Allowance for Loan and Lease Losses

As you are aware, NCUA issued a Policy Statement addressing the methods credit unions are to employ in determining the appropriate level of the Allowance for Loan and Lease Losses (ALLL). On the following pages are some key excerpts from the Policy Statement along with our comments and suggestions for how you should act on this Policy Statement.

The main thrust of the Policy Statement is that you follow Generally Accepted Accounting Principles (GAAP), and that you document your policies and procedures you elect to follow in determining the appropriate level of ALLL for your credit union.

In summary, this is what has to be done:

(1) Comply with GAAP. In a nutshell GAAP states that a loss has to be accrued for when,
  (a) it is probable that a loss has been incurred and
  (b) the amount of the loss can be reasonably estimated.
By its very nature the ALLL exists under the assumption that there are losses within every loan portfolio. It is therefore reasonable to state that at any given point in time some of the loans in your loan portfolio are losses. The purpose of this exercise is to reasonably determine the amount of that loss.
(2) Use sound judgment. No matter how many times we cite GAAP, losses are determined based on management's best judgment. Just document how you arrived at that judgment.
(3) Document everything. Policies and procedures, methodologies used to compute ALLL estimates, the basis for management's judgments, the rationale for any adjustment to the ALLL, and the procedures to be followed in monitoring the ALLL all have to be in writing.
(4) Segmenting the loan portfolio. Historical loss ratio computations now have to be done based on separate segments of the loan portfolio. Segments are defined based on management's judgments of different risks within the separate segments.
(5) Identify specific losses through a loan grading system. Substandard, doubtful and loss classifications are one example of a grading system.

(6) Review the ALLL, the methodologies used and the computations on a regular basis.

Following are some key excerpts from NCUA's Policy Statement. Our comments appear in *italics* throughout the following pages.

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.

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.

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 committee should oversee and monitor the internal controls over the ALLL determination process.

For financial reporting purposes, including regulatory reporting, the provision for loan and lease losses and the ALLL must be determined in accordance with 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. The key words are ***probable that a loss has occurred*** *and the* ***amount can be reasonably estimated.***

An ALLL 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. A credit union 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 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.*

Under GAAP 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.

This is a significant paragraph. Most credit unions do not have a complex lending portfolio. Credit union lending tends to be consumer loans and residential mortgages (including home equities and home improvement loans). Under GAAP, these are not considered complex loans. If you are doing commercial lending your portfolio does get a little more complex.

Simplified documentation can include spreadsheets, check lists, and other summary documents that many credit unions currently use.

DOCUMENTATION STANDARDS

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 above documentation requirements are fairly evident. You need a written policy that defines how the ALLL is to be computed, who will do the computation, how frequently it will be done, and who will review and evaluate the results. Loan grading is the classification of loan balances. Substandard, doubtful and loss is one form of loan grading.

FAS 114 IMPAIRED LOANS

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.

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.

Large groups of smaller-balance homogeneous loans that are collectively evaluated for impairment are *not* included in the scope of FAS 114. Such groups of loans may include, but are not limited to, **credit card, residential mortgage, and consumer installment loans**.

FAS 114 rarely applies to credit unions. Credit cards, residential mortgages, and consumer installment loans pretty much encompass all of the lending the vast majority of credit unions do. We have in the past classified residential mortgages as impaired if a credit union has a significant number of real estate loans that have impaired collateral values. Those occasions have been rare.

LAYERING

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.

Layering could happen if you have a specific allowance for a particular loan and you incorporate that loan balance in your historical loss percentage computation.

METHODOLOGY

There are certain common elements that should be included in any loan loss allowance methodology.

Generally, a credit union's methodology should:

1. Include a detailed analysis of the loan portfolio, performed on a regular basis;

This would be an analysis of delinquency both by loan type and by length of delinquency.

