corporation, the Federal Reserve Board, the Office of the Comptroller of the Currency, the Office of Thrift Supervision, and the Securities and Exchange Commission (the Agencies) issued a joint letter to financial institutions on the allowance for loan and lease losses (the Joint Letter). In the Joint Letter, the Agencies agreed to establish a Joint Working Group to study ALLL issues and to assist financial institutions by providing them with improved guidance on this topic. The Agencies agreed that the Joint Working Group would develop and issue parallel guidance for two key areas regarding the ALLL:

- Appropriate methodologies and supporting documentation, and
- Enhanced disclosures.

As a result, the banking agencies issued a final Policy Statement providing guidance to banks and savings institutions relating to methodologies and supporting documentation for the ALLL. The Securities and Exchange Commission staff has issued parallel guidance on this topic for public companies in Staff Accounting Bulletin No. 102.¹ This IRPS is intended to provide parallel guidance for federally-insured credit unions.

This IRPS clarifies the NCUA's expectations regarding methodologies and documentation support for the ALLL. For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with generally accepted accounting principles (GAAP). GAAP requires that a credit union maintain written documentation to support the amounts of the ALLL and the provision for loan and lease losses reported in the financial statements.

The IRPS does not change existing accounting guidance in, or modify the documentation requirements of, GAAP. It is intended to supplement, not replace, current guidance. The IRPS does not address or change current guidance regarding loan charge-offs; therefore, credit unions should continue to follow existing regulatory guidance that addresses the timing of charge-offs.

¹ In addition, the American Institute of Certified Public Accountants (AICPA) is developing guidance on the accounting for loan losses and the techniques for measuring probable incurred losses in a loan portfolio.

The guidance in this IRPS recognizes that credit unions should adopt methodologies and documentation practices that are appropriate for their size and complexity. For credit unions with fewer and less complex loan products, the amount of supporting documentation for the ALLL may be less exhaustive than for credit unions with more complex loan products or portfolios.

Recognizing that a primary mission of the NCUA is to support a safe and sound credit union system, examiners will continue to evaluate the overall adequacy of the ALLL, including the adequacy of supporting documentation, to ensure that it is appropriate. While the IRPS generally does not provide guidance to examiners in conducting safety and soundness examinations, examiners may take exception to credit union practices that fail to document and maintain an adequate ALLL in accordance with this IRPS, and other NCUA guidance. In such cases, credit union management may be cited for engaging in unsafe and unsound practices and may be subject to further supervisory action.

III. The Proposed IRPS

The NCUA sought public comment on a proposed IRPS on ALLL methodologies and documentation practices for credit unions on October 26, 2001 (66 FR 54290). The proposal indicated that the purpose of the policy statement was to provide federally-insured credit unions with enhanced guidance on appropriate ALLL methodologies and documentation practices.

The proposed IRPS explained that the board of directors of each federally-insured credit union is responsible for ensuring that controls are in place to determine the appropriate level of the ALLL. It also emphasized the NCUA's long-standing position that credit unions should maintain and support the ALLL with documentation that is consistent with their stated policies and procedures, GAAP, and applicable supervisory guidance.

The proposed IRPS described significant aspects of ALLL methodologies and documentation practices. Specifically, the proposal provided guidance on maintaining and documenting policies and procedures that are appropriately tailored to the size and complexity of the credit union and its loan portfolio. The proposed IRPS stated that a credit union's ALLL methodology must be a thorough, disciplined, and consistently applied process that incorporates management's current judgments about the credit quality of the loan portfolio.

The proposal also discussed the methodology and documentation needed to support ALLL estimates prepared in accordance with GAAP, which requires loss estimates based upon reviews of individual loans and groups of loans. The proposal stated that after determining the allowance on individually reviewed loans and groups of loans, management should consolidate those loss estimates and summarize the amount to be reported in the financial statements for the ALLL. To verify that the ALLL methodology is effective and conforms to GAAP and supervisory guidance, the supervisory

committee, the internal or external auditors or some other designated party who is independent from the ALLL estimation process should review the methodology and its application in a manner appropriate to the size and complexity of the credit union.

The proposal included illustrations of implementation practices that credit unions may find useful for enhancing their own ALLL practices; a summary of applicable GAAP guidance; an appendix that provided examples of certain key aspects of ALLL guidance; and a bibliographical list of relevant GAAP guidance, joint interagency statements, and other literature on ALLL issues.

IV. Discussion of Public Comments

A. General Comments

The NCUA received thirteen letters commenting on the proposed IRPS. Five of the letters were received from credit unions; four were received from credit union league groups; two letters were from credit union trade groups; one letter was from another credit union group; and one letter came from a banking trade group.

Overall, eight of the thirteen commenters supported the IRPS: three favoring the IRPS and welcoming the guidance and policy clarification; five others supporting the IRPS but expressing cautious approval. One of the eight summarized the flavor of the comments well in pointing out that the IRPS was an enhancement to current guidelines; provided a given framework without endorsing a fixed formula; and provided valuable discussion points on generally accepted accounting principles (GAAP). Another of the eight welcomed the IRPS guidance as offering areas of policy clarification. One commenter welcomed the IRPS guidance arguing that a new process is needed to replace the outdated historical loss approach. Other favorable comments included approval of the useful appendix illustrations; appreciation for the discussion points on FAS 5 and FAS 114 as particularly helpful; and acknowledgement that the policy recognized that credit unions with homogeneous pools of consumer loans should have a lesser burden. A banking trade group supported the effort and encouraged the NCUA to issue identical guidance to credit unions as the other regulators issue for banks.

One commenter was unclear in setting forth his position as either favoring or opposing the IRPS. Another commenter expressed the view that current practices within its credit union satisfied the major points in the IRPS. He understood that the guidance did not attempt to expand current GAAP requirements and allowed credit unions to continue to use judgment in implementing loan loss estimation methodologies that are appropriate to individual credit unions.

The NCUA believes that credit unions currently complying with GAAP should not need to dedicate additional resources to create or support the ALLL included in their regulatory reports. The NCUA has expected credit unions to follow GAAP, as it applies to the ALLL, for regulatory reporting purposes for a number of years. The IRPS is consistent with existing GAAP, which requires that allowances be well documented, with clear explanations of the supporting analysis and rationale. The NCUA encourages

credit unions to carefully evaluate their current ALLL methodologies and supporting documentation practices as well as other credit risk management practices and reports before making significant changes to their current practices or creating new processes, reports, or other supporting documents in order to follow this guidance.

Two of the thirteen commenters opposed the change outright both arguing it would impose a regulatory burden without a corresponding benefit. One of these categorized the IRPS as an extensive policy change and the other objected to the documentation requirements. These comments are discussed more fully below in the section dealing with “IRPS Burden on Small Credit Unions”.

The remaining commenter expressed caution and anticipated overly-zealous agency enforcement of the IRPS, fearing that the examiners would likely challenge the ALLL result even when the methodology had been validated by a third party. The NCUA plans several initiatives to update examiner directives and train examiners in the less familiar aspects of the IRPS. The Board does not anticipate an unreasonable enforcement of the IRPS with regard to affected credit unions.

B. Board Approval Requirement

The proposed IRPS required that amounts to be reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. The NCUA did not intend through this language to expand the board of directors responsibilities beyond those that currently exist.

Two commenters that favored the IRPS proposal and one that opposed it objected to the referenced language. One of these three stated that it was inappropriate to require the board of directors by regulatory ruling to provide such approvals. Another suggested it was unwise to add responsibilities on credit union boards of directors at a time when attracting qualified volunteers was becoming increasingly difficult. Each argued that boards should have oversight over the methodology used, periodically validating the methodology and ensuring it was revised when appropriate; but, otherwise, not be required to provide approvals.

At present, boards of directors are responsible for approving ALLL policies and attesting to the validity of the regulatory reports, which includes the ALLL. While the board of directors has ultimate responsibility for these functions, daily administration of policies and recordkeeping may be delegated to operating management. The IRPS includes the statement that the scope of board of directors’ responsibilities is not changed or expanded with the issuance of this Policy Statement.

C. Independent Review Of ALLL

The proposed IRPS required that credit union policies governing the ALLL methodology should include procedures for a review, by a party who is independent of the ALLL

estimation process, of the ALLL methodology and its application in order to confirm its effectiveness. Further, the supervisory or audit committee should oversee and monitor the internal controls over the ALLL determination process.

Three commenters request modifications to the IRPS language. One opposed this provision outright arguing that an independent review carries little or no weight at the examiner level. One argued that since the supervisory committee could delegate these functions to the internal or external auditor, the IRPS should acknowledge that fact. The third stated it was inappropriate and unnecessary to require, by regulatory ruling, that the oversight and monitoring of the internal controls over the ALLL determination process is a specific responsibility of the supervisory committee.

The NCUA did not intend through this language to expand the supervisory committee's responsibilities beyond those that currently exist. The supervisory committee's responsibilities with regard to oversight and monitoring of the internal controls over the ALLL determination process are already encompassed within its general responsibilities set forth in § 715.3 of the NCUA Rules and Regulations. The IRPS simply highlights and reinforces the supervisory committee's role (which may be delegated to the internal or external auditor) with regard to the ALLL estimation process and specifically, its role in the independent review of management's implementation of the board's policies with regard to the process. The Board believes the IRPS guidance would be deficient if it failed to mention and reinforce this role.

D. IRPS Burden On Small Credit Unions

The IRPS provided in several places that credit unions currently complying with GAAP should not need to dedicate additional resources to create or support the ALLL included in regulatory reports. Essentially, those credit unions currently following GAAP should not be greatly affected by the IRPS nor find their current practices in need of substantial change.

One commenter acknowledged that the current practices within his credit union satisfy the major points in the IRPS. However, two other commenters did not agree: one of these, opposed to the IRPS generally, argued that the additional regulatory burden it will impose is without a corresponding benefit. The other commenter objected that the IRPS imposes a needless burden to credit unions; that the ALLL within credit unions is not systemically deficient; and that they support a simpler rule without adding new burden to credit union management and board members. Further, this commenter opposed a particular methodology.

The IRPS provides throughout that if a credit union is currently complying with GAAP in its ALLL estimation practices and methodology, the IRPS will not substantially change current practice. The guidance in the IRPS includes a broad description of the steps taken during the ALLL estimation process that must be documented. The types of documentation described in the examples illustrate that management has considerable

flexibility in determining the appropriate level and type of supporting documentation given the type of loans and associated credit risks being evaluated. Additionally, the guidance specifically states that credit unions with less complex products or portfolios may consider combining some of the procedures outlined in the proposed guidance. Furthermore, when appropriate, these credit unions may use documentation that is already being generated for other purposes to support their ALLLs. The NCUA believes these suggestions will assist these credit unions in supporting their ALLLs without any unnecessary burden.

E. Statement Of Financial Accounting Standard (FAS) 5

The proposed IRPS included a discussion of relevant GAAP particularly FAS 5 and FAS 114, and provides illustrations of how the two standards work in tandem.

One commenter suggested that small credit unions should not have to apply either FAS 5 or FAS 114, but that NCUA should develop a simplistic methodology for their use. FAS 5 and FAS 114 comprise GAAP and all credit unions must comply with GAAP in their ALLL estimation process: credit unions under \$10 million in assets must comply with GAAP in their ALLL estimation process in order to meet full and fair disclosure requirements of the NCUA Rules and Regulations; in addition, credit unions with \$10 million or more in assets must comply with GAAP under requirements of the Federal Credit Union Act as amended by the Credit Union Membership Access Act. However, the IRPS does concede a lesser methodology and documentation burden for less complex credit unions.

Another commenter, generally favoring the IRPS, acknowledged that the IRPS approach is technically accurate but argued that it does not protect the National Credit Union Share Insurance Fund (NCUSIF) by building a cushion in good times to cover losses in bad times. The commenter is correct. The GAAP rules, aimed at fair presentation of financial statements, are predicated on an “incurred loss” accounting model for estimating loan losses rather than an “expected loss” model; the latter model is arguably more favorable in cushioning against future losses. Nonetheless, the entire ALLL must be determined in accordance with GAAP and supported with adequate documentation. Credit unions are already required to follow GAAP (incurred loss model) when determining the ALLL and the guidance does not change existing GAAP; therefore, following this IRPS should not result in material adjustments to the ALLL by credit unions currently following GAAP.

A third commenter addressed the requirement that homogeneous pools be segmented based on predominant risk characteristics. The commenter expressed concern about the examiners interpretation of this provision and strongly advocated for additional examiner guidance. This commenter also suggested the final IRPS omit the paragraph dealing with loss estimation models. The NCUA agrees that examiner guidance will be needed and will be following the issuance of this IRPS with Examiner Guide revisions and examiner education to ensure the smooth implementation of this policy. The Board

considered the elimination of the loss estimation models paragraph but determined there was merit to segments of the credit union population in retaining the paragraph.

A final commenter wanted the NCUA to emphasize that obtaining an appropriate ALLL that correctly recognizes risk is more important than the minute details of the methodology. The NCUA agrees but acknowledges that a sound methodology ensures an appropriate ALLL. This commenter also wants NCUA to recognize in the guidance that many credit unions are already abiding by these practices. The NCUA agrees this statement is true and believes the guidance recognizes this fact.

F. Statement Of Financial Accounting Standard (FAS) 114

The proposed IRPS discussed GAAP generally and FAS 114 specifically. FAS 114 deals with individual classification of large-balance, non-homogeneous loans which for credit unions will predominantly consist of business and agricultural loans.

One commenter suggested that rarely will a credit union have such a loan, and if they do, it is unlikely they will have the means to analyze and calculate the present value of future cash flows. He believes FAS 114 is intended to provide job security to CPAs. This commenter further suggested that the vast majority of credit unions will have loans within the scope of FAS 5, i.e., smaller balance, homogeneous pools of consumer loans. He encouraged parameters defining “larger balance” for each of consumer loans and commercial loans. The NCUA agrees that the vast majority of credit unions will have loans within the scope of FAS 5 and that it will be only the most complex credit unions that may have a large balance business loan within the scope of FAS 114 requiring individual classification. Nonetheless, the NCUA resists setting parameters defining “larger balance” as to do so would eliminate the intended discretion the Financial Accounting Standards Board (FASB) preserved in promulgating FAS 114. The IRPS includes illustrations to help guide a credit union’s judgment as it implements the guidance.

In the Q&A Appendix to the IRPS, question #2 discusses “a \$750,000 loan outstanding that is secured by real estate, which Credit Union B individually evaluates under FAS 114 due to the loan’s size (emphasis added).” The example was originally published by the banking agencies as collateralized at \$10 million. When drafting the proposed IRPS, NCUA staff reduced the dollar threshold from the \$10 million level to make the example more realistic in relation to a credit union. Clearly only large balance, non-homogeneous loans are scoped within FAS 114, and since rarely would a credit union have a large balance, real estate-secured loan within the scope of FAS 114 unless it were a business loan, staff have concluded that the collateral value reduction included when drafting the proposed rule has proved misleading to readers of the IRPS in a proper interpretation of FAS 114. Accordingly, the dollar threshold for real estate collateral in the Q&A example for purposes of applying FAS 114 has been raised to the \$10 million threshold consistent with the banking agencies similar policy statement.

G. Miscellaneous

The proposed IRPS mentioned that the American Institute of Certified Public Accountants (AICPA) is drafting and intends to issue a Statement of Position setting forth further GAAP with regard to the ALLL. Two commenters suggest the NCUA wait to issue its final IRPS until the AICPA issues its final SOP. Because the IRPS provides beneficial clarifying guidance within existing GAAP, and since the SOP document has yet to be advanced through the accounting standard-setting due process, NCUA chooses to proceed with issuing this IRPS. The AICPA continues to develop its guidance, and the NCUA along with the banking agencies are closely monitoring and actively contributing to that process.