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;

As previously stated, it is unlikely that many credit unions will have individually impaired loans. However, you need to keep in mind that a loan does not have to be delinquent to be considered impaired. A credit union could have $500,000 in mortgage loans outstanding on a single piece of property whose value has declined to $400,000. If this decline is deemed to be permanent (because of damage to the property the value is unlikely to go back up), then this loan would be impaired, even though it may be paid up to date.

Grouping of loans with similar characteristics may be something new for many credit unions. In this methodology different loss percentages are assigned to different categories of loans. Credit cards, for example, may have a higher loss frequency than new auto loans.

4. Consider all known relevant internal and external factors that may affect loan collectibility;

This is a wide open provision, and can really have an impact on the level of the ALLL. It could be that, in your judgment, the ALLL should be higher because your are uncomfortable with the economy. You are concerned your employee group will go out on strike. The sponsor company is facing layoffs. You just fired your loan officer for policy violations. The reasons are too many to list. Just keep in mind that ultimately, the ALLL is based primarily on management's judgment.

5. Be applied consistently but, when appropriate, be modified for new factors affecting collectibility;

This goes hand in hand with the previous provision. Your methodology for determining the ALLL should not change every month, but there will be events occurring throughout the year (i.e. 9/11/01) that may cause you to adjust your allowance up or down.

6. Consider the particular risks inherent in different kinds of lending;

This was discussed in number 3 above. Certainly unsecured lending has a higher risk factor than secured lending. You should eventually try to establish a historical loss ratio for each major category of loans. Determine what percentage of credit cards have historically been charged off. Do the same for auto loans, personal loans, etc.

7. Consider current collateral values (less costs to sell), where applicable;

When considering individual loans for loss classification 100% of an unsecured loan may be deemed loss. If the loan in question is an auto loan, you would classify as a loss only the portion of the balance that may not be recovered through the repossession and sale of the vehicle.

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;

Historical loss ratios need to be updated at least annually, possibly quarterly.

10. Be well documented with clear explanations of the supporting analyses and rationale; and

Documentation is one of the key components of NCUA's Policy Statement. The regulators will not accept your ALLL balance unless you can document how you arrived at it. I know of credit unions who maintain their ALLL at 1% of the loan portfolio. This may be appropriate, but without supporting documentation NCUA will force an adjustment of the ALLL balance to their calculated level. While management's judgment is extremely important, you will have to take the time to document the rationale behind your judgment if you want to make it stick.

11. Include a systematic and logical method to consolidate the loss estimates and ensure the ALLL balance is recorded in accordance with GAAP.

By loss estimates they are referring to the historical loss percentage ratios you apply to the various groups of loans. By GAAP losses they are referring to the loans that can be identified as probable losses under FAS 5 and 114.

POLICIES AND PROCEDURES

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

Got to have policies for everything, right?

CONTROLS AND REVIEW

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. 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).

Not only will we, your friendly auditors, be evaluating your ALLL more closely, but you are going to have to institute your own internal reviews. With most credit unions now filing Call Reports quarterly, you need to make sure that the ALLL balance on your call report is consistent with all of the policies and procedure you will be adopting. A slap on the wrist from the regulators is one thing. Having to go back and restate four or five Call Reports is a pain in the you know what! In the banking industry, where commercial lending is prevalent, a whole specialized loan review industry is flourishing. Firms like Chaston Associates perform loan reviews like we perform audits and internal audits. Do you have to bring in an outside loan review firm? I see no reason for that. Credit unions are primarily retail lenders. As such, I think every credit union is capable of establishing a reasonable grading system for their delinquent loans. Establish a formula for classifying loans as substandard, doubtful and loss. Assign a percentage of each category to be reserved for in the ALLL. Following is an example of one credit union's program:

Days Delinquent	Classification	Required reserve
0 – 60 days	Past due	10%
60 – 90 days	Substandard	20%
90 – 120 days	Doubtful	40%
Over 120 days	Loss	100%

This is one method. Any reasonable variation would be acceptable.

METHODOLOGY DOCUMENTATION

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.

The loan classification chart above is a good example of a methodology that incorporates management's judgment. You know your loans and your borrowers best. Use your judgment and experience to develop a methodology that fits your credit union.