One commenter objected to footnote language that seemed to obligate all insured credit unions to have a supervisory or audit committee. They argued the footnote language is inconsistent with the construction of Title II of the Federal Credit Union Act and applicable parts of the NCUA Rules and Regulations. Because of differing state requirements and the fact that some state credit unions have audit committees rather than supervisory committees, the footnote has been amended to provide that while federal credit unions are required to establish a supervisory committee; and while state chartered credit unions are encouraged to have either a supervisory or audit committee, in credit unions without either a supervisory or an audit committee, the board of directors retains this responsibility. The revised footnote more closely parallels a similar footnote included in the banking agencies' related final interagency policy statement.

One commenter noted that, for purposes of the Regulatory Flexibility Act (RFA), the Board considers credit unions under \$1 million in assets to be small credit unions. The commenter suggested that the Board use a threshold of \$10 million instead of \$1 million. In suggesting that the threshold be raised, they argue that credit unions under \$10 million do not need to comply with GAAP in funding the ALLL. NCUA regulations mandate, however, that credit unions under \$1 million be considered as small for purposes of the RFA. See 12 CFR 791.8(a) and Interpretive Ruling and Policy Statement 87-2. Additionally, all credit unions regardless of asset size must comply with GAAP in funding the allowance as discussed above in the section dealing with FAS 5.

V. Regulatory Procedures

Regulatory Flexibility Act

The Regulatory Flexibility Act requires that NCUA prepare an analysis describing any significant economic impact agency rulemaking may have on a substantial number of small credit unions. 5 U.S.C. §601 et seq. For purposes of this analysis, NCUA considers credit unions under \$ 1 million in assets as small credit unions.

Credit unions over \$10 million in assets must follow GAAP in the call reports they file with the NCUA Board. All other credit unions must comply with GAAP in relation to the ALLL in order to meet regulatory requirements of full and fair disclosure. This IRPS describes simplified ALLL requirements for the less complex loan activities that small credit unions engage in. For example, small credit unions may satisfy their ALLL responsibilities with consolidated documentation, the use of standardized checklists and worksheets, and simplified loan categorizations and segmentation. Accordingly, the NCUA has determined and certifies that this IRPS will not have a significant economic impact on a substantial number of small credit unions beyond what is already required of them.

Paperwork Reduction Act

NCUA has determined that this IRPS does not increase paperwork requirements under the Paperwork Reduction Act of 1995 (44 U.S.C. chapter 35) and regulations of the Office of Management and Budget.

Executive Order 13132

Executive Order 13132 encourages independent regulatory agencies to consider the impact of their regulatory actions on state and local interests. In adherence to fundamental federalism principles, NCUA, an independent regulatory agency as defined in 44 U.S.C. 3502(5), voluntarily complies with the executive order.

This IRPS applies to all credit unions, but does not have substantial direct effect on the states, on the relationship between the national government and the states, or on the distribution of power and responsibilities among the various levels of government. NCUA has determined that this IRPS does not constitute a policy that has federalism implications for purposes of the executive order.

By the National Credit Union Administration Board, on May 16, 2002.

Becky Baker

Secretary of the Board

Authority: 12 U.S.C. 1782a; 12 CFR 702.402.

IRPS 02-3 is as follows:

Interpretive Ruling and Policy Statement No. 02-3

ALLOWANCE FOR LOAN AND LEASE LOSSES METHODOLOGIES AND DOCUMENTATION FOR FEDERALLY-INSURED CREDIT UNIONS (IRPS 02-3)

Boards of directors of federally-insured credit unions are responsible for ensuring that their credit unions have controls in place to consistently determine the allowance for loan and lease losses (ALLL) in accordance with the credit union's stated policies and procedures, generally accepted accounting principles (GAAP), and ALLL supervisory guidance.¹ To fulfill this responsibility, boards of directors instruct management to develop and maintain an appropriate, systematic, and consistently applied process to determine the amounts of the ALLL and provisions for loan losses. Management should create and implement suitable policies and procedures to communicate the ALLL process internally to all applicable personnel. Regardless of who develops and implements these policies, procedures, and the underlying controls, the board of directors should assure themselves that the policies specifically address the credit union's unique goals, systems, risk profile, personnel, and other resources before approving them. Additionally, by creating an environment that encourages personnel to follow these policies and procedures, management improves procedural discipline and compliance.

The determination of the amounts of the ALLL and provisions for loan and lease losses should be based on management's current judgments about the credit quality of the loan portfolio, and should consider all known relevant internal and external factors that affect loan collectibility as of the reporting date. The amounts to be reported each period for the provision for loan and lease losses and the ALLL should be reviewed and approved by the board of directors. To ensure the methodology remains appropriate for the credit union, the board of directors should have the methodology periodically validated and, if appropriate, revised. Further, the supervisory or audit committee² should oversee and monitor the internal controls over the ALLL determination process.³

¹ A bibliography is attached that lists applicable ALLL GAAP guidance, interagency policy statements, and other reference materials that may assist in understanding and implementing an ALLL in accordance with GAAP. See "Application of GAAP" section for additional information on applying GAAP to determine the ALLL.

² All federal credit unions must establish a supervisory committee. If a federally insured state chartered credit union does not have either a supervisory or audit committee, the board of directors retains this responsibility.

³ Credit union supervisory or audit committees and their auditors should refer to Statement on Auditing Standards No. 61, *Communication With Audit Committees* (as amended by Statement on Auditing Standards No. 90, *Audit Committee Communications*), which requires certain discussions between the auditor and the audit committee. These discussions should include items, such as accounting policies and estimates, judgments, and uncertainties, that have a significant impact on the accounting information included in the financial statements.

The NCUA has a long-standing examination policy that calls for examiners to review a credit union's lending and loan review functions and recommend improvements, if needed. Agency guidance assists a credit union in estimating and establishing a sufficient ALLL supported by adequate documentation. Additionally, guidance requires operational and managerial standards that are appropriate for a credit union's size and the nature and scope of its activities.

For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with GAAP. GAAP requires that allowances be well documented, with clear explanations of the supporting analyses and rationale.⁴ This IRPS describes but does not increase the documentation requirements already existing within GAAP. Failure to maintain, analyze, or support an adequate ALLL in accordance with GAAP and supervisory guidance is generally an unsafe and unsound credit union practice.⁵

This guidance applies equally to all credit unions, regardless of the size. However, credit unions with less complex lending activities and products may find it more efficient to combine a number of procedures (e.g., information gathering, documentation, and internal approval processes) while continuing to ensure the credit union has a consistent and appropriate methodology. Thus, much of the supporting documentation required for a credit union with more complex products or portfolios may be combined into fewer supporting documents in a credit union with less complex products or portfolios. For example, simplified documentation can include spreadsheets, check lists, and other summary documents that many credit unions currently use. Illustrations B and D provide specific examples of how less complex credit unions may determine and document portions of their ALLL.

Documentation Standards

Appropriate written supporting documentation facilitates review of the ALLL process and reported amounts, builds discipline and consistency into the ALLL determination process, and improves the process for estimating loan and lease losses by helping to ensure that all relevant factors are appropriately considered in the ALLL analysis. A credit union should document the relationship between

⁴ The documentation guidance within this IRPS is predominantly based upon the GAAP guidance from Financial Accounting Standards Board Statement Numbers 5 and 114 (FAS 5 and FAS 114, respectively); Emerging Issues Task Force Topic No. D-80 (EITF Topic D-80 and attachments), *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (which includes the *Viewpoints* Article – an article issued in 1999 by FASB staff providing guidance on certain issues regarding the ALLL, particularly on the application of FAS 5 and FAS 114 and how these statements interrelate); and Chapter 6 – *Allowance for Loan Losses*, the American Institute of Certified Public Accountants' (AICPA) Audit and Accounting Guide, *Audits of Credit Unions* 2000 edition (AICPA Audit Guide).

⁵ Failure to maintain adequate supporting documentation does not relieve a credit union of its obligation to record an appropriate ALLL.

the findings of its detailed review of the loan portfolio and the amount of the ALLL and the provision for loan and lease losses reported in each period.

At a minimum, credit unions should maintain written supporting documentation for the following decisions, strategies, and processes:

1. Policies and procedures:
 - a. Over the systems and controls that maintain an appropriate ALLL, and
 - b. Over the ALLL methodology,
2. Loan grading system or process,
3. Summary or consolidation of the ALLL balance,
4. Validation of the ALLL methodology, and
5. Periodic adjustments to the ALLL process.

The following sections of this IRPS provide guidance on significant aspects of ALLL methodologies and documentation practices. Specifically, this IRPS provides documentation guidance on:

1. Application of GAAP,
2. Policies and Procedures,
3. Methodology,
4. ALLL Under FASB Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114),
5. ALLL Under FASB Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5),
6. Consolidating the Loss Estimates, and
7. Validating the ALLL Methodology.

APPLICATION OF GAAP

An ALLL recorded pursuant to GAAP is a credit union's best estimate of the probable amount of loans and lease-financing receivables that it will be unable to collect based on current information and events.⁶ A creditor should record an ALLL when the criteria for accrual of a loss contingency as set forth in GAAP have been met. Estimating the amount of an ALLL involves a high degree of management judgment and is inevitably imprecise. Accordingly, a credit union

⁶ This section provides guidance on the ALLL and does not address allowances for credit losses for off-balance sheet instruments (e.g., loan commitments, guarantees, and standby letters of credit). Credit unions should record liabilities for these exposures in accordance with GAAP. Further guidance on this topic is presented in the American Institute of Certified Public Accountants' Audit and Accounting Guide, *Audits of Credit Unions*, 2000 edition (AICPA Audit Guide). Additionally, this section does not address allowances or accounting for assets or portions of assets sold with recourse, which is described in Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Servicing of Financial Assets and Extinguishments of Liabilities - a Replacement of FASB Statement No. 125* (FAS 140).

may determine that the amount of loss falls within a range. A credit union should record its best estimate within the range of loan losses.⁷

Under GAAP, Statement of Financial Accounting Standards No. 5, *Accounting for Contingencies* (FAS 5), provides the basic guidance for recognition of a loss contingency, such as the collectibility of loans (receivables), when it is probable that a loss has been incurred and the amount can be reasonably estimated. Statement of Financial Accounting Standards No. 114, *Accounting by Creditors for Impairment of a Loan* (FAS 114) provides more specific guidance about the measurement and disclosure of impairment for certain types of loans.⁸ Specifically, FAS 114 applies to loans that are identified for evaluation on an individual basis. Loans are considered impaired when, based on current information and events, it is probable that the creditor will be unable to collect all interest and principal payments due according to the contractual terms of the loan agreement.

For individually impaired loans, FAS 114 provides guidance on the acceptable methods to measure impairment. Specifically, FAS 114 states that when a loan is impaired, a creditor should measure impairment based on the present value of expected future principal and interest cash flows discounted at the loan's effective interest rate, except that as a practical expedient, a creditor may measure impairment based on a loan's observable market price or the fair value of collateral, if the loan is collateral dependent. When developing the estimate of expected future cash flows for a loan, a credit union should consider all available information reflecting past events and current conditions, including the effect of existing environmental factors. The Illustration A provides an example of a credit union estimating a loan's impairment when the loan has been partially charged-off.⁹

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are *not* included in the scope of FAS 114.¹⁰ Such groups of loans may include, but are not limited to, credit card, residential mortgage, and consumer installment loans. FAS 5 addresses the accounting for impairment of these loans. Also, FAS 5 provides the accounting guidance for impairment of loans that are not identified for evaluation on an individual basis

⁷ Refer to FASB Interpretation No. 14, *Reasonable Estimation of the Amount of a Loss*, and Emerging Issues Task Force Topic No. D-80, *Application of FASB Statements No. 5 and No. 114 to a Loan Portfolio* (EITF Topic D-80).

⁸ Emerging Issues Taskforce (EITF) Topic D-80 includes additional guidance on the requirements of FAS 5 and FAS 114 and how they relate to each other. The AICPA is currently developing a Statement of Position (SOP) that will provide more specific guidance on accounting for loan losses.

⁹ The referenced "gray box" illustrations are presented to assist credit unions in evaluating how to implement the guidance provided in this document. The methods described in the illustrations may not be suitable for all credit unions and are not considered required processes or actions. For additional descriptions of key aspects of ALLL guidance, a series of ALLL Questions and Answers (Q&As) are included in Appendix A of this paper.

¹⁰ In addition, FAS 114 does not apply to loans measured at fair value or at the lower of cost or fair value, leases, or debt securities.

ILLUSTRATION A

INTERACTION OF FAS 114 WITH AN ADVERSELY CLASSIFIED LOAN, PARTIAL CHARGE-OFF, AND THE OVERALL ALLL

A credit union determined that a collateral dependent loan, which it identified for evaluation, was impaired. In accordance with FAS 114, the credit union established an ALLL for the amount that the recorded investment in the loan exceeded the fair value of the underlying collateral, less costs to sell.

Consistent with relevant regulatory guidance, the credit union classified as “Loss,” the portion of the recorded investment deemed to be the confirmed loss, and classified the remaining recorded investment as “Substandard.” For this loan, the amount classified “Loss” was less than the impairment amount (as determined under FAS 114). The credit union charged off the “Loss” portion of the loan. After the charge-off, the portion of the ALLL related to this “Substandard” loan (1) reflects an appropriate measure of impairment under FAS 114, and (2) is included in the aggregate FAS 114 ALLL for all loans that were identified for evaluation and individually considered impaired. The aggregate FAS 114 ALLL is included in the credit union’s overall ALLL.

and loans that are individually evaluated but are not individually considered impaired.

Credit unions should ensure that they do not layer their loan loss allowances. Layering is the inappropriate practice of recording in the ALLL more than one amount for the same probable loan loss. Layering can happen when a credit union includes a loan in one segment, determines its best estimate of loss for that loan either individually or on a group basis (after taking into account all appropriate environmental factors, conditions, and events), and then includes the loan in another group, which receives an additional ALLL amount.¹¹

While different credit unions may use different methods, there are certain common elements that should be included in any loan loss allowance methodology. Generally, a credit union’s methodology should:¹²

1. Include a detailed analysis of the loan portfolio, performed on a regular basis;
2. Consider all loans (whether on an individual or group basis);
3. Identify loans to be evaluated for impairment on an individual basis under FAS 114 and segment the remainder of the portfolio into groups of loans with similar risk characteristics for evaluation and analysis under FAS 5;

¹¹ According to the Federal Financial Institutions Examination Council’s Federal Register Notice, *Implementation Issues Arising from FASB Statement No. 114, Accounting by Creditors for Impairment of a Loan*, published February 10, 1995, institution-specific issues should be reviewed when estimating loan losses under FAS 114. This analysis should be conducted as part of the evaluation of each individual loan reviewed under FAS 114 to avoid potential ALLL layering.

¹² Refer to paragraph 6.04-6.10 of the AICPA Audit Guide.

4. Consider all known relevant internal and external factors that may affect loan collectibility;
5. Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;
6. Consider the particular risks inherent in different kinds of lending;
7. Consider current collateral values (less costs to sell), where applicable;
8. Require that analyses, estimates, reviews and other ALLL methodology functions be performed by competent and well-trained personnel;
9. Be based on current and reliable data;
10. Be well documented with clear explanations of the supporting analyses and rationale; and
11. Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

A systematic methodology that is properly designed and implemented should result in a credit union's best estimate of the ALLL. Accordingly, credit unions should adjust their ALLL balance, either upward or downward, in each period for differences between the results of the systematic determination process and the unadjusted ALLL balance in the general ledger.¹³

POLICIES AND PROCEDURES

Credit unions use a wide range of policies, procedures, and control systems in their ALLL process. Sound policies should be appropriately tailored to the size and complexity of the credit union and its loan portfolio.