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.

Loan grading is the easier aspect of establishing the methodology. A system similar to the chart above should work as a reasonable grading system. Segmentation will take a little more effort. You will have to develop a method of calculating a historical loss percentage ratio for whatever categories of loans you decide to use. Traditionally credit unions and regulators have computed the historical loss ratio as follows:

Year	Total Loans	Net Losses*	Loss Ratio
2002	$35,000,000	$250,000	.71%
2001	$34,000,000	$190,000	.56%
2000	$32,000,000	$200,000	.63%
1999	$29,000,000	$150,000	.52%
1998	$25,000,000	175,000	.70%
Average	$31,000,000	$193,000	.62%

* total charge offs less total recoveries

In this example the total portfolio historical loan loss percentage is .62%. In segmenting the loan portfolio you will need to break down the net losses by loan type. Your break down might look something like this:

2002

Loan type	Total loans	Net losses	Loss ratio
First mortages	$7,000,000	$0	0$
Home equities	$5,250,000	$5,000	.10%
New car loans	$10,500,000	$25,000	.24%
Used car loans	$4,200,000	$50,000	1.19%
Personal loans	$3,500,000	$65,000	1.86%
Credit cards	$4,550,000	$105,000	2.31%
	$35,000,000	$250,000	.71%

This type of segmentation would have to be done for a 3 to 5 year historical period. You will then have a historical percentage for each type of loan. Segmenting loans by loan type is only one form of segmentation. It could be done in a number of different ways:

Industry - If your credit unions serves different SEGs in different industries, some SEGs might have a better track record and present less loss risk than borrowers in a different SEG.

Credit risk - Many credit unions are getting into risk based lending. A loan to a member with "A" credit not only will have a lower interest rate, but also a lower loss risk factor. Conversely a loan to a member with "D" credit will carry a higher interest rate and a much higher loss risk factor.

I'm sure you will think of other ways to segment your loans.

(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.

As I stated earlier, impaired loans under FAS 114 are a rarity in credit unions. It has been years since I have classified a loan as impaired. This is because FAS 114 exempts smaller balance homogeneous loans from impairment consideration. The only times I have classified loans in a credit union as impaired has been when a credit union has had a number of real estate loans whose market values had dropped below the balance of the loan. Even then it was a stretch to classify these loans as impaired, as, by definition, the impairment is supposed to be permanent. I suspect that all of the loans that I classified as impaired in years past now have plenty of equity.

If your credit union is writing commercial real estate loans you may have some impairment issues at some point in time. If your credit union is only writing consumer loans then you certainly would not waste any time computing impairment under FAS 114.

(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) 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.

ADJUSTMENTS

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.

Adjustments to the methodology are going to be necessary from time to time. Factors both under and beyond your control do arise. The economy, problems at a particular SEG, layoffs, etc. All will effect your methodology.

Some adjustments will be necessary due to internal changes. You venture into risk based lending, credit card loans, or a change in membership. Your credit union changes from an industrial to a community credit union. This change may bring new loan risks. The same could be true in adding a new SEG. We have one industrial based credit union that will be admitting family members as credit union members. This change could certainly affect risk assessments. You will need to document the rationale for any changes or adjustments you make.

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; 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.

As discussed, you will be computing the ALLL using a two pronged methodology.

Step one will be a loss amount based on the historical trends of loan losses in that various segments you have identified.

Step two is the identification of actual losses. This would be a method similar to the one discussed before where delinquent loans are classified as substandard, doubtful and loss.

These two amounts are combined to determine the amount of the ALLL.

To many credit unions this Policy Statement will not bring many changes. Most of the credit unions we deal with have good methodologies in place. A little tweaking of those procedures may be all that is needed. Documentation may be the time consuming aspect of all this. The regulators are just starting to review and enforce this Policy Statement. My take so far is the documentation is going to be the key. If you have your policies and procedures in place your examination should go smoothly.