In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures for the systems and controls that maintain an appropriate ALLL should address but not be limited to:

- (1) The roles and responsibilities of the credit union's departments and personnel (including the lending function, credit review, financial reporting, internal audit, senior management, audit committee, board of directors, and others, as applicable) who determine, or review, as applicable, the ALLL to be reported in the financial statements;
- (2) The credit union's accounting policies for loans and loan losses, including the policies for charge-offs and recoveries and for estimating the fair value of collateral, where applicable;

¹³ For informational purposes, credit unions may want to refer to the guidance on materiality provided in SEC Staff Accounting Bulletin No. 99, *Materiality*.

(3) The description of the credit union's systematic methodology, which should be consistent with the credit union's accounting policies for determining its ALLL;¹⁴ and

(4) The system of internal controls used to ensure that the ALLL process is maintained in accordance with GAAP and supervisory guidance.

An internal control system for the ALLL estimation process should:

(1) Include measures to ensure the reliability and integrity of information and compliance with laws, regulations, and internal policies and procedures;

(2) Reasonably ensure that the credit union's financial statements (including regulatory reports) are prepared in accordance with GAAP and ALLL supervisory guidance; and

(3) Include a well-defined loan review process containing:

(a) An effective loan grading system that is consistently applied, identifies differing risk characteristics and loan quality problems accurately and in a timely manner, and prompts appropriate administrative actions;

(b) Sufficient internal controls to ensure that all relevant loan review information is appropriately considered in estimating losses. This includes maintaining appropriate reports, details of reviews performed, and identification of personnel involved; and

(c) Clear formal communication and coordination between a credit union's credit administration function, financial reporting group, management, board of directors, and others who are involved in the ALLL determination process or review process, as applicable (e.g., written policies and procedures, management reports, audit programs, and committee minutes).

METHODOLOGY

An ALLL methodology is a system that a credit union designs and implements to reasonably estimate loan and lease losses as of the financial statement date. It is critical that ALLL methodologies incorporate management's current judgments about the credit quality of the loan portfolio through a disciplined and consistently applied process.

A credit union's ALLL methodology is influenced by credit union-specific factors, such as a credit union's size, organizational structure, business environment and strategy, management style, loan portfolio characteristics, loan administration procedures, and management information systems. However, there are certain common elements a credit union should incorporate in its ALLL methodology. A summary of common elements was provided in *Application of GAAP* section of this IRPS.¹⁵

¹⁴ Further explanation is presented in the Methodology section that appears below.

¹⁵ Also, refer to paragraph 6.04-6.10 of the AICPA Audit Guide, 2000 edition.

Documentation of ALLL Methodology in Written Policies and Procedures

A credit union's written policies and procedures should describe the primary elements of the credit union's ALLL methodology, including portfolio segmentation and impairment measurement. In order for a credit union's ALLL methodology to be effective, the credit union's written policies and procedures should describe the methodology:

(1) For segmenting the portfolio:

- (a) How the segmentation process is performed (i.e., by loan type, industry, risk rates, etc.),
- (b) When a loan grading system is used to segment the portfolio:
 - (i) The definitions of each loan grade,
 - (ii) A reconciliation of the internal loan grades to supervisory loan grades, and
 - (iii) The delineation of responsibilities for the loan grading system.

(2) For determining and measuring impairment under FAS 114:

- (a) The methods used to identify loans to be analyzed individually;
- (b) For individually reviewed loans that are impaired, how the amount of any impairment is determined and measured, including:
 - (i) Procedures describing the impairment measurement techniques available and
 - (ii) Steps performed to determine which technique is most appropriate in a given situation.
- (c) The methods used to determine whether and how loans individually evaluated under FAS 114, but not considered to be individually impaired, should be grouped with other loans that share common characteristics for impairment evaluation under FAS 5.

(3) For determining and measuring impairment under FAS 5:

- (a) How loans with similar characteristics are grouped to be evaluated for loan collectibility (such as loan type, past-due status, and risk);
- (b) How loss rates are determined (e.g., historical loss rates adjusted for environmental factors or migration analysis) and what factors are considered when establishing appropriate time frames over which to evaluate loss experience; and

- (c) Descriptions of qualitative factors (e.g., industry, geographical, economic and political factors) that may affect loss rates or other loss measurements.

The supporting documents for the ALLL may be integrated in a credit union's credit files, loan review reports or worksheets, board of directors' and committee meeting minutes, computer reports, or other appropriate documents and files.

ALLL UNDER FAS 114

A credit union's ALLL methodology related to FAS 114 loans begins with the use of its normal loan review procedures to identify whether a loan is impaired as defined by the accounting standard. Credit unions should document:

- (1) The method and process for identifying loans to be evaluated under FAS 114 and
- (2) The analysis that resulted in an impairment decision for each loan and the determination of the impairment measurement method to be used (i.e., present value of expected future cash flows, fair value of collateral less costs to sell, or the loan's observable market price).

Once a credit union has determined which of the three available measurement methods to use for an impaired loan under FAS 114, it should maintain supporting documentation as follows:

- (1) When using the present value of expected future cash flows method:
 - (a) The amount and timing of cash flows,
 - (b) The effective interest rate used to discount the cash flows, and
 - (c) The basis for the determination of cash flows, including consideration of current environmental factors and other information reflecting past events and current conditions.
- (2) When using the fair value of collateral method:
 - (a) How fair value was determined, including the use of appraisals, valuation assumptions, and calculations,
 - (b) The supporting rationale for adjustments to appraised values, if any,
 - (c) The determination of costs to sell, if applicable, and
 - (d) Appraisal quality, and the expertise and independence of the appraiser.
- (3) When using the observable market price of a loan method:
 - (a) The amount, source, and date of the observable market price.

Illustration B describes a practice used by a small credit union to document its FAS 114 measurement of impairment using a comprehensive worksheet. Q&A #1 and #2 in Appendix A provide examples of applying and documenting impairment measurement methods under FAS 114.

Some loans that are evaluated individually for impairment under FAS 114 may be fully collateralized and therefore require no ALLL. Q&A #3 in Appendix A presents an example of a credit union whose loan portfolio includes fully collateralized loans and describes the documentation maintained by that credit union to support its conclusion that no ALLL was needed for those loans.

ILLUSTRATION B

DOCUMENTING AN ALLL UNDER FAS 114

Comprehensive worksheet for the impairment measurement process

A small credit union uses a comprehensive worksheet for each loan being reviewed individually under FAS 114. Each worksheet includes a description of why the loan was selected for individual review, the impairment measurement technique used, the measurement calculation, a comparison to the current loan balance, and the amount of the ALLL for that loan. The rationale for the impairment measurement technique used (e.g., present value of expected future cash flows, observable market price of the loan, fair value of the collateral) is also described on the worksheet.

ALLL UNDER FAS 5

Segmenting the Portfolio

For loans evaluated on a group basis under FAS 5, management should segment the loan portfolio by identifying risk characteristics that are common to groups of loans. Credit unions typically decide how to segment their loan portfolios based on many factors, which vary with their business strategies as well as their information system capabilities. Smaller credit unions that are involved in less complex activities often segment the portfolio into broad loan categories. This method of segmenting the portfolio is likely to be appropriate only in small credit unions offering a narrow range of loan products. Larger credit unions typically offer a more diverse and complex mix of loan products. Such credit unions may start by segmenting the portfolio into major loan types but typically have more detailed information available that allows them to further segregate the portfolio into product line segments based on the risk characteristics of each portfolio segment. Regardless of the segmentation method used, a credit union should maintain documentation to support its

conclusion that the loans in each segment have similar attributes or characteristics.

As economic and other business conditions change, credit unions often modify their business strategies, which may result in adjustments to the way in which they segment their loan portfolio for purposes of estimating loan losses. Illustration C presents an example in which a credit union refined its segmentation method to more effectively consider risk factors and maintains documentation to support this change.

Credit unions use a variety of documents to support the segmentation of their

ILLUSTRATION C DOCUMENTING SEGMENTING PRACTICES

Documenting a refinement in a segmentation method

A credit union with a significant portfolio of consumer loans performed a review of its ALLL methodology. The credit union had determined its ALLL based upon historical loss rates in the overall consumer portfolio. The ALLL methodology was validated by comparing actual loss rates (charge-offs) for the past two years to the estimated loss rates. During this process, the credit union decided to evaluate loss rates on an individual product basis (e.g., auto loans, unsecured loans, or home equity loans). This analysis disclosed significant differences in the loss rates on different products. With this additional information, the methodology was amended in the current period to segment the portfolio by product, resulting in a better estimation of the loan losses associated with the portfolio. To support this change in segmentation practice, the credit review committee records contain the analysis that was used as a basis for the change and the written report describing the need for the change.

portfolios.

Some of these documents include:

- Loan trial balances by categories and types of loans,
- Management reports about the mix of loans in the portfolio,
- Delinquency and nonaccrual reports, and
- A summary presentation of the results of an internal or external loan grading review.

Reports generated to assess the profitability of a loan product line may be useful in identifying areas in which to further segment the portfolio.

Estimating Loss on Groups of Loans

Based on the segmentation of the portfolio, a credit union should estimate the FAS 5 portion of the ALLL. For those segments that require an ALLL,¹⁶ the credit union should estimate the loan and lease losses, on at least a quarterly basis, based upon its ongoing loan review process and analysis of loan performance. The credit union should follow a systematic and consistently applied approach to select the most appropriate loss measurement methods and support its conclusions and rationale with written documentation. Regardless of the method used to measure losses, a credit union should demonstrate and document that the loss measurement methods used to estimate the ALLL for each segment are determined in accordance with GAAP as of the financial statement date.¹⁷

One method of estimating loan losses for groups of loans is through the application of loss rates to the groups' aggregate loan balances. Such loss rates typically reflect historical loan loss experience for each group of loans, adjusted for relevant environmental factors (e.g., industry, geographical, economic, and political factors) over a defined period of time. If a credit union does not have loss experience of its own, it may be appropriate to reference the loss experience of other credit unions, provided that the credit union demonstrates that the attributes of the loans in its portfolio segment are similar to those of the loans included in the portfolio of the credit union providing the loss experience.¹⁸ Credit unions should maintain supporting documentation for the technique used to develop their loss rates, including the period of time over which the losses were incurred. If a range of loss is determined, credit unions should maintain documentation to support the identified range and the rationale used for determining which estimate is the best estimate within the range of loan losses. An example of how a small credit union performs a comprehensive historical loss analysis is provided as the first item in Illustration D.

¹⁶ An example of a loan segment that does not generally require an ALLL is loans that are fully secured by deposits maintained at the lending credit union.

¹⁷ Refer to paragraph 8(b) of FAS 5. Also, the AICPA is currently developing a Statement of Position that will provide more specific guidance on accounting for loan losses.

¹⁸ Refer to paragraph 23 of FAS 5.

ILLUSTRATION D

DOCUMENTING THE SETTING LOSS RATES

Comprehensive loss analysis in a small credit union

A small credit union determines its loss rates based on loss rates over a three-year historical period. The analysis is conducted by type of loan and is further segmented by originating branch office. The analysis considers charge-offs and recoveries in determining the loss rate. The credit union also considers the loss rates for each loan grade and compares them to historical losses on similarly rated loans in arriving at the historical loss factor. The credit union maintains supporting documentation for its loss factor analysis, including historical losses by type of loan, originating branch office, and loan grade for the three-year period.

Adjustment of loss rates for changes in local economic conditions

A credit union develops a factor to adjust loss rates for its assessment of the impact of changes in the local economy. For example, when analyzing the loss rate on business real estate loans, the assessment identifies changes in recent commercial building occupancy rates. The credit union generally finds the occupancy statistics to be a good indicator of probable losses on these types of loans. The credit union maintains documentation that summarizes the relationship between current occupancy rates and its loss experience.

Before employing a loss estimation model, a credit union should evaluate and modify, as needed, the model's assumptions to ensure that the resulting loss estimate is consistent with GAAP. In order to demonstrate consistency with GAAP, credit unions that use loss estimation models typically document the evaluation, the conclusions regarding the appropriateness of estimating loan losses with a model or other loss estimation tool, and the support for adjustments to the model or its results.

In developing loss measurements, credit unions should consider the impact of current environmental factors and then document which factors were used in the analysis and how those factors affect the loss measurements. Factors that should be considered in developing loss measurements include the following:¹⁹

- (1) Levels of and trends in delinquencies and impaired loans;
- (2) Levels of and trends in charge-offs and recoveries;
- (3) Trends in volume and terms of loans;
- (4) Effects of any changes in risk selection and underwriting standards, and other changes in lending policies, procedures, and practices;
- (5) Experience, ability, and depth of lending management and other relevant staff;
- (6) National and local economic trends and conditions;

¹⁹ Refer to paragraph 6.08 in the AICPA Audit Guide.

- (7) Industry conditions; and
- (8) Effects of changes in credit concentrations.

For any adjustment of loss measurements for environmental factors, the credit union should maintain sufficient, objective evidence to support the amount of the adjustment and to explain why the adjustment is necessary to reflect current information, events, circumstances, and conditions in the loss measurements.

The second item in Illustration D provides an example of how a credit union adjusts its business real estate historical loss rates for changes in local economic conditions. Q&A #4 in Appendix A provides an example of maintaining supporting documentation for adjustments to portfolio segment loss rates for an environmental factor related to an economic downturn in the borrower's primary industry. Q&A #5 in Appendix A describes one credit union's process for determining and documenting an ALLL for loans that are not individually impaired but have characteristics indicating there are loan losses on a group basis.

CONSOLIDATING THE LOSS ESTIMATES

To verify that ALLL balances are presented fairly in accordance with GAAP and are auditable, management should prepare a document that summarizes the amount to be reported in the financial statements for the ALLL. The board of directors should review and approve this summary.

Common elements in such summaries include:

- (1) An estimate of the probable loss or range of loss incurred for each category evaluated (e.g., individually evaluated impaired loans, homogeneous pools, and other groups of loans that are collectively evaluated for impairment);
- (2) The aggregate probable loss estimated using the credit union's methodology;
- (3) A summary of the current ALLL balance;
- (4) The amount, if any, by which the ALLL is to be adjusted;²⁰ and
- (5) Depending on the level of detail that supports the ALLL analysis, detailed sub-schedules of loss estimates that reconcile to the summary schedule.

²⁰ Subsequent to adjustments, there should be no material differences between the consolidated loss estimate, as determined by the methodology, and the final ALLL balance reported in the financial statements.

Illustration E describes how a credit union documents its estimated ALLL by adding comprehensive explanations to its summary schedule.

ILLUSTRATION E

SUMMARIZING LOSS ESTIMATES

Descriptive comments added to the consolidated ALLL summary schedule

To simplify the supporting documentation process and to eliminate redundancy, a credit union adds detailed supporting information to its summary schedule. For example, this credit union's board of directors receives, within the body of the ALLL summary schedule, a brief description of the credit union's policy for selecting loans for evaluation under FAS 114. Additionally, the credit union identifies which FAS 114 impairment measurement method was used for each individually reviewed impaired loan. Other items on the schedule include brief descriptions of loss factors for each segment of the loan portfolio, the basis for adjustments to loss rates, and explanations of changes in ALLL amounts from period to period, including cross-references to more detailed supporting documents.

Generally, a credit union's review and approval process for the ALLL relies upon the data provided in these consolidated summaries. There may be instances in which individuals or committees that review the ALLL methodology and resulting allowance balance identify adjustments that need to be made to the loss estimates to provide a better estimate of loan losses. These changes may be due to information not known at the time of the initial loss estimate (e.g., information that surfaces after determining and adjusting, as necessary, historical loss rates, or a recent decline in the marketability of property after conducting a FAS 114 valuation based upon the fair value of collateral). It is important that these adjustments are consistent with GAAP and are reviewed and approved by appropriate personnel. Additionally, the summary should provide each subsequent reviewer with an understanding of the support behind these adjustments. Therefore, management should document the nature of any adjustments and the underlying rationale for making the changes. This documentation should be provided to those making the final determination of the ALLL amount. Q&A #6 in Appendix A addresses the documentation of the final amount of the ALLL.

VALIDATING THE ALLL METHODOLOGY

A credit union's ALLL methodology is considered valid when it accurately estimates the amount of loss contained in the portfolio. Thus, the credit union's methodology should include procedures that adjust loss estimation methods to reduce differences between estimated losses and actual subsequent charge-offs, as necessary.

To verify that the ALLL methodology is valid and conforms to GAAP and supervisory guidance, a credit union's directors should establish internal control policies, appropriate for the size of the credit union and the type and complexity of its loan products. These policies should include procedures for a review, by a party who is independent of the ALLL estimation process, of the ALLL methodology and its application in order to confirm its effectiveness.

In practice, credit unions employ numerous procedures when validating the reasonableness of their ALLL methodology and determining whether there may be deficiencies in their overall methodology or loan grading process. Examples are:

- (1) A review of trends in loan volume, delinquencies, restructurings, and concentrations.
- (2) A review of previous charge-off and recovery history, including an evaluation of the timeliness of the entries to record both the charge-offs and the recoveries.
- (3) A review by a party that is independent of the ALLL estimation process. This often involves the independent party reviewing, on a test basis, source documents and underlying assumptions to determine that the established methodology develops reasonable loss estimates.
- (4) An evaluation of the appraisal process of the underlying collateral. This may be accomplished by periodically comparing the appraised value to the actual sales price on selected properties sold.

Supporting Documentation for the Validation Process

Management usually supports the validation process with the workpapers from the ALLL review function. Additional documentation often includes the summary findings of the independent reviewer. The credit union's board of directors, or its designee, reviews the findings and acknowledges its review in its meeting minutes. If the methodology is changed based upon the findings of the validation process, documentation that describes and supports the changes should be maintained.

APPENDIX A – ALLL QUESTIONS AND ANSWERS

Introduction

The Questions and Answers (Q&As) presented in this appendix serve several purposes, including (1) to illustrate the NCUA's views, as set forth in this IRPS, about the types of decisions, determinations, and processes a credit union should document with respect to its ALLL methodology and amounts; and (2) to illustrate the types of ALLL documentation and processes a credit union might prepare, retain, or use in a particular set of circumstances. The level and types of documentation described in the Q&As should be considered neither the minimum acceptable level of documentation nor an all-inclusive list. Credit unions are expected to apply the guidance in this IRPS to their individual facts, circumstances, and situations. If a credit union's fact pattern differs from the fact patterns incorporated in the following Q&As, the credit union may decide to prepare and maintain different types of documentation than did the credit unions depicted in these Q&As.

Q&A #1 - ALLL Under FAS 114 – Measuring and Documenting Impairment

Facts: Approximately one-third of Credit Union A's business loan portfolio consists of large balance, non-homogeneous loans. Due to their large individual balances, these loans meet the criteria under Credit Union A's policies and procedures for individual review for impairment under FAS 114. Upon review of the large balance loans, Credit Union A determines that certain of the loans are impaired as defined by FAS 114.

Question: For the business loans reviewed under FAS 114 that are individually impaired, how should Credit Union A measure and document the impairment on those loans? Can it use an impairment measurement method other than the methods allowed by FAS 114?

Interpretive Response: For those loans that are reviewed individually under FAS 114 and considered individually impaired, Credit Union A must use one of the methods for measuring impairment that is specified by FAS 114 (that is, the present value of expected future cash flows, the loan's observable market price, or the fair value of collateral). Accordingly, in the circumstances described above, for the loans considered individually impaired under FAS 114, it would not be appropriate for Credit Union A to choose a measurement method not prescribed by FAS 114. For example, it would not be appropriate to measure loan impairment by applying a loss rate to each loan based on the average historical loss percentage for all of its business loans for the past five years.

Credit Union A should maintain, as sufficient, objective evidence, written documentation to support its measurement of loan impairment under FAS 114. If Credit Union A uses the present value of expected future cash flows to measure impairment of a loan, it should document the amount and timing of cash flows, the effective interest rate used to discount the cash flows, and the basis for the determination of cash flows, including consideration of current environmental factors¹ and other information reflecting past events and current conditions. When Credit Union A uses the fair value of collateral to measure impairment, Credit Union A should document how it determined the fair value, including the use of appraisals, valuation assumptions and calculations, the supporting rationale for adjustments to appraised values, if any, and the determination of costs to sell, if applicable, appraisal quality, and the expertise and independence of the appraiser. Similarly, Credit Union A should document the amount, source, and date of the observable market price of a loan, if that method of measuring loan impairment is used.

Q&A #2 – ALLL Under FAS 114 – Measuring Impairment for a Collateral Dependent Loan

Facts: Credit Union B has a \$10 million loan outstanding to Member X that is secured by real estate, which Credit Union B individually evaluates under FAS 114 due to the loan's size. Member X is delinquent in its loan payments under the terms of the loan agreement. Accordingly, Credit Union B determines that its loan to Member X is impaired, as defined by FAS 114. Because the loan is collateral dependent, Credit Union B measures impairment of the loan based on the fair value of the collateral. Credit Union B determines that the most recent valuation of the collateral was performed by an appraiser eighteen months ago and, at that time, the estimated value of the collateral (fair value less costs to sell) was \$12 million.

Credit Union B believes that certain of the assumptions that were used to value the collateral eighteen months ago do not reflect current market conditions and, therefore, the appraiser's valuation does not approximate current fair value of the collateral. Several buildings, which are comparable to the real estate collateral, were recently completed in the area, increasing vacancy rates, decreasing lease rates, and attracting several tenants away from the borrower. Accordingly, credit review personnel at Credit Union B adjust certain of the valuation assumptions to better reflect the current market conditions as they relate to the loan's collateral.² After adjusting the collateral valuation assumptions, the credit review department determines that the current estimated fair value of the collateral, less costs to sell,

¹ Question #16 in Exhibit D-80A of EITF Topic D-80 and attachments indicates that environmental factors include existing industry, geographical, economic, and political factors.

² When reviewing collateral dependent loans, Credit Union B may often find it more appropriate to obtain an updated appraisal to estimate the effect of current market conditions on the appraised value instead of internally estimating an adjustment.

is \$8 million. Given that the recorded investment in the loan is \$10 million, Credit Union B concludes that the loan is impaired by \$2 million and records an allowance for loan losses of \$2 million.

Question: What type of documentation should Credit Union B maintain to support its determination of the allowance for loan losses of \$2 million for the loan to Member X?

Interpretive Response: Credit Union B should document that it measured impairment of the loan to Member X by using the fair value of the loan's collateral, less costs to sell, which it estimated to be \$8 million. This documentation should include the credit union's rationale and basis for the \$8 million valuation, including the revised valuation assumptions it used, the valuation calculation, and the determination of costs to sell, if applicable. Because Credit Union B arrived at the valuation of \$8 million by modifying an earlier appraisal, it should document its rationale and basis for the changes it made to the valuation assumptions that resulted in the collateral value declining from \$12 million eighteen months ago to \$8 million in the current period.³

Q&A #3 – ALLL Under FAS 114 – Fully Collateralized Loans

Facts: Credit Union C has \$500,000 in business loans that are fully collateralized by purchased business equipment. The loan agreement for each of these loans requires the borrower to provide qualifying collateral sufficient to fully secure each loan. The member borrowers have physical control of the collateral. Credit Union C perfected its security interest in the collateral when the funds were originally distributed. On an annual basis, Credit Union C determines the market value of the collateral for each loan using two independent market quotes and compares the collateral value to the loan carrying value. Semiannually or more frequently as needed, the Credit Union C's credit administration function physically inspects the equipment. If there are any collateral deficiencies, Credit Union C notifies the borrower and requests that the borrower immediately remedy the deficiency. Due in part to its efficient operation, Credit Union C has historically not incurred any material losses on these loans. Credit Union C believes these loans are fully-collateralized and therefore does not maintain any ALLL balance for these loans.

Question: What documentation does Credit Union C maintain to adequately support its determination that no allowance is needed for this group of loans?

³In accordance with the FFIEC's **Federal Register** Notice, Implementation Issues Arising from FASB No. 114, "Accounting by Creditors for Impairment of a Loan," published February 10, 1995 (60 FR 7966, February 10, 1995), impaired, collateral-dependent loans must be reported at the fair value of collateral, less costs to sell, in regulatory reports. This treatment is to be applied to all collateral-dependent loans, regardless of type of collateral.

Interpretive Response: Credit Union C's management summary of the ALLL includes documentation indicating that, in accordance with the credit union's ALLL policy, the collateral protection on these loans has been verified by the credit union, no probable loss has been incurred, and no ALLL is necessary. Documentation in Credit Union C's loan files includes the two independent market quotes obtained annually for each loan's collateral amount, the documents evidencing the perfection of the security interest in the collateral, and other relevant supporting documents. Additionally, Credit Union C's ALLL policy includes a discussion of how to determine when a loan is considered "fully collateralized" and does not require an ALLL. Credit Union C's policy requires the following factors to be considered and the credit union's findings concerning these factors to be fully documented:

1. Volatility of the market value of the collateral;
2. Recency and reliability of the appraisal or other valuation;
3. Recency of the credit union or other third party inspection of the collateral;
4. Historical losses on similar loans;
5. Confidence in the credit union's lien or security position including appropriate:
 - a. Type of security perfection (e.g., physical possession of collateral or secured filing);
 - b. Filing of security perfection (i.e., correct documents and with the appropriate officials); and
 - c. Relationship to other liens.
6. Other factors as appropriate for the loan type

Q&A #4 – ALLL Under FAS 5 – Adjusting Loss Rates

Facts: Credit Union D's field of membership (lending area) includes a metropolitan area that is financially dependent upon the profitability of a number of sponsor manufacturing businesses. These businesses use highly specialized equipment and significant quantities of rare metals in the manufacturing process. Due to increased low-cost foreign competition, several of the parts suppliers servicing these sponsor manufacturing firms declared bankruptcy. The foreign suppliers have subsequently increased prices and the sponsor manufacturing firms have suffered from increased equipment maintenance costs and smaller profit margins. Additionally, the cost of the rare metals used in the manufacturing process increased and has now stabilized at double last year's price. Due to these events, the sponsor manufacturing businesses are experiencing financial difficulties and have recently announced downsizing plans.

Although Credit Union D has yet to confirm an increase in its loss experience as a result of these events, management knows that the credit union lends to a significant number of member's for business and individual purposes whose repayment ability depends upon the long-term viability of the sponsor

manufacturing businesses. Credit Union D's management has identified particular segments of its business and consumer member bases that include member borrowers highly dependent upon sales or salary from the sponsor manufacturing businesses. Credit Union D's management performs an analysis of the affected portfolio segments to adjust its historical loss rates used to determine the ALLL. In this particular case, Credit Union D has experienced similar business and lending conditions in the past that it can compare to current conditions.

Question: How should Credit Union D document its support for the loss rate adjustments that result from considering these manufacturing firms' financial downturns?

Interpretive Response: Credit Union D should document its identification of the particular segments of its business and consumer loan portfolio for which it is probable that the sponsor manufacturing business' financial downturn has resulted in loan losses. In addition, Credit Union D should document its analysis that resulted in the adjustments to the loss rates for the affected portfolio segments. As part of its documentation, Credit Union D maintains copies of the documents supporting the analysis, including relevant newspaper articles, economic reports, and economic data, and notes from discussions with individual member borrowers.

Because in this case Credit Union D has had similar situations in the past, its supporting documentation also includes an analysis of how the current conditions compare to its previous loss experiences in similar circumstances. As part of its effective ALLL methodology, Credit Union D creates a summary of the amount and rationale for the adjustment factor, which management presents to the audit committee and board for their review and approval prior to the issuance of the financial statements.

Q&A #5 – ALLL Under FAS 5 – Estimating Losses on Loans Individually Reviewed for Impairment but Not Considered Individually Impaired

Facts: Credit Union E has outstanding loans of \$875,000 to Member Y and \$725,000 to Member Z, both of which are paying as agreed upon in the loan documents. The credit union's ALLL policy specifies that all loans greater than \$700,000 must be individually reviewed for impairment under FAS 114. Member Y's financial statements reflect a strong net worth, good profits, and ongoing ability to meet debt service requirements. In contrast, recent information indicates Member Z's profitability is declining and its cash flow is tight. Accordingly, this loan is rated substandard under the credit union's loan grading system. Despite its concern, management believes Member Z will resolve its problems and determines that neither loan is individually impaired as defined by FAS 114.

Credit Union E segments its loan portfolio to estimate loan losses under FAS 5. Two of its loan portfolio segments are Segment 1 and Segment 2.

The loan to Member Y has risk characteristics similar to the loans included in Segment 1 and the loan to Member Z has risk characteristics similar to the loans included in Segment 2.⁴

In its determination of the ALLL under FAS 5, Credit Union E includes its loans to Member Y and Member Z in the groups of loans with similar characteristics (i.e., Segment 1 for Member Y's loan and Segment 2 for Member Z's loan). Management's analyses of Segment 1 and Segment 2 indicate that it is probable that each segment includes some losses, even though the losses cannot be identified to one or more specific loans. Management estimates that the use of its historical loss rates for these two segments, with adjustments for changes in environmental factors provides a reasonable estimate of the credit union's probable loan losses in these segments.

Question: How does Credit Union E adequately support and document an ALLL under FAS 5 for these loans that were individually reviewed for impairment but are not considered individually impaired?

Interpretive Response: As part of Credit Union E's effective ALLL methodology, it documents the decision to include its loans to Member Y and Member Z in its determination of its ALLL under FAS 5. It also documents the specific characteristics of the loans that were the basis for grouping these loans with other loans in Segment 1 and Segment 2, respectively. Credit Union E maintains documentation to support its method of estimating loan losses for Segment 1 and Segment 2, including the average loss rate used, the analysis of historical losses by loan type and by internal risk rating, and support for any adjustments to its historical loss rates. The credit union also maintains copies of the economic and other reports that provided source data.

Q&A #6 - Consolidating the Loss Estimates – Documenting the Reported ALLL

Facts: Credit Union F determines its ALLL using an established systematic process. At the end of each period, the accounting department prepares a summary schedule that includes the amount of each of the components of the ALLL, as well as the total ALLL amount, for review by senior management, the Credit Committee, and, ultimately, the board of directors. Members of senior management and the Credit Committee meet to discuss the ALLL. During these discussions, they identify changes to be made to certain of the ALLL estimates. As a result of the adjustments made by senior management, the total amount of the ALLL changes. However, senior management (or its designee) does not update the ALLL summary schedule to reflect the adjustments or reasons for the

⁴ These groups of loans do not include any loans that have been individually reviewed for impairment under FAS 114 and determined to be impaired as defined by FAS 114.

adjustments. When performing their audit of the financial statements, the independent accountants are provided with the original ALLL summary schedule that was reviewed by management and the Credit Committee, as well as a verbal explanation of the changes made by senior management and the Credit Committee when they met to discuss the loan loss allowance.

Question: Are Credit Union F's documentation practices related to the balance of its loan loss allowance appropriate?

Interpretive Response: No. A credit union must maintain supporting documentation for the loan loss allowance amount reported in its financial statements. As illustrated above, there may be instances in which ALLL reviewers identify adjustments that need to be made to the loan loss estimates. The nature of the adjustments, how they were measured or determined, and the underlying rationale for making the changes to the ALLL balance should be documented. Appropriate documentation of the adjustments should be provided to the board of directors (or its designee) for review of the final ALLL amount to be reported in the financial statements. For credit unions subject to external audit, this documentation should also be made available to the supervisory committee and its independent accountants. If changes frequently occur during management or committee reviews of the ALLL, management may find it appropriate to analyze the reasons for the frequent changes and to reassess the methodology the credit union uses.

